Initial Public Offerings (IPO) and Directors and Officers (D&O)

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WELCOME TO THIS INTERACTIVE CLICK-THROUGH GUIDE FROM OUR MANAGEMENT LIABILITY SPECIALTY TEAM

Whilst this document is designed to be a traditional read and click, it also has the following interactive features:

Where you see a word in **Blue Bold** you can rollover for further reference and definitions.

Where you see a word in **Blue Bold and underlined** you can click to find further information.

Where you see a ? symbol, you can rollover for client and underwriter considerations.

INTRODUCTION

Offering shares on a stock exchange (or "**Going Public**" as its known) can be an exciting milestone in the journey for any Company.

Building something from scratch and seeing the investment realised through a process that allows others to share in the success story, whilst also boosting the profile and ability to raise funds is what many investors and directors aspire to.

Whether it's to allow existing shareholders or founders to recognise all their hard work and cash in on success, or to raise money to grow the business and fund expansion, floating on a stock exchange is undoubtedly a great tool for unlocking value in a business that's ready for the next step.

There is also a growing popularity in **Special Purpose Acquisition Companies** (or Cash Shells as they are commonly known) looking to unlock value in Private Companies by taking them Public. So even if an IPO is not on the agenda for a trading entity, it can still present itself as a fantastic opportunity.

But it's also fraught with risks – be it **shareholder litigation** due to failure, or increased **regulatory scrutiny** – and as such requires adequate insurance consideration.

In the following document, we will explore some of these risks, and summarise a number of key facts relating to insuring a floatation, such as:

- Risks to Directors, Officers and the Company associated with an Initial Public Offering (IPO).
- Impact of an IPO on coverage available under the current D&O policy.
- Insurance coverage options to address the risks specific to the IPO, together with the advantages and disadvantages associated with each approach.
- A suggested timeline and process to obtain insurance to address these risks.
- A number of claims examples.

IPO AND THE RISKS

The directors, the company and any **selling shareholders** can incur liability for the particulars and information that are included in a **prospectus** in order to comply with **listing rules and regulations**. This applies to non-executive directors and proposed new directors who are to be appointed at the time of floatation. Such liability generally arises where particulars and information in the prospectus are misleading or the prospectus fails to disclose material information to potential investors.

It is usual for the directors, the company and any selling shareholders to provide representations, warranties and indemnities about the prospectus to the **underwriter or sponsor** of the floatation within the **underwriting agreement**. The liability for the directors and any selling shareholders under these warranties is personal, possibly joint and several and may not be subject to indemnity from the company.

Liability under the underwriting agreement generally arises out of:

- An untrue statement or alleged untrue statement of a material fact contained in any prospectus
- Any breach or alleged breach by the company, the directors or the selling shareholders of the representations, warranties or undertakings contained in an underwriting agreement.

Liability can arise from the moment **Roadshows** start, and as we will explore in the next section, relying on D&O insurance is not always ideal.

IMPACT OF AN IPO ON THE CURRENT D&O INSURANCE

More often than not, D&O Policies* specifically exclude the risks associated with an IPO, as insurers seek to evaluate the risk rather than inadvertently covering it. This is excluded by way of a "Prospectus Exclusion", an example of which is below:

Prospectus Exclusion

The insurer shall not be liable to make any payment under this policy based on, arising from or attributable to any future offering of any:

(i) equity on any public exchange

(ii) any initial public offering

In addition to excluding the specific IPO exposures, D&O policies will also contain a "*Changes in Risk*" provision– usually defined as follows:

Changes in Risk

Cover for any claim shall apply only for wrongful acts committed while the individual insured person serves in an individual insured person capacity.

The insurer shall not be liable to make any payment, or to provide any services in connection with any claim arising out of, based upon or attributable to a wrongful act committed after the occurrence of a transaction.

*Note : Policy language is illustrative only, and will differ from policy to policy and from one insurer to the next.

With a "*Transaction*" generally being defined as:

Transaction

Any one of the following events:

(i) the *policyholder* consolidates with or merges into, or sells all or a majority of its assets to, any other person or entity or group of persons and/or entities acting in concert; or ?

(ii) any person or entity, whether individually or together with any other person or persons, entity or entities becomes entitled to exercise more than 50% of the rights to vote at general meetings of the *policyholder* or control the appointment of directors who are able to exercise a majority of votes at meetings of the board of directors of the *policyholder*, or ?

Or policies can even go a step further and include:

(iii) any *company* or any *outside entity* lists its securities on any securities exchange.

So, depending on the percentage of the company being included in the floatation (and sold to new investors) this change in ownership, voting rights and/or control over the company can often trigger this "Changes in Risk" provision, upon which the current D&O policy will convert into run-off (therefore only providing coverage for claims made for Wrongful Acts committed prior to the change of ownership.)

In addition to "Changes in Risk", the "Discovery Period" provision within the policy (example below) confirms that the Insured has no automatic right to a discovery period as a result of the IPO, and that a quotation should be sought if coverage is required.

The definition of "*Discovery Period*" generally states:

Discovery Period

The *policyholder* must make any request for a *discovery period* in writing no later than 60 days after expiry of the *policy period*. A *discovery period* is not cancellable.

While this policy affords to the *policyholder* no right to a *discovery period* if a *transaction* takes place; upon written request of the *policyholder*, the *insurer* **may** quote a run-off *discovery period*. In considering such request, the *insurer* shall be entitled to fully underwrite the exposure and to extend such offer on whatever terms, conditions and limitations that the *insurer* deems appropriate.

But even if the company is only offering a small amount of the business (say, 10-15%) to new investors, it is normal for a six year run- off policy to be arranged for the D&O's of the 'Old Company' – ring-fencing the past exposures, with a new policy being arranged to provide coverage for the ongoing risks that the "New Company" faces as a publicly listed entity.

So to summarise, IPO claims are commonly excluded, and if the "Changes in Risk" clause is triggered, there is no cover for wrongful acts that occur after the date of the IPO, and in most cases the insurer is not contractually obliged to offer an extended reporting period for wrongful acts that occurred before either.

All of the above makes it vital to consider IPO Insurance that runs concurrently with the D&O, the features and benefits of which we will explore in the next section.

PROSPECTUS RISKS COVERAGE OPTIONS

1. Cover under the D&O policy

The D&O policy can be extended to include Directors and Officers Wrongful Acts emanating from Pre-Offer / Roadshow risks, and the Offering itself, protecting the individuals from claims made against them for the exposures associated with the IPO.

Coverage under the policy could also be extended to include **"Securities Entity Coverage"** - insuring Wrongful Acts of the corporate Entity (in relation to a Securities claim).

2. Purchase stand-alone Public Offering of Securities Insurance (POSI).

This is a one-off non-renewable policy which is typically purchased for six years and attracts a one-off premium, fully payable at inception.

In addition to providing the same coverage as that available under the D&O (Section 1 above), this **separate policy** can also provide coverage for the contractual obligations of the Company to the Underwriter, selling shareholders and controlling shareholders.

Therefore, as well as **ring-fencing** this specific risk exposure, this type of policy can also provide wider coverage than the current D&O policy.

A summary of the coverage options available under each structure is outlined below

Insuring Agreement	Description	D&O Policy	Prospectus
A	**Directors and Officers**	Y	Y
B	**Company Reimbursement**	Y	Y
C	**Company or Entity coverage** (see NB below)	Y	Y
D	**Selling Shareholders**	N	Y
E	**Controlling Shareholders**	N	Y
F	**Underwriter Agreement Cover**	N	Y

The availability (and cost!) of a POSI policy will vary depending on market conditions, so is not always a viable option, but is certainly the most prudent approach.

NB: Contractual liabilities are only insurable under the prospectus cover section C and not an extension under the D&O.

These are brief product descriptions only. Please refer to the policy documentation paying particular attention to the terms and conditions, exclusions, warranties, subjectivities, excesses and any endorsements.

A summary of the main advantages and disadvantages of each approach is outlined below.

Policy Class	Advantages	Disadvantages
D&O	• On annualised basis premium cash flow preferential • Policy can just cover the D&O's rather than cover extending to the company for securities claims potentially eroding the D&O's limit • Policy can be reviewed annually • As each renewal moves further away from the IPO, the exposure decreases, so premium ? can be negotiated downwards (depending on prevailing market conditions)	• Maximum period of 12-18 months although liability attaches for circa six years. Coverage could be withdrawn or restricted at renewal • No cover for Company obligations unless specifically requested • Any securities claim may impact on ongoing D&O renewal negotiations for a significant time • Single limit purchased needs to reflect past and ongoing D&O acts in addition to Securities claims where extended for such acts • Current Insurers may have limitations with regards to floats, particularly with reference to **USA** – despite s.144 restrictions • Limit may be eroded by a Company claim leaving D&O's without protection until renewal

Policy Class	Advantages	Disadvantages
POSI	• Six year policy period available • Premium can be capitalised against **float proceeds** (seek tax advice) • Covers both wrongful acts of the D&O's and the Company • Indemnity limit segregated from day to day D&O acts i.e. IPO exposure is ring-fenced • Covers certain contractual obligations of the Company • Coverage for selling and controlling shareholders can be included	• Tends to be more expensive and single premium payment can impact on cash flow

TIMELINE & PROCESS

In order to ensure that the risks surrounding the IPO are adequately addressed we would recommend that the following timeline is followed:

	STAGE	SUGGESTED TIMELINE	DOCUMENTS / INFORMATION REQUIRED
1	Further discussions with insurance broker regarding the planned floatation, potential insurance coverage structures, limits and premiums	As and when ready to discuss, but the earlier the better!	Overview of the proposed transaction and timeline - amount to be raised, location of stock exchange, anticipated **market cap**
2	Initiate discussions with Insurers and obtain premium indications	As and when draft documents are available - but prior to road shows	• Copies of all draft documents associated with the offer, such as: – the listing particulars/prospectus and any other public offer document required – draft underwriting agreement – sponsorship agreement • Description of the proposed transaction • The target of net funds to be raised • Purpose of the funds • A description of the parties involved in the transaction, including the financial adviser(s), solicitor(s) and auditor(s). • Completed proposal form
3	Updated documentation, information and timeline to be provided to prospective Insurers throughout the process	As and when documents are updated	Any updates to the prospectus, underwriting agreement, sponsorship agreement and other public offer document – until full and final published drafts are available
4	Final quotations sought	Floatation minus 3 weeks	None
5	Coverage incepted (and backdated to include coverage for pre-offer risks e.g. 'road shows')	Date of Floatation or **Date of First Roadshow** ?	None

CLAIMS EXAMPLES

UK IPO Misrepresentation of Risk

The company floated on LSE raising GBP50 million. There were alleged misrepresentations, breach of fiduciary duty and non-disclosure of certain risk factors in the company's flotation prospectus.

A shareholder derivative action is being pursued in relation to the IPO. The company has been forced to issue three profit warnings and been the subject of investigations by the **DTI** and FCA.

SPAC / de-SPAC Class Action

Shareholder files a securities class action lawsuit against individuals who served as pre-merger board members of a listed SPAC, as well as a pre-merger board member of the target company acquired, alleging that the defendants made false or misleading statements or failed to disclose lost sales and revenues to a competitor in the run up to the de-SPAC.

This lead to an inflated price being paid for the target company, with the claimant seeking damages for alleged material misrepresentations and omissions, that if included in published merger documents, would have resulted in a request for redemption rather than de-SPAC approval.

US IPO Laddering Claim

Following a successful IPO, a securities class action was filed against the Company and a number of its Directors, alleging that at the time of its launch they violated federal securities laws by issuing and selling common stock without disclosing to investors that several of the Banks underwriting the IPO had solicited and received excessive and undisclosed commissions from certain new investors.

In exchange for these excessive commissions, the complaint alleged that the various investment banks allocated new shares to customers at the IPO price, but only if they agreed to purchase additional shares in the aftermarket at progressively higher prices.

This practice (known as "laddering") is intended to drive up the share price to artificial levels. The price inflation enables both the banks (and their customers) to reap enormous profits by buying stock at the lower IPO price and then selling it later for a profit in exchange for a "kick-back" by way of commission.

Would you like to talk?

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