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THE JOBS ACT: NEW D&O LIABILITY CONCERNS

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act ("JOBS Act"). For an estimated 97% of all businesses in the U.S., the new legislation is the most significant change since enactment of the Securities Act of 1933 regarding how companies raise capital. The Act, which generally applies to private companies with up to $1 billion in annual revenue, substantially reduces the regulatory burdens of raising capital. The legislative expectation is that by allowing these small and mid-sized companies easier access to capital, they will grow and hire more employees faster and thus will help fuel the country's economic recovery.

Under the new rules, qualifying private companies can sell their securities with fewer disclosures and less regulatory oversight. If those securities sales result in investor losses, the investors will have greater opportunity as a result of the new rules to allege they did not receive all material information when they made their investment decisions. Unquestionably, the Act will lead to increased securities litigation against companies and their directors and officers. Private companies will be selling more securities more often to more investors with fewer disclosures as a result of the Act, thereby creating largely unprecedented liability exposures for directors and officers of those private companies. In addition, history confirms that in the aftermath of governmental deregulation of an industry or business practice, there is a higher likelihood that some individuals will seek to take advantage of the lack of regulatory oversight by engaging in abusive practices for the benefit of themselves and their companies.

Directors and officers of private companies that avail themselves of the new and less restrictive options for raising capital should proceed carefully in light of this heightened risk of securities claims. In addition, the D&O insurance industry will need to adapt to the Act by re-evaluating underwriting practices, policy terms and pricing models especially for private companies.

The following discussion summarizes the key provisions of the Act for purposes of D&O insurance, the likely practical consequences of those provisions, and specific considerations for both the insureds and insurers in response to the Act.

A. KEY PROVISIONS OF JOBS ACT

1. <u>Emerging Growth Company IPOs</u>

The Act creates a more streamlined IPO process and post-IPO disclosure requirements for "Emerging Growth Companies" (EGCs), which are defined as private companies that (i) had less than $1 billion in total annual gross revenues during its last completed fiscal year, and (ii) did not conduct an initial public offering of equity securities on or before December 8, 2011. An EGC can now conduct an IPO with substantially reduced financial reporting and executive compensation disclosures. In addition, for up to five years after the IPO, an EGC is subject to those same reduced disclosure requirements and is exempt from the SOX Section 404 internal controls reporting requirements and the Dodd-Frank say-on-pay shareholder vote requirements. The Act also allows private companies to submit to the SEC draft IPO registration statements on a confidential basis, thereby preventing competitors or others from obtaining sensitive information about the company if the IPO is delayed or unsuccessful. The Act also eliminates the prohibition against certain so-called "gun-jumping" practices (i.e. private companies and their securities underwriters are now permitted to "test the waters" prior to the IPO by communicating with qualified institutional investors about the potential IPO). The net effect of these changes is to significantly reduce the administrative burdens, regulatory restrictions and certain potential competitive disadvantages associated with IPOs by an EGC.

2. General Advertising of Private Offerings

The Act also permits general solicitation and general advertising by a private company in connection with its private placement of securities, provided the securities are sold to accredited investors. For example, a private company can now advertise its private offering in newspapers or on the internet and can conduct a mass mailing to solicit investors as long as all of the ultimate purchasers of securities in the private placement are qualified or accredited investors.

3. Crowdfunding

One of the more controversial and potentially significant provisions of the Act allows a domestic private company to engage in "crowdfunding" capital-raising activities, which is a financing technique pursuant to which securities are sold in small quantities to a large network of investors often over the internet. Under this provision, an eligible private company is permitted to raise, in the aggregate, up to $1 million during any 12-month period either through brokers registered with the SEC or through a newly established SEC-registered crowdfunding portal. The maximum amount of securities that can be sold to any one individual investor through this crowdfunding exemption in a 12-month period is limited to (i) $2,000 or 5% of the investor's annual income or net worth, if either the investor's annual income or net worth is less than $100,000, and (ii) 10% of the investor's annual income or net worth, not to exceed $100,000, if either the investor's annual income or net worth is $100,000 or more. The SEC will be formulating rules regarding minimum disclosures to crowdfunding investors, although such disclosure requirements will be far less than the disclosure requirements applicable to public offerings.

4. $50 Million Regulation A Private Offerings

The Act expands the so-called "Regulation A" private placement exemption by increasing the maximum size of the exempt offering from $5 million to $50 million and by preempting any state blue sky registration requirements for such exempt offerings.

5. Public Company Reporting Obligations

In the past, companies were required to file Form 10-K's, 10-Q's and other periodic reports with the SEC if the company had total assets exceeding $10 million and 500 or more shareholders. The Act increases this shareholder threshold to 2000 shareholders. Importantly, when calculating that 2000 shareholder threshold, shareholders who purchase stock through an exempt crowdfunding offering or who receive stock pursuant to an employee compensation plan are not included. As a result, fewer mid-sized companies will be required to comply with the rather onerous SEC reporting rules.

B. PRACTICAL CONSEQUENCES OF THE ACT

The following summarizes several likely ways in which the Act will change the practices and strategies of private companies with respect to raising capital.

1. More IPOs. More private companies will likely explore and conduct IPOs in light of the relaxed disclosure requirements for IPOs by EGCs under the Act. Whether the number of IPOs will increase significantly as a result of the Act will depend in large part upon how the market reacts to these streamlined IPO procedures.

From a claims perspective, any IPO generally creates heightened liability exposure for the company and its directors and officers. It does not appear, though, that the Act will likely increase materially that liability exposure for the vast majority of IPOs because (i) the company is still required to make very significant disclosures as part of the abbreviated IPO process, and (ii) companies conducting successful IPO's will likely continue to use experienced securities counsel and securities underwriters who will insist upon full and meaningful disclosure during the IPO process in order to minimize their own potential liability exposures. In other words, the liability exposure in an EGC IPO pursuant to the Act is probably not significantly greater than traditional IPO liability exposures, but the overall increased frequency of IPOs as a result of the Act will likely result in total losses paid by D&O insurers to increase.

2. Private Company Financing Flexibility. By allowing companies to raise capital through various new alternatives without triggering significant regulatory oversight, the Act should encourage private companies to raise more capital with only modest disclosures. For example, the crowdfunding and the "super" Regulation A offerings, when combined with the increased threshold for the periodic SEC reporting requirements, should be very attractive to cash-hungry small and mid-sized companies. Conversely, investors will have many more opportunities to invest in private companies with perceived large growth potential.

3. Increased Securities Litigation. Obviously, many of the private companies that will utilize the Act to raise capital will not ultimately perform consistent with the investors' expectations, thereby setting the stage for potential litigation by those investors. Even though the Act reduces various disclosure and registration requirements for those companies, the Act does not change the applicability of the general antifraud provisions of the securities laws. As a result, disappointed investors will have the same ability in the future to assert securities class

action claims against the issuer company and its directors and officers as has existed in the past. In other words, securities litigation appears to now replace strong regulatory oversight as the primary method to protect the interest of investors in these streamlined securities offerings.

4. <u>Voluntary Disclosures</u>. A company that qualifies for the reduced disclosure requirements under the Act is, of course, free to voluntarily make the more complete disclosures otherwise required under the securities laws for other issuing or public companies. More risk adverse companies may elect to make the more complete disclosures.

C. D&O INSURANCE CONSIDERATIONS

The following summarizes some of the considerations for insureds and insurers under D&O insurance policies as a result of the Act.

1. <u>Public Company v. Private Company Distinction</u>. The D&O insurance industry has historically categorized companies as "public" companies or "private" companies. Depending on the categorization, different underwriting analyses, different policy terms and conditions, and different pricing models applied. As a result of the Act, the distinction between those two categories of companies is now blurred. Although a company's shares may not be publicly traded and may not be subject to SEC periodic reporting requirements, the company may now have a large number of shareholders and more disclosure requirements than normally associated with a classic "private" company. D&O insurers will need to identify such hybrid companies and define the appropriate underwriting analysis, scope of coverage and pricing model for those companies.

2. <u>Private Company Securities Exclusions</u>. Private company D&O policies typically have some type of securities exclusion which eliminates coverage for claims relating to certain securities offerings or sales. These exclusions vary among insurers. Some such exclusions eliminate coverage for <u>any</u> securities claim. Other such exclusions eliminate coverage only with respect to claims arising out of the public offering or sale of securities. In light of the new crowdfunding rules and the broader private placement rules in the Act, these securities exclusions should be reconsidered by both insureds and insurers. Insurers will likely want to move toward a more absolute securities exclusion which applies to any purchase or sale (or offer to purchase or sell) any securities of the company, but insureds will likely want the exclusion to be inapplicable to many of the capital-raising alternatives which are now authorized by the Act.

3. <u>More Public Companies</u>. Assuming the Act results in more IPOs, there will be more public companies in need of a traditional public company D&O insurance program. This should be viewed generally as good news to D&O insurers since the number of public companies has significantly decreased in recent years. For example, according to published reports, the number of public companies listed on the New York Stock Exchange, the American Stock Exchange and NASDAQ decreased from 8,823 in 1997 to 4,998 as of the end of 2011 (i.e., a 43% reduction). During that same time period, the number of D&O insurers increased

dramatically, resulting in many more insurers seeking to insure far fewer public companies. Not surprisingly, that dynamic resulted in an ultracompetitive D&O insurance market in recent years. By creating more public companies through the streamlined IPO process and by indirectly creating the likelihood of increased securities litigation against directors and officers, the Act may be the impetus for a somewhat harder D&O insurance market in future years.

D. CONCLUSIONS

The JOBS Act undeniably is a significant change in how small and mid-sized private companies can raise capital, and will likely have both positive and negative effects on companies that take advantage of the new rules under the Act. More capital will likely be raised, more investors will likely acquire securities in emerging companies, and fewer disclosures will likely be made to those investors. Among other consequences, these developments will likely result in an increase in securities and derivative suits against companies and their directors and officers. In addition, like most other "game-changing" laws, there will be a number of unexpected and unintended consequences which will not be identified for several years but which may further increase D&O claims activity.

From a D&O insurance perspective, the Act will probably be more good than bad news for public company D&O insurers since it should create more traditional public companies to purchase D&O insurance and since the additional liability exposure arising from increased IPO activity should generally be manageable. However, the Act will probably be more bad news than good news for private company D&O insurers since it materially increases the liability exposures for those companies and their directors and officers.

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