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Role of the insurance broker

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Carpenter Moore℠, a NASDAQ OMX company, looks at the vital role of directors' and officers' liability (D&O) insurance for companies going public and the importance of using an experienced, specialist D&O insurance broker

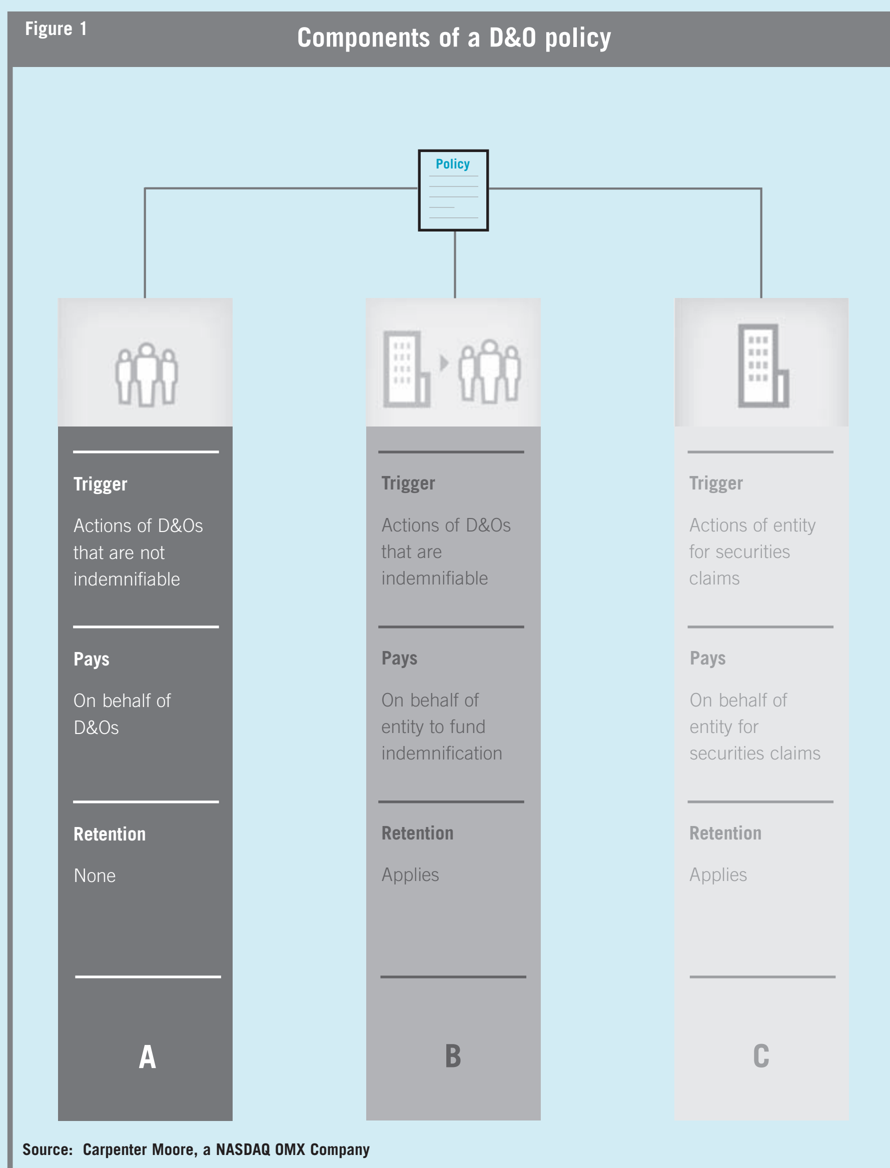
The risks associated with an initial public offering (IPO) – and thereafter, with being a public company – as well as the need to recruit talented individuals to the board and management, make D&O insurance essential for every well-run company. D&O insurance plays an important role protecting individuals and the corporate entity, as both a private and a publicly traded company. To maximize the effectiveness of this asset, a thoughtful process should be undertaken with an experienced, specialist D&O insurance broker that can provide essential benchmarking information and negotiate state-of-the-art insurance coverage. The purchase of D&O insurance is an important step in the journey toward the IPO.

The role of D&O insurance

The vast majority of public companies purchase D&O insurance. Most pre-IPO companies purchase a private company D&O policy even before they go public, to provide insurance for the period during which they prepare to go public. Indeed, qualified board members routinely insist on a robust D&O insurance program prior to joining the board of directors of a public company, and increasingly before joining the board of a company planning an IPO.

D&O insurance serves two general purposes. Its primary objective is to protect directors and officers, whose personal assets may be exposed as a result of liabilities arising from the activities they undertake serving the company. A second objective is to shift risk from the company's balance sheet, both by having insurance reimburse the cost of indemnifying directors and officers and by insuring the company's own liability. 'Insuring Agreement A' of a D&O policy – the so-called 'A-side' – protects the individuals from non-indemnifiable loss. 'Insuring Agreements B and C' – the B and C-sides – protect the company's balance sheet. The B-side pays on behalf of the company the costs of indemnifying directors and officers. The C-side provides coverage for the entity's own wrongdoing in connection with a securities suit.

Figure 1 Components of a D&O policy



Source: Carpenter Moore, a NASDAQ OMX Company

No self-insured retention (deductible) applies to the A-side of the policy, but a retention will apply to claims brought under the B and C-sides.

Personal protection for directors and officers

Directors and officers face personal liability in their roles serving the company. Liability can arise from a myriad of alleged wrongful acts, including:

- employment-related violations;
- misrepresentations in the registration statement (e.g., under Section 11 of the Securities Act of 1933);
- selling shareholder violations (e.g., under Section 12 of the 1933 act);
- control person violations (e.g., under Section 15 of the 1933 act and/or Section 20 of the Securities and Exchange Act of 1934);
- misrepresentations in post-distribution filings (e.g., under Section 10 of the 1934 act);
- Sarbanes-Oxley violations;
- state and federal antitrust and trade regulation violations; and
- state blue-sky law violations.

Companies would have tremendous trouble finding talented director and officer candidates if the individuals faced this liability without protection. The first level of protection comes from indemnification provided by the company for the liability that directors and officers face in their roles. Indemnification is provided for in the company bylaws and/or through individual indemnification agreements, subject to the laws of the state of incorporation.

The A-side of a D&O insurance policy steps in to protect the individuals when the company cannot indemnify them. As a result, D&O insurance provides the last line of defense for the individuals' personal assets when the company is not there to protect them.

At least three scenarios exist when A-side coverage kicks in. The most common situation in which a company cannot indemnify is when it is insolvent – when there are no funds to pay the directors' and officers' costs of defense, settlement and/or judgment. Another situation arises when a company is barred by law from indemnifying an individual. Finally, a former director or officer might have difficulty obtaining indemnification following a change of control at the company. Insurance coverage for such non-indemnifiable loss springs from the A-side of a D&O policy.

Every traditional D&O policy has A-side insurance built into it, but the limits of liability – the policy proceeds – are shared with the B and C-sides, which protect the corporate balance sheet. In order to provide greater protection for directors and officers, a significant majority of corporations purchase a separate, dedicated A-side policy as part of the D&O program. In 2007, more than 70 per cent of Carpenter Moore's IPO clients included a dedicated layer of A-side insurance in their program.

Properly negotiated, an A-side policy not only offers a dedicated limit of liability for the individuals, but also offers broader coverage terms. Ideally, the A-side policy should have a 'difference in conditions' (DIC) feature, which enables the policy to drop down and respond when its terms are broader than the terms of the underlying A-side program. Such excess DIC A-side policies are the industry standard.

Balance-sheet protection for the company

Historically, the vast majority of D&O lawsuits have resulted in indemnifiable loss paid by the company (or its insurance carrier). As a result, the B/C-sides of the D&O policy can be an important asset for transferring risk away from the balance sheet.

When coverage is triggered under the B and C-sides, the company first pays a self-insured retention (deductible). Thereafter, the insurance pays on behalf of the company all loss covered by the terms of the insurance policy. It is important to negotiate the lowest retention available to the company at the time the D&O insurance is placed. The lower the retention, the earlier the company gets the benefit of the insurance proceeds in its litigation. In most instances, the cost savings associated with a higher retention are outweighed by the potential benefit of tapping into the insurance proceeds even in low-dollar nuisance cases.

How much D&O insurance is required?

Nearly all securities suits are resolved by settlement, with no verdict ever rendered by a judge or jury. A number of case-specific variables are involved in predicting the size of an actual settlement, which makes it impossible to foresee the settlement value of a hypothetical case before it has even been filed. Still, by analyzing a variety of types of data, it is possible to align D&O program size with a company's

unique tolerance for risk. The most important types of data relate to historical claims results and peer purchasing behavior.

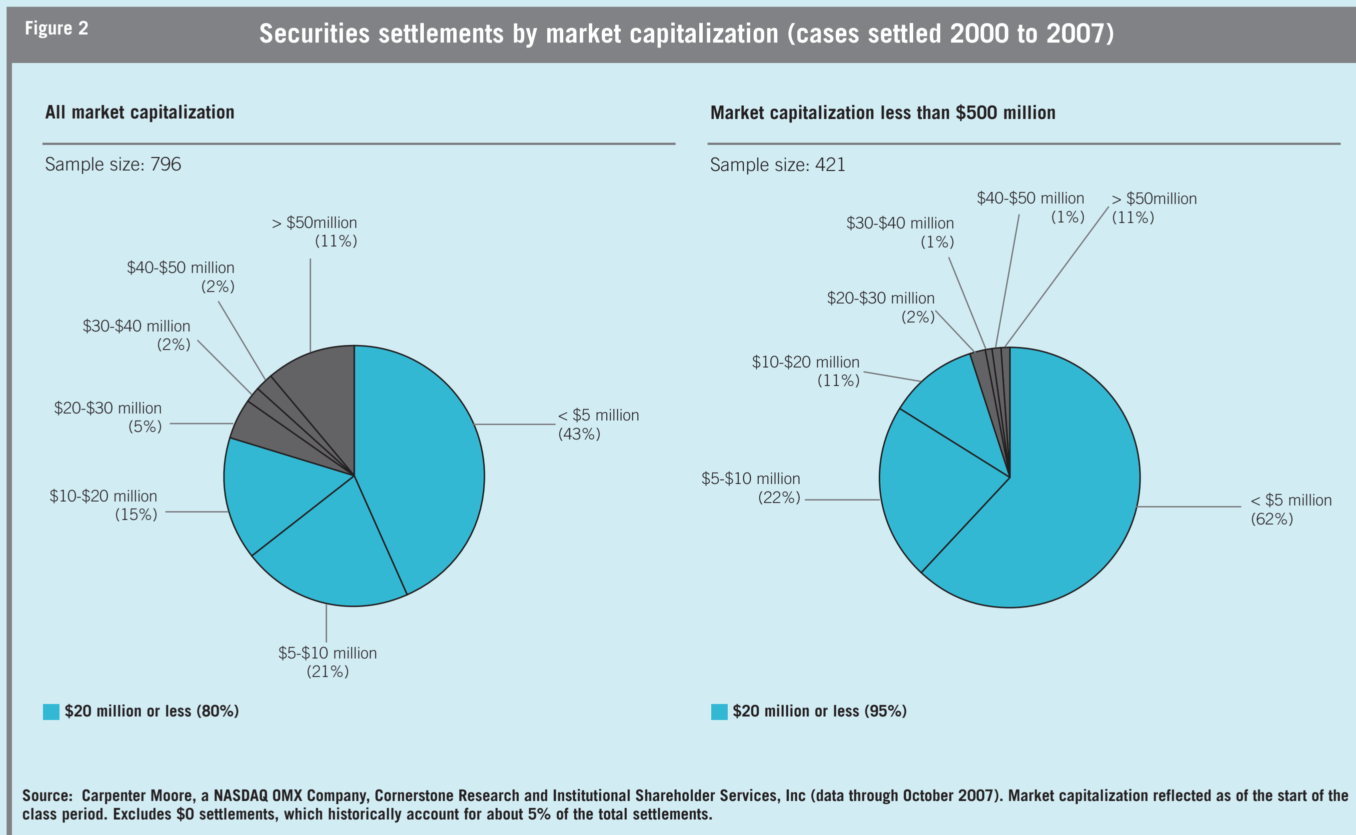
Claims data is critical in assessing D&O limits

By looking at trends in the size of securities class action settlements, a company can begin to estimate the damages it might face from a lawsuit. The cost to settle class action litigation is on a steady climb.

According to NERA Economic Consulting (Stephanie Plancich, PhD *et al*, *2007 Year-End Update, Recent Trends in Shareholder Class Actions: Filings Return to 2005 Levels as Subprime Cases Take Off; Average Settlements Hit New High* (NERA Economic Consulting, December 2007)), which tracks settlements of securities class action suits, settlement values increased notably between 1996 and 2007. The average settlement from 1996 to 2001 was $11.5 million, whereas from 2002 to 2007 the average was $24.4 million. In 2007 the average was $33.2 million. (These averages exclude mega-settlements in excess of $1 billion.) NERA reported that the median settlement also gradually increased. The median settlement from 2002 to 2007 was $6.8 million and this figure reached an all-time high of $9.6 million in 2007.

Companies should take into consideration the distribution of class action settlements by market capitalization as a way of avoiding the purchase of more D&O insurance than they are likely to need. For example, as Figure 2 illustrates, from 2000 to 2007 the average settlement for all settlements in all market cap ranges (mega-settlements are not excluded) was $55.8 million, but 78 per cent of the cases settled for less than $20 million. When the peer group is narrowed to cases filed against

Figure 2 Securities settlements by market capitalization (cases settled 2000 to 2007)



Source: Carpenter Moore, a NASDAQ OMX Company, Cornerstone Research and Institutional Shareholder Services, Inc (data through October 2007). Market capitalization reflected as of the start of the class period. Excludes $0 settlements, which historically account for about 5% of the total settlements.

companies with market caps less than $500 million, substantially all of the cases (95 per cent) settle for less than $20 million. Companies should focus on data from a reasonable market cap peer group, while not losing sight of how historical settlement values are trending.

Historical claims data by itself is only partly informative. A company must assess how the historical data might be relevant in light of the company's own risk profile. A number of analyses can help:

- distribution of historical settlements based on expected market capitalization;
- correlation between size of hypothetical market cap drop and historical settlements; and
- modeling of a hypothetical stock volatility against the historical distribution of settlements for different sizes of investor loss.

Analyzing the company's risk profile against various types of claims data helps the company feel comfortable that it is purchasing a reasonable amount of D&O insurance based on its unique situation and tolerance for risk.

Peer data plays a central role in sizing a D&O program

Executives making D&O purchasing decisions find it informative to analyze what their peer corporations are buying and how much they are paying for it. They use such information to reassure the board and management that their D&O program is at a level comparable to other companies in their market cap range and industry sector. Effective use of quality peer data can help a company to perform due diligence in deciding how to balance personal asset protection and corporate risk transfer.

Corporations look at a number of peer purchasing data points, including price, program structure, self-insured retentions and program size (i.e., limits of liability). Assessing what is a proper peer first takes into consideration market capitalization (since the size of investor losses is a driving factor in calculating potential settlements). However, industry sector is a second consideration that can be instructive, since it is often related to the likelihood of suit.

Unfortunately, peer data can be hard to come by since companies are not required to include information regarding their D&O programs in their public filings. There are several sources of D&O purchasing trends available in the marketplace, but many of these suffer from obvious shortcomings. A qualified D&O insurance broker, in addition to outside counsel, can be helpful in providing confidential peer purchasing information and in analyzing its applicability to a particular company. Carpenter Moore produces an annual D&O Peer Benchmarking Report that provides unique benchmarking information, including in-depth information by industry sector.

As the next section of this chapter notes, every company's D&O policy is an individually negotiated contract with terms and conditions that can vary widely. Thus, when benchmarking against peers, particularly on the topic of price, a company should not lose sight of the importance of the quality of the policy's terms and conditions. A cheap D&O program might not look like a bargain if the coverage is well below average. Benchmarking the coverage terms and conditions requires careful review by a D&O insurance broker and the company's attorneys.

Not all D&O policies are created equal and IPO companies face unique coverage issues

The breadth of coverage offered by the D&O policy is the most important consideration when purchasing D&O insurance. In the event of a claim, the actual language of the policy will dictate whether there is coverage. There is no universal policy form used by all D&O insurers. Although every carrier begins with a base form that is similar from carrier to carrier, there are substantial differences that must be understood. The terms of every company's D&O policy can be negotiated, with numerous modifications added onto the base form in order to tailor the coverage.

A D&O policy contains several key sections:

- insuring agreements;
- definitions;
- exclusions (and exceptions to the exclusions); and
- general terms and conditions (including matters such as choice of counsel, process for providing notice of claim and mechanisms for bringing disputes against the carrier).

Modifications (i.e., endorsements) can be made to any of these sections as part of the

Figure 3

D&O limits purchased by market capitalisation

	Market capitalisation	Sample size	Average limit
Non-US domiciled	< $500 million	37	$15.4 million
	$500 million - $1 billion	15	$25 million
	$1 - $5 billion	10	$54.4 million
US domiciled	< $500 million	295	$14.7 million
	$500 million - $1 billion	57	$31.1 million
	$1 - $5 billion	59	$43.8 million

Source: Carpenter Moore *D&O Peer Benchmarking Survey*, 2008

negotiation of a D&O policy. Sometimes carriers will make modifications that restrict the breadth of coverage and create an insurance policy less favorable to the insureds. On other occasions, through the work of an expert D&O broker, carriers will agree to modifications that make the policy much more favorable to the directors, officers and company. It is imperative, therefore, to leave sufficient time for a full-fledged negotiation to take place prior to the inception of the public company D&O policy.

In addition to the typical negotiations that occur when placing any D&O policy, corporations going public for the first time face several unique coverage issues. For example, many corporations will have a private company D&O policy in place before filing a registration statement. It is important that the policy does not have broad exclusionary terms that would bar coverage for the registration and trading of securities. The private company policy needs to be designed to protect the directors and officers (and the company) for activities leading up to the trading date, particularly in the event that the IPO does not occur. At the point that the company begins trading, the public company D&O policy steps into place. Thus, the public company D&O policy needs to be written so that there is no gap in coverage when the company goes public.

Special terms must also be negotiated if corporate insiders will be selling shares in connection with the IPO. Without modifications to the policy, insiders who sell shares may find themselves without D&O insurance at a critical time. It is important that pre-IPO corporations carefully review with their D&O brokers the likely scenarios under which insiders might be involved in selling shares, including in a subsequent offering.

In some instances, D&O insurance can also be obtained to cover the company's indemnification obligations to the bankers. The availability of such coverage varies considerably based on timing in the insurance market cycle and based on the company's place of domicile. In addition, potential downsides must be evaluated, including diluting the policy's proceeds for use by the directors and officers.

A process-focused approach to securing D&O insurance will reap the greatest benefits

Mapping out an effective D&O strategy and timeline is critical to ensuring the placement of an effective D&O policy for an IPO company. The IPO process itself will put great demands on the management team, but getting state-of-the-art D&O coverage is important for recruiting and retaining board members. Effective D&O insurance could be the last defense against individuals losing their personal wealth in the event of a lawsuit.

Identify a strategy and establish a timeline early

Focus on developing the D&O placement strategy early by involving the insurance brokers well before the registration statement is filed. The broker and company should map out a timeline that maximizes the use of key executives' time for the D&O placement,

carefully maneuvering around strategic dates associated with the IPO.

Present your company to the D&O carriers in a way that distinguishes you as a lower risk than your peers

The D&O brokers must take the company through an extensive risk-profiling exercise in order to understand how to market the D&O placement to the carriers. A comprehensive review of operational, financial and governance practices will ensure that the company distinguishes itself from the pack. D&O carriers reward companies that can demonstrate a lower risk profile. Corporations that are in industry sectors considered higher risk by D&O carriers must take the time to demonstrate how they are different from their peers.

There will be greater choice in the carriers that participate in a D&O program after the company has presented itself as better risk. More than 30 insurance carriers provide private and public company D&O insurance. Among other differences, these carriers offer variety in industry specialization, financial ratings and claims-handling reputation. Thus, corporations should take the time to review with the D&O brokers the carriers that are best matched to that company. A carefully planned process will ensure sufficient time exists to consider these variables, despite the time constraints created by the process of going public.

Select a D&O insurance broker that will be a trusted adviser, managing your executive liability risk for years to come

The effective negotiation of a state-of-the-art D&O program requires a specialist broker well versed in the important nuances of this niche market. Corporations should carefully assess their brokers to ensure they are getting the level of expertise required for this important area of insurance.

Key considerations when selecting a D&O broker include the following:

- Is the broker experienced in handling D&O insurance for both private and public companies?
- Does the broker use a consultative approach so that the company gets a trusted advisor on the topic of executive liability risk management?
- Has the broker outlined a clear and thorough process for the D&O negotiations which fits with the IPO timing?
- What unique data can the broker provide to do meaningful benchmarking when determining the size and structure of the D&O program?
- Is the broker specialized in D&O for IPO companies such that it has knowledge of the very latest trends in the market?
- How large is the team of brokers dedicated to D&O insurance and how does that team keep itself apprised of market developments?
- Is the broker focused on providing claims advocacy and management that will be uniquely tailored to the company's needs in the event of a suit?

The insurance program negotiated by the D&O broker ahead of the IPO sets the tone for the company's D&O program for years to come. A state-of-the-art D&O program can mean the difference between having coverage in the event of a suit or being without meaningful insurance. Given the potential exposure of individual directors' and officers' personal assets, getting the D&O insurance wrong can have disastrous results. Perhaps no line of insurance is more important to an IPO company than D&O insurance. And having the right experts negotiating the program is a corporate imperative.

Carpenter Moore is a leading provider of executive risk management services, including D&O insurance solutions. It offers its services to public and private companies, both directly and through a premier network of regional co-brokerage partners. Carpenter Moore has more than 20 years of experience advising pre-IPO companies on the intricacies of D&O insurance for this unique time in a company's history.

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