alpharoot

D&O Insurance Considerations Before Going Public

Going public requires companies to manage many moving parts, plus exposes executives to loads of scrutiny and lawsuits, making public D&O insurance a top priority.

The past year has been a particularly eventful one in the world, in general, not to mention in the world of directors and officers (D&O) insurance. Although D&O litigation has decreased in frequency over the past few years, securities suits, merger-related cases, and class action lawsuits remain ongoing threats. This guide reviews how D&O insurance is designed to protect companies and their leaders if someone sues them and how to build these nuanced layers of coverage.

The D&O Landscape

There were 402 federal court securities suit filings in 2019. The following year, only 324 surfaced, and 2021 brought even fewer still. While these stats could signal a more forgiving environment, another message might be that we're in the eye of a perfect storm.

D&O litigation has peppered the cannabis space for the past several years, specifically in healthcare, financial, and consumer verticals. However, no industry is untouched by D&O litigation. Some cannabis D&O cases remain ongoing, with other settlements nearing the $12 million mark.

Also, considering that the pandemic caused a couple of lulls in litigation during 2020, D&O lawsuits climbed, but the number of listed companies has fallen. The bottom line is that the threat for D&O litigation is still very real, with the total value of settlements in 2020 being $4.2 billion.

Risks for Companies Going Public

As the adage goes, "there's more than one way to skin a cat." There are several paths aside from the traditional IPO route regarding going public. However, each course has its unique D&O risks.

SPACs

Roughly 25% of special purpose acquisition companies (SPACs) face D&O lawsuits, mostly because of the following exposures:

- Lack of D&O insurance by the company being acquired.
- Lack of visibility regarding various disclosures and executives' compensation.
- Insider trading risk before SPAC chooses a target company.

Direct Listing

Although direct listings are historically less risky, going public this route still presents vulnerabilities, including:

- More unpredictability since stock sales rely on willing employees and investors.
- Higher susceptibility to the rhythm of supply and demand (i.e., market demand).
- Lower range at which stock is traded.

Reverse Merger

- The due diligence process is nearly as grueling as with a traditional IPO.
- A holding period clause is necessary to eliminate riskier stocks being sold immediately after the transaction.
- Smaller companies might not be attractive enough to Wall Street financially or operationally.

Cannabis Public Claims

UPDATED AS OF 4/2022 | SOURCE: STANFORD

COMPANY	FILLING DATE	JURISDICTION	EXCHANGE	TICKER	VERTICAL	STATUS/SETTLEMENT
Instadose Pharmadose	12/30/2021	E.D. Virginia	OTC-BB	INSD	Healthcare	Ongoing
GW Pharmaceuticals, PLC	5/27/2021	S.D. California	NASDAQ	GWPH	Healthcare	Ongoing
Verus International, Inc	4/23/2021	D. Maryland	OTC-BB	VRUS	Consumer Non-Cyclical	Dismissed
Neptune Wellness Solutions Inc.	3/16/2021	E.D. New York	NASDAQ	NEPT	Healthcare	Ongoing
Aurora Cannabis Inc.	10/2/2020	D. New Jersey	New York SE	ACB	Healthcare	Dismissed
Harborside, Inc.	9/8/2020	D. Oregon	OTC-BB	HSDEF	Healthcare	Dismissed
iAnthus Capital Holdings, Inc.	4/15/2020	S.D. New York	OTC-BB	ITHUF	Healthcare	Ongoing
Cronos Group Inc.	3/11/2020	E.D. New York	NASDAQ	CRON	Healthcare	Ongoing
PharmaCielo Ltd.	3/6/2020	C.D. California	OTC-BB	PCLOF	Healthcare	Dismissed
Tilray, Inc.	3/6/2020	S.D. New York	NASDAQ	TLRY	Healthcare	Ongoing
Trulieve Cannabis Corp.	12/30/2019	N.D. Florida	OTC-BB	TCNNF	Healthcare	Dismissed
HEXO Corp.	11/26/2019	S.D. New York	New York SE	HEXO	Healthcare	Dismissed
Canopy Growth Corporation	11/20/2019	D. New Jersey	New York SE	CGC	Healthcare	$32,700,000
Zynerba Pharmaceuticals, Inc.	10/23/2019	E.D. Pennsylvania	NASDAQ	ZYNE	Healthcare	$4,000,000
Greenlane Holdings, Inc.	9/11/2019	S.D. Florida	NASDAQ	GNLN	Consumer Non-Cyclical	Dismissed
CannTrust Holdings, Inc.	7/10/2019	S.D. New York	New York SE	CTST	Consumer Non-Cyclical	$83,000,000
Curaleaf Holdings, Inc.	8/5/2019	E.D. New York	OTC-BB	CURLF	Healthcare	Dismissed
Pyxus International, Inc.	6/7/2019	E.D. North Carolina	New York SE	PYX	Consumer Non-Cyclical	Dismissed
KushCo Holdings, Inc.	4/30/2019	C.D. California	OTC-BB	KSHB	Basic Materials	Dismissed
22nd Century Group, Inc.	1/21/2019	W.D. New York	New York SE	XXII	Healthcare	Dismissed
Liberty Health Sciences Inc.	1/7/2019	S.D. New York	OTC-BB	LHSIF	Healthcare	$1,800,000
Aphria Inc.	12/5/2018	S.D. New York	New York SE	APHA	Healthcare	Ongoing
India Globalization Capital, Inc.	11/2/2018	D. Maryland	New York SE	IGC	Healthcare	$1,000,000
Namaste Technologies Inc.	10/6/2018	S.D. New York	OTC-BB	NXTTF	Services	$2,750,000
Cronos Group, Inc.	9/4/2018	S.D. New York	NASDAQ	CRON	Healthcare	Dismissed
CV Sciences, Inc.	8/24/2018	D. Nevada	OTC-BB	CVSI	Healthcare	$712,000
Paragon Coin, Inc.	1/30/2018	N.D. California	N/A	N/A	Financial	$12,000,000

D&O Insurance Defined

D&O insurance protects the company and its executives if someone sues either or both of them. As mentioned, the allegations against directors and officers run rampant nowadays; however, most cases stem from mismanagement of the company. There are three layers to D&O insurance worth reviewing, including:

Side A

If a director is individually named in a suit and forced to pay defense costs and settlements. This portion of D&O insurance kicks in to protect the individual. Side A will only pay the individual directors if the entity (company) unable to or unwilling to indemnify the individual, such as if the company is insolvent or the claim goes against the company by laws.

Side B

When the entity indemnifies individuals named in the lawsuit, Side B coverage reimburses those costs. However, it only extends to indemnifying insured individuals named in the lawsuit.

Side C

This coverage provides a balance sheet protection for the company named in the lawsuit alongside an individual executive. Side C coverage will reimburse the costs and settlements incurred.

Considerations When Securing Public D&O Insurance

As mentioned above, securing public D&O isn't a one-size-fits-all effort. It's not even the same as purchasing private D&O insurance. However, we've walked clients through this process many times before, and we offer the following key concepts to guide you along the way.

Engaging a Broker Timeline

Many executives look for milestones in the going public process, prompting them to revamp their D&O program. For example, our bench of experts usually knows that an insured is considering going public at least a year in advance. Part of the conversation is regarding their roadshow, generally, 3-8 months before going public. The need for roadshow coverage in their private company D&O policy often triggers a revamping process.

Adiitionally, one popular fintech company reported that they would have built a stronger relationship with the public D&O carrier had they been able to do it over. Naturally, the transition from a private to a public company is complicated on many levels, and not all. Still, companies must monitor the state of the market to determine the most suitable timing.

Key Elements in a Public D&O Program

All D&O policy forms are not created equal, and leaders must consider several elements. However, optionality is critical when faced with a difficult market from both a limit, retention, and carrier standpoint. The following are key considerations when formulating your public D&O program:

- Market cap
- Industry
- Size of the offering
- Trading market (i.e., OTC, Nasdaq, Internation, etc.)
- BOD composition
- Risk tolerance
- Limits
- Structure
- Coverage needs
- Structuring D&O Insurance Towers

How a company structures its D&O insurance tower is based on its size (market cap). Our team has built towers for as much as $750 million in D&O limits and as small as $1 million. Regarding structure, a fair baseline is 2/3 A-B-C coverage and 1/3 Side A coverage.

That said, there will typically be a minimum base layer of A-B-C coverage of $5 million, and sometimes $10 million, depending on the company. Excess of $5 million/$10 million will usually focus on Side A coverage.

However, public D&O insurance relies heavily on a company's risk tolerance and budget. Some companies with a high-risk tolerance purchase Side A-only programs solely to protect their directors and officers from personal financial loss, mainly for budgetary reasons.

As imagined, a lot of benchmarking and analytics go into these choices. We've seen many management teams work diligently on what was non-negotiable on Side A alone. Their strategy was to then get as much A-B-C coverage as possible. It's a necessary spend, no matter how the cookie crumbles.

D&O Insurance Enhancements

Insurance endorsements or enhancements are also known as riders or add-ons. These options modify a commercial policy by adding, deleting, or excluding specific coverage. As a helpful way to customize a public D&O policy, the following are a few standard enhancements:

- **Additional Side A Limit**
  Additional Side A coverage responds if the insured exhausts the rest of the policy.
- **Dilution Claims**
  Sometimes, shareholders think that a funding round might have "watered down" or diluted their stake in the company.
- **Bump-up Claims**
  This endorsement comes into play when shareholders feel dissatisfied with an acquisition offer.
- **Employed Lawyers**
  In-house lawyers often become heavily involved in D&O litigation but aren't typically covered by a standard D&O policy.
- **Class Certification Investigation**
  Carriers can include a sublimit to help pay for specific class certification investigation costs.

- **Roadshow Coverage**

  Claims sometimes arise from alleged misinterpretation during the preparation period before the going public process.

- **Broad Change in Control and M&A Provisions**

  Many companies experience transitions regularly; however, carriers can drop their coverage if they think too much change occurs.

- **Pre-arranged ERP ("Tail") Pricing**

  An extended reporting period (ERP) add-on lets you report claims ever after the policy expires.

Navigating Industry Challenges

Unsurprisingly, some industries face more challenges than others. For example, the cannabis and psychedelic industries will be priced at a premium relative to industries with historically lower claims frequencies. Also, the regulatory exposure is much greater due to the legality of the aforementioned industries. Given that these industries are nascent compared to more well established industries plays a role because there is not as much claims data to price off of. Underwriters prefer to see stability. Drastic changes — positive or negative — will more likely lead to D&O claims.

As a result, the number of carriers willing to consider legitimate coverage is a tiny subset. Plus, the cost for these industries tend to be on the higher Side.

The insurance market is cyclical, so no one honestly knows how long a specific market condition will last. Plus, terms like "hard, soft, and neutral" are often purely based on perspective. Still, the global pandemic caused an uncomfortable hardening in the insurance market. Management teams strived to structure deals the best they could — and continue to do so.

Private vs. Public D&O Insurance

Private and public D&O policies cover similar situations; however, a few fundamental differences exist. For one, a public D&O policy tends to be more expensive and have higher retentions than its private counterpart, mainly due to more frequent claims activity. After all, there are more stakeholders in public companies than private companies: shareholders, regulators, customers, etc.

The most critical difference between public and private D&O is the Side C coverage. Public company Side C coverage is strictly for securities claims, whereas private company Side C is broad form coverage and not limited to any specific type of litigation.

Private forms, as a standard, have public offering exclusions. When approaching going public, the company's public D&O must take effect on the going public date, moving the private policy into runoff. An extended reporting period (ERP) is vital for claims that preceded the public offering.

Lastly, a private company's D&O policy typically includes a duty to defend provision, while a public company's policy does not. Instead, the policy will reimburse the insured for the covered loss, less the retention amount of the policy.

Public D&O Timeline

Time relating to filing S-1 Form

IPO

	1 year before	3-8 months before	90 days before	35-40 days before	0 days	30 days after	35-50 days after	45-60 days after	60-75 days after
D&O Process	Engage a commercial insurance broker about public D&O insurance	Invest in Roadshow Coverage	First strategy meeting	Underwriter Meeting	Submit S-1 and full public filing information to insurers	Second strategy meeting	Wait for D&O program quote	Review D&O quote with board Build D&O tower (Many companies spend 2 weeks deciding on limits, structure, enhancements, etc.)	Bind public D&O insurance Cancel or runoff private D&O insurance
Going Public Process	Draft S-1 Form	Confidential filing			SEC comments received and respond	File public S-1 Form	Amend public S-1 Form	Start roadshow	Pricing

Private D&O Factors

- Invest in road show coverage
- Develop public Narrative
- Engage public D&O broker
- Discuss runoff or policy cancellation

Public D&O Factors

- Expect higher retentions and premium
- Purchase dedicated Side A coverage
- Reassess other insurance needs
- Keep continuity date of private limits
- Review internationale exposure
- Evaluate carriers
- Increase limits

NASDAQ Partnership

The Baldwin Group Announces New Exclusive Collaboration With Nasdaq to Offer D&O Insurance Solutions

TAMPA, Fla., June 17, 2021 (GLOBE NEWSWIRE) -
The Baldwin Group, Inc. (“The Baldwin Group” or the “Company”) (NASDAQ: THE BALDWIN GROUP), a rapidly growing independent insurance distribution firm delivering tailored insurance solutions, today announced an exclusive collaboration with Nasdaq, to offer tailored D&O Liability Insurance programs and solutions for companies listed on Nasdaq.

The Baldwin Group provides property and casualty, employee benefits, retirement, personal and international services for clients. They have specialized expertise and experience in providing D&O insurance services. The Baldwin Group has created innovative and exclusive programs for Nasdaq listed companies, IPOs, and SPACs that incorporate both corporate governance initiatives and unique captive insurance risk transfer solutions.

“We’re thrilled about our new collaboration with Nasdaq,” says Trevor Baldwin, The Baldwin Group’s Chief Executive Officer. “The Baldwin Group has deep expertise and experience in providing solutions that can meet the needs of the high-growth companies on The Nasdaq Stock Market.”

Mike Tomasulo, The Baldwin Group’s National Management Liability practice leader added, “D&O Insurance has become a major budget item for public companies, especially IPOs & SPACs. We understand that companies are looking for new and creative solutions to help them manage these increasing costs while also securing best in class coverage.”

About AlphaRoot

AlphaRoot is a full service insurance brokerage that focuses exclusively in the cannabis, hemp and CBD space. We work with companies across the entire supply chain, from seed to sale, as well as, ancillary providers. We take pride in providing solutions that are calibrated for cannabis companies. Our team is heavily invested in cannabis and our goal is to help operators scale to propel the industry forward.

We partner with the leading D&O insurance carriers to craft tailored risk management programs for public companies and venture-backed companies preparing initial public offerings.

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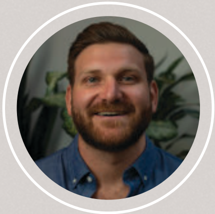

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