A Lesson from Facebook: Where D&O Insurance May Fall Short

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By John Orr

A Potential Gap

News of Goldman Sachs's recent investment in Facebook brings to the forefront a not-so-recently enacted S.E.C. requirement that potentially affects D&O coverage for privately held companies. Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act") provides that companies with greater than $10 million in assets and 500 or more shareholders are required to file public disclosures with the S.E.C. This creates an exposure for some private companies under the federal securities laws that may not be covered under their D&O insurance policies[1].

The insurance issue that arises from the filing requirement relates to the "securities claim exclusion" contained in virtually all private company D&O policies. Language of the exclusion varies, but is worded in some forms broadly to bar coverage for claims alleging violations of any federal, state or other similar securities law. As a consequence, private companies with S.E.C. disclosure obligations may have an important gap in coverage. The discussion below focuses on the exposure and potential coverage gap, and how to address the risk in policy language and program structure.

Private Company Disclosure Requirements Under the Exchange Act

Section 12(g) mandates companies that cross the statute's asset and shareholder thresholds register as public companies. The Rule does not require these companies to list on public exchanges, but, rather, it compels them to disclose their financials and other information in public filings with the S.E.C. As the companies are governed in this regard by the federal securities laws, they also are subject to potential liability for alleged violations of these laws. In insurance parlance, this creates a "securities claim exposure."

Numerous questions arise as to whether, or to what extent, a company surpasses the shareholder threshold. For example, Goldman Sachs's creation of a special purpose vehicle ("S.P.V.") to trade shares of Facebook stock presents the problem of whether those who purchase shares through the S.P.V. count toward the 500 shareholder figure. Or does Goldman Sachs count as one shareholder without regard to the number of investors purchasing shares through the S.P.V.? Also, do employees who have equity in their companies count toward the threshold? How do grants of restricted stock, stock options, warrants, etc., factor into the count?

Resolving these and other questions requires an analysis of governing law and company-specific facts. As such, organizations should rely on guidance from qualified securities counsel. If a company concludes it is subject to the statute, it then needs

[1] Section 12(g) specifically requires that a company register its securities with the S.E.C. if it "has total assets exceeding $1,000,000 and a class of equity security … held of record by five hundred or more … persons…" By rule-making, the S.E.C. raised the $1 million threshold to $10 million.

to evaluate its exposure to possible securities-related claims. As an example, those who purchase shares of private company stock in reliance upon its public disclosures may allege claims under the federal securities laws for losses in stock value if those disclosures turned out to be materially false and misleading and if shareholders satisfied other legal standards. Shareholders more commonly assert such "securities fraud" claims against public companies and their directors and officers, but they also may aver the claims against private companies and their directors and officers to the extent the organization is governed by the Exchange Act or other securities laws.

The D&O Policy's Securities Claim Exclusion

The scope of D&O coverage for public companies can differ substantially from that of private company coverage. One of the more important differences lies in the policies' treatment of coverage for securities claims. Public company insurers pick up the exposure but generally charge more premium to issue the coverage. In contrast, private company insurers typically limit coverage for claims relating to securities trading and offerings.

Whether a securities claim exclusion is broad enough to exempt coverage for the private company faced with public disclosure obligations will depend on the exclusion's wording and the specifics of the alleged violations. A common variation of the exclusion bars coverage for claims alleging violation of just about any securities law or regulation. It reads as follows:

> *The Insurer shall not be liable to make any payment for Loss … in connection with any Claim … for any actual or alleged violation of the Securities Act of 1933, the Securities Exchange Act of 1934, any state "blue sky" securities law, or any other federal, state or local securities law, including any amendments thereto, or any rule or regulation promulgated thereunder or any similar common law imposing liability in connection with the offering, sale or purchase of securities of the Company…"*[2]

In the hypothetical in which a private company is sued for violations of the Exchange Act arising from asserted misrepresentations in its public filings, the above language would appear to be broad enough to bar coverage for the claim. For companies with this exposure, this would present a critical gap in D&O coverage.

Other variations of the exclusion may be more limited (i.e., less restrictive), exempting coverage only for claims pertaining to company shares issued in a public offering. At first blush, such exclusions may appear not to apply to private companies with disclosure obligations under the Exchange Act, but are, for the most part, untested in the context of private company/public disclosure claims.

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[2] XL Specialty Insurance Company, Management and Company Liability Coverage Part, Form No. PS 71 01 07 07, Exclusion III.J.

D&O Underwriting and Renewal Considerations

For companies that may be considering potentially crossing the asset and shareholder thresholds of Section 12(g), it is recommended that their risk and insurance personnel, legal advisors and insurance brokers first evaluate the adequacy of coverage for the securities claim risk. Where a gap in coverage may exist, perhaps the clearest, least complicated option is to endorse the private company policy to cover the new securities exposure. This approach would address the securities risk without jeopardizing existing entity coverage in the private company form.

Another option may be to transfer coverage from a private company form to a public company form, which more comprehensively covers the securities exposure. In doing so, however, companies may lose entity coverage for non-securities claims that private company forms provide. Although insureds could attempt to negotiate entity coverage back onto the policy, great care would have to be taken to ensure the breadth of entity coverage is not compromised.

Whether modifying current private company forms or transferring to public company forms is advantageous to any given insured will depend on company-specific risk factors, existing policy language and market considerations.

With either option, however, companies should anticipate their insurers wanting to charge additional premium to pick up any new, heightened risk.

We welcome the opportunity to discuss further these issues and their implications with you. Toward that end, do not hesitate to contact an Integro Management Risk professional.

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About Integro

Integro is an insurance brokerage and risk management firm dedicated to serving the insurance and risk management needs of complex institutional risks. Integro has offices across North America, as well as in Bermuda and London. Its headquarter office is located at 1 State Street Plaza, 9th Floor, New York, NY 10004. 1-877-688-8701. www.integrogroup.com.
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