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riskINSIGHTS

The Impact of the JOBS Act on D&O Liability and Insurance

On April 5, 2012, President Obama signed into law the *Jumpstart Our Business Startups Act* (commonly referred to as the JOBS Act). This legislation, which enjoyed strong bipartisan support in Congress, is intended to ease the IPO process for emerging growth companies and facilitate capital-raising by reducing regulatory burdens and disclosure obligations. Among other things, the Act also introduces changes that could impact the potential liability exposures of directors and officers of both public and private companies. These changes could have important D&O insurance implications.

The Act's Provisions

Emerging Growth Companies and the IPO Process

Many of the changes in the JOBS Act are geared toward "emerging growth companies" (EGCs) which are broadly defined as companies with annual gross revenues under $1 billion in their most recent fiscal year. An issuer will retain its status as an EGC for five years after its IPO or until its revenues exceed $1 billion. An issuer will not qualify as an EGC if it went public prior to December 8, 2011. The JOBS Act provisions regarding the IPO process and the disclosure requirements for EGCs generally became applicable upon President Obama's signature of the Act.

EGCs are afforded certain IPO "on ramp" advantages which are intended to ease the going public process. For example, EGCs can elect to submit their IPO registration statement for SEC review on a confidential, nonpublic basis, although the registration statement must be publicly filed at least 21 days before the IPO roadshow. Further, the Act allows EGCs to "test the waters" for a prospective IPO by allowing the companies to meet with qualified institutional investors or institutional accredited investors – notwithstanding the pending offering. In addition, the Act allows EGCs to discern the level of prospective investor interest in the offering by allowing analysts to publish research relating to an EGC – despite the pending IPO.

Reduced Disclosure Requirements for Emerging Growth Companies: The Act also provides for reduced disclosure and reporting burdens for EGCs for as long as five years after an IPO – as long as the company continues to meet the definitional requirements. In these provisions, the Act unwinds many of the compliance and disclosure

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requirements Congress only recently enacted through the Sarbanes-Oxley Act and the Dodd-Frank Act. For example, an EGC will not be subject to Section 404(b) of the Sarbanes Oxley Act requiring an outside auditor's attestation report on the company's internal controls. Similarly, an EGC would be exempt from the requirements under the Dodd-Frank Act to hold shareholder advisory votes on executive compensation and on golden parachutes. EGCs are also exempt from recently enacted executive compensation disclosure requirements. Additionally, EGCs are exempt from the requirement to disclose the ratio of compensation of the CEO to the median compensation of all employees. Further, the EGCs are not required to comply with new or revised financial accounting standards until private companies are also required to comply.

Private Capital Fundraising and Revised Registration Thresholds

The JOBS Act introduces a number of reforms relating to private capital-raising. For instance, the JOBS Act eliminates the prohibition on "general solicitation and general advertising" applicable to Rule 144A offerings; provided the securities are sold only to persons reasonably believed to be qualified institutional investors. The SEC must provide rules implementing these provisions within 90 days of the Act's enactment.

The JOBS Act expands the registration exemption available to "small issue" securities offerings by increasing the exemption threshold from $5 million to $50 million. The Act also raises the threshold number of investors that would trigger the Exchange Act registration requirements. Instead of the current threshold of 500 investors, the Act specifies that companies will only be required to register their securities after they have over $10 million in assets and equity securities held either by 2,000 persons or by 500 persons who are not accredited investors. These provisions became effective upon President Obama's signature of the Act.

Crowdfunding: The Act also introduces measures designed to allow companies to use "crowdfunding" to raise small amounts of capital directly from the investing public through online platforms. The provisions create a new exemption from registration for private companies selling no more than $1 million of securities within any 12-month period – as long as the amount sold to any one investor does not exceed specified per investor annual income and net worth limitations. The crowdfunding provisions specify that the online portals participating in these types of offerings must register with the SEC. The Act also requires the issuing companies to provide certain specified information to the SEC, investors and to the portal. The SEC must adopt rules to implement the crowdfunding provisions within 270 days.

The Act itself specifies that issuers raising capital through crowdfunding cannot advertise their securities outside the funding portal or broker. The issuer must provide the SEC with an initial filing that includes a description of the company's business and financial condition; income tax and financial statements; and description of the ownership and capital structure of the business. The issuers must also describe the intended use of the proceeds and the target offering amount, as well as other information that the SEC may deem necessary.

The Act expressly incorporates provisions imposing liability on crowdfunding issuers for misrepresentations and omissions in the offerings, on terms similar to the existing provisions of Section 12 of the Securities Act of 1933. Under these provisions, a person who purchases securities issued under the crowdfunding exemption may bring an action based on any material misrepresentation or omission against the issuer, directors and executives for a full refund or damages.

Discussion

As is often the case when new legislation introduces significant innovations, it remains to be seen how the JOBS Act's changes will ultimately play out. The uncertainty is increased where, as here, many of the Act's provisions (such as, for example, the crowdfunding provisions) are subject to significant additional rulemaking. Even before the JOBS Act was enacted, the SEC was already straining under rulemaking obligations imposed by the Dodd-Frank Act. As the SEC is far behind on many rulemakings required by the Dodd-Frank Act, the sheer weight of the agency's obligations could mean delays for the rulemakings required under the JOBS Act.

The provisions modifying the IPO process for EGSs could encourage some smaller companies to "test the waters" and perhaps even to go public sooner. The reduced compliance and disclosure requirements for EGCs should reduce the post-IPO costs for the qualifying companies. It certainly can be hoped that these provisions will encourage an increased number of companies to go public. On the other hand, the ability to file registration statements confidentially and to "test the waters" will permit companies to withdraw their registration statements without any negative repercussions, if they conclude their offering would not attract sufficient investor interest. There could be a flurry of companies that file their registration statements confidentially and then decide to withdraw the filing.

The Act's exemptions for EGCs from many of the compliance and disclosure requirements that Congress only recently imposed on all public companies could at least potentially reduce the liability exposures for Emerging Growth Companies and their respective directors and officers. For example, a company that does not have to conduct a say-on-pay vote will not get served with a say-on-pay lawsuit. Similarly, the elimination of requirements for executive compensation disclosures eliminates the possibility that those companies could be subject to allegations that the compensation disclosures were incomplete or misleading.

But while the reduced compliance and disclosure requirements for EGCs reduces the costs and affords these companies certain advantages, that does not necessarily mean that D&O insurance underwriters will regard ECGs as having less risk. To the contrary, the reduced compliance and disclosure requirements may well raise underwriters' concerns that EGCs represent a riskier class of business.

Among other things, the Act's elimination of the requirement for auditor attestation of internal controls could be a significant concern, as many newer companies' internal controls are untested.

The Act also introduces provisions that could increase potential liabilities under certain circumstances. For example, Section 302(c) of the Act expressly imposes liability on issuers and their directors and officers for material misrepresentations and omissions made to investors in connection with a crowdfunding offering.

The crowdfunding provisions may blur the clarity between private and public companies. The crowdfunding provisions expressly contemplate that a private company would be able to engage in crowdfunding financing activities without otherwise assuming public company reporting obligations. Yet, at the same time, that same private company will be required to make certain disclosure filings with the SEC in connection with the crowdfunding offering; and could also potentially incur liability under the federal securities laws, Section 302(c) of the JOBS Act.

Conclusion

The JOBS Act could require the D&O insurance industry to make changes in its underwriting and perhaps in policy forms. Though the insurance industry's ultimate response to the Act's various provisions necessarily remains to be seen, there are certain D&O insurance implications that are apparent now.

First, ECGs seeking to take advantage of the new IPO processes will have to provide ample advance communications to their outside insurance advisors to ensure that the appropriate D&O insurance is in place at the time the company goes public. In the past, the company's public filing of its initial registration statement was usually the point where the processes commenced for the placement of the IPO company's public company D&O insurance. But under the JOBS Act provisions, the registration statement may not be publicly available until 21 days before the road show begins. This short 21-day period will strain the procurement of the insurance placement process as the insurance should be structured and presented prior to the commencement of the road show. The company's senior managers will not want to be distracted with insurance issues during the road show. Accordingly, ECGs contemplating submitting a registration statement to the SEC under the JOBS Act's confidentiality provisions will want to keep their insurance advisors fully informed.

Second, private companies interested in taking advantage of the crowdfunding provisions once they become effective will want to review their D&O insurance policies' public offering exclusions to determine whether or not these exclusions would preclude coverage for a crowdfunding liability action under Section 302(c) of the Jobs Act. The wordings of this exclusion vary widely among different policies, and some wordings could be sufficiently broad to preclude coverage.

Going forward, however, carriers may seek to adjust the wordings of these exclusions or other policy provisions in light of the crowdfunding liability exposure. Some carriers may try to take the position that crowdfunding liability is a kind of risk that they did not intend to cover in a private company D&O insurance policy. On the other hand, an insurance marketplace that remains competitive may constrain the insurers' ability to try to back away from the risk, even on private company D&O forms. Whether the private company D&O insurers accept the crowdfunding liability risk as an exposure within the basic form or whether it is something they only accept by extension or endorsement, there will be pressure for the carriers to provide some type of insurance solution.

As the D&O insurance marketplace response evolves, there will be one issue that will be particularly important to watch, given that the crowdfunding liability is based upon the liability provisions of Section 12 of the '33 Act. As a result of the coverage positions that some D&O insurers have taken in the past with respect to liability under Sections 11 and 12 of the '33 Act, most public company D&O insurance policies now expressly provide that the carriers will not take the position that settlements and judgments under Section 11 and 12 of the '33 Act do not represent covered loss. Given that the crowdfunding liability provisions expressly mirror Section 12 of the '33 Act, it would seem that the D&O insurance industry should develop similar protections in private company D&O forms providing that the carrier will not take the position that settlements or judgments under Section 302 (c) of the JOBS Act do not represent covered loss. It will remain to be seen whether or to what extent the D&O insurance industry is willing to adapt these kinds of crowdfunding liability protections for private companies.

As was the case with the Sarbanes-Oxley Act and the Dodd-Frank Act, the D&O insurance industry may face a long period where it must assess the impact of changes introduced by this broad, new legislation. It may be some time before all of the Act's implications and ramifications can be identified and understood. It will be important for companies and their advisors to monitor these developments as they unfold. We intend to keep our clients and partners fully informed as the industry evolves its response to these developments.

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