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Insurtech IPO Success Highlights Shifting Investor Priorities

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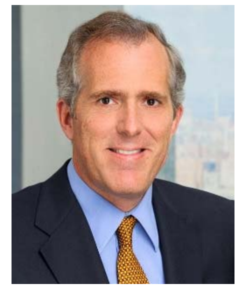

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Law360 (August 19, 2020, 6:02 PM EDT) --The last six months have been marked by profound changes in how we live and interact with one another. The COVID-19 pandemic has cast a spotlight on societal inequities and racial injustice and reinvigorated dialogue around sustainability and environmental reform.

While lawyers have long engaged with corporate governance and more specifically environmental, social and governance-related issues,[1] the dialogue on those issues has recently focused sharply on the role of the corporation and the extent to which corporations should consider stakeholder interests other than stockholder pecuniary gain.

In this article, we take a closer look at online insurer Lemonade Inc.'s successful July 2 initial public offering as a means of considering the public's shifting view of what some have described as the nexus between value and values.

We start with a detailed overview of Lemonade's IPO and business model, as an insurer and as both a public benefit corporation, or PBC, and certified B corporation, a rarity in the public markets.

We then discuss the PBC model and conclude by examining the extent to which Lemonade's success is attributable to its status as a PBC and whether such a status may be rendered obsolete as corporations feel more pressure to do the right thing by various stakeholders other than stockholders.

Lemonade as a Unique Insurtech Company

Lemonade stands out in the insurance industry as a tech-centric startup that principally provides renters and homeowners insurance. Lemonade claims to make insurance "more delightful" by orchestrating a "breezy" automated experience of obtaining coverage.[2]

Customers sign up and file claims through two-minute conversations with artificial intelligence chatbots accessed through the Lemonade mobile app or website.[3] According to Lemonade's prospectus, these bots handle about a third of all customer claims and inquires without any human involvement.

Lemonade also departs from the traditional property insurance business model in its handling of premiums. The company relies heavily on reinsurance, retaining a quota share that, for the fiscal year that began July 1, equals 25% of all premiums written. Lemonade says it is at least as much a generator of fee income as of insurance earnings, describing in its prospectus the 25% ceding commission it retains under its current proportional treaties as a fixed fee.

With respect to the remaining 25% of premiums written, Lemonade's signature giveback program entails donating residual funds from excess premiums to charities chosen by customers to "bring positive social impact to local communities and global causes."[4]

Although at several points in its prospectus and on its website Lemonade appears to imply that leftover funds are equal to any amount by which premiums retained exceed Lemonade's losses paid net of reinsurance, on page 131 of its prospectus, Lemonade finally provides more detail.

The giveback — which is subject in all cases to board discretion and to the Lemonade insurers maintaining adequate capitalization ratios — is determined by dividing insureds into cohorts based on the respective charities they have selected to benefit with any share of Giveback attributable to them.[5] The loss ratio[6] of each of these cohorts is separately determined, and to the extent that any cohort has a loss ratio of less than 40%, the difference in dollars is contributed to the chosen charity.

Lemonade made a contribution of over $600,000 in aggregate in 2019 to 26 charities, including the American Civil Liberties Union, the Trevor Project, UNICEF and the American Red Cross.[7] It is hard to square the notion that 26 separate cohorts had loss ratios of under 40%, when Lemonade as a whole had a loss ratio in 2019 of 79%. Lemonade's prospectus doesn't speak to this point.

It is noteworthy, as well, that Lemonade made these contributions in a year when it had a GAAP net loss of $108.5 million. Virtuous corporate altruism, or necessary startup marketing spend? The two may overlap here.

In sum, Lemonade hopes that its "mobile-first, digitally native"[8] approach to insurance, coupled with its unique handling of excess premiums, will help attract younger customers who tend to be first-time purchasers of insurance and retain those customers as they transition from renters insurance to homeowners coverage and other products.

Lemonade as Public Benefit Corporation and Certified B Corporation

Central to Lemonade's unique business model is its status as a PBC and a B corporation. Although related in concept, these two designations are distinct. A PBC is a for-profit corporation organized under a special subchapter of state corporation law.

For example, a corporation like Lemonade organized under Delaware's public benefit corporation statute is legally required, among other things, to (1) balance the pecuniary interests of its stockholders with the interests of other constituencies materially affected by the corporation's conduct; (2) promote a specific public benefit identified in its corporate charter; and (3) operate in a responsible and sustainable manner.[9]

Currently 36 states have similar PBC legislation.[10] A B corporation, on the other hand, has been certified by the independent nonprofit organization B Lab as meeting "the highest standards of verified social and environmental performance, public transparency, and legal accountability."[11] It must have been in business for at least one year and submitted a 200-question impact assessment, which B Lab uses to score the company on ESG metrics based on its size, operations and business model.[12]

Lemonade's IPO is notable as only the second of a PBC, the first being the IPO of Laureate Education in 2017.[13] There have been B corporations that have gone public, such as Etsy Inc., the online marketplace for handcrafted items. Etsy chose to drop its status as a B corporation, however, because it would have been required to formally convert to a PBC to maintain that status.[14]

Although it has not yet gone public, Warby Parker, the eyewear company, also chose to drop its status as a B corporation for the same reason.[15] Nevertheless, many well-known private companies today are either PBCs or B corporations or both, including Allbirds Inc., Ben & Jerry's Homemade Inc. and Patagonia Inc.[16] Allbirds, for example, is a privately held sustainable shoe startup that is both a PBC and a B corporation and was valued at over $1 billion in 2018.[17]

Under the Delaware law, the public benefit outlined in the corporation's charter must be "a positive effect (or reduction of negative effects) on [one] or more categories of persons, entities, communities, or interests" other than the corporation's stockholders.[18]

The public benefit Lemonade identifies in its charter is "to harness novel business models, technologies, and private-nonprofit partnerships to deliver insurance products where charitable giving is a core feature, for the benefit of communities and their common causes."[19]

Thus, the giveback program appears to be the principal public benefit that Lemonade seeks to provide as a PBC. In this way Lemonade differs from some other PBCs because its underlying business, selling insurance, only indirectly supports its public benefit, i.e., only to the extent that the giveback program donates excess premiums to charity.

By contrast, the underlying business of Allbirds, selling sustainable shoes, is directly related to the public benefit of protecting the environment.[20] And the simple fact that Lemonade donates to charity does not necessarily distinguish it from traditional corporations. Of course, as a PBC, Lemonade does have other, more general and undefined commitments to consider the interests of communities materially affected by its conduct other than its shareholders and to operate in a responsible and sustainable manner.

In its prospectus and on its website, Lemonade makes clear that the giveback program is not guaranteed.[21] The amount of money donated through the giveback program fluctuates each year. In 2019, for example, the $600,000 Lemonade donated through the program was less than 1% of its revenue, whereas two years before it donated over 10%.[22]

In addition, Lemonade notes that the ability of the giveback program to attract customers is uncertain, saying the program "may not resonate with our existing customers or may fail to attract new customers."[23]

Investors' Views of Public Benefit Corporations

The Lemonade IPO raises an important question about whether investors are willing to invest in companies that are legally required to consider communities and interests other than the pecuniary interests of their stockholders. Understandably, investors could hesitate to invest in a company with a substantive limit on its profit-generating capabilities.

However, if investors believe that the advantages of PBC status outweigh the potential drawbacks — for example, as a "conscious appeal to consumers aligned with the firm's prosocial messaging"[24] — we could see more PBCs receiving private investment and completing IPOs in the future.[25]

An empirical study forthcoming in the Harvard Business Law Review addresses this question. The study surveyed 295 Delaware PBCs that received investment between 2013 and 2019 to determine "whether for-profit investment is occurring in PBCs, and if so, whether it is different in kind from traditional [venture capital] investment."[26]

The study found that "early-stage investment in PBCs is indeed significant (over $2.5 billion), and includes well-known companies such as Allbirds, Lemonade, and Numi Tea."[27] The investors tend to be "traditional, profit-seeking VC firms" that "believe [PBCs] will yield sufficient returns to justify investments."[28] PBC investors therefore tend to focus on "consumer-facing companies where PBC status is more likely to buttress a profit purpose."[29]

The study concludes that the social purpose of PBCs will likely "remain secondary to their for-profit motive."[30] The study also notes that the "lack of case law on the scope of fiduciary duties" of PBC directors constitutes a "significant [hurdle] to widespread adoption,"[31] despite the fact that the Delaware statute limits director liability when making decisions that balance the public benefit with stockholder pecuniary gain.[32]

As the study mentions, companies like Lemonade received substantial private investment notwithstanding their status as PBCs. Lemonade received around $480 million before going public and was valued at over $2 billion in 2019.[33] Considering Lemonade's successful IPO, in which its stock price jumped 144%,[34] investors in both public and private markets seem at least tentatively willing to accept this new corporate form.[35]

However, Lemonade's fundraising success is not necessarily attributable to its status as a PBC and B corporation. Perhaps enthusiasm for Lemonade is another example of exuberance for old-line businesses dressed in a new-age tech wrapper. And social impact or ESG-focused mutual funds that believe they have to own a stake in one of only two public PBCs may have played a part in its share price run-up.

By contrast, Trean Insurance Group Inc., another property and casualty insurer but one with a more old-school approach — and $31 million of net income in 2019, as compared with Lemonade's $108.5 million net loss — went public on July 15 at $15 per share; its stock closed at $16.70 per share on July 17.

A related question is whether PBC status is even necessary to achieve recognition on ESG issues from the public or investors.[36] A company can be a responsible and sustainable corporate citizen and support important ESG-related causes, thereby appealing to the same demographic as PBCs, without formally organizing as a public benefit corporation or even being certified as a B corporation.

Indeed, for-profit corporations of all kinds are increasingly devoting substantial attention and resources to ESG-related causes, whether for purely self-interested marketing and long-term value purposes, because their employees and shareholders are pushing them to do so, or in fact as part of a broader reimagining of the corporation's purpose in society.[37]

Recent specific examples include Bank of America Corp. pledging $1 billion to address racial and economic inequality and BlackRock Inc.'s chairman and CEO recently stating that every company and shareholder must confront climate change.[38]

In addition, smaller companies like Etsy and Warby Parker continue to generate goodwill and popularity among consumers on ESG issues, despite not being PBCs or B corporations.[39]

It is true that a company formally organized as a PBC is legally required to act for some broader societal interest, and thus may pack more punch on ESG issues and be more accountable in the long term. Nevertheless, the traditional corporate form may already be evolving naturally toward a similar model, which could limit PBCs largely to smaller companies and startups.[40]

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[1] ESG stands for "environmental, social, and governance." See Timothy J. McClimon, The Impact of Environmental, Social, And Governance (ESG) Issues on Companies Today, Forbes (June 29, 2020), https://www.forbes.com/sites/timothyjmcclimon/2020/06/29/the-impact-of-environmental-social-and-governance-esg-issues-on-companies-today/.

[2] Lemonade, Inc., Prospectus (Form 424(b)(4)) at 1 (July 2, 2020).

[3] Id.

[4] About Lemonade, Lemonade, https://www.lemonade.com/faq (last visited July 16, 2020).

[5] Lemonade Prospectus, supra note 2, at 131.

[6] The loss ratio of an insurer for any period is equal to its losses and loss adjustment expenses divided by its net premiums earned for that period.

[7] The Lemonade Giveback, Lemonade, https://www.lemonade.com/giveback (last visited July 23, 2020).

[8] Lemonade Prospectus, supra note 2, at 3.

[9] Del. Code Ann. tit. 8, § 362(a) (West 2020).

[10] Yuliya Chernova, Lemonade to Test IPO Waters as a Public Benefit Corporation, Wall St. J. Pro Venture Cap. (June 12, 2020), https://www.wsj.com/articles/lemonade-to-test-ipo-waters-as-a-public-benefit-corporation-11591995018.

[11] About B Corps, B Lab, https://bcorporation.net/about-b-corps (last visited July 16, 2020).

[12] Certification Requirements, B Lab, https://bcorporation.net/certification/meet-the-requirements (last visited July 28, 2020).

[13] Chernova, supra note 10. Laureate Education is a global for-profit network of higher education institutions. It remains a public benefit corporation and Certified B-Corp to this day. See About Laureate, Laureate Education, https://www.laureate.net/aboutlaureate/ (last visited July 16, 2020).

[14] Dennis R. Shaughnessy, The Pubic Capital Markets and Etsy and Warby Parker, Soc. Enter. Inst. at Ne. Univ. (Oct. 10, 2018), https://www.northeastern.edu/sei/2018/10/the-public-capital-markets-and-etsy-and-warby-parker/.

[15] Id.; Chernova, supra note 10.

[16] See Shaughnessy, supra note 14; Jay Coen Gilbert, AllBirds Quickly Soars to Success As It Aims to 'Make Better Things in a Better Way', B The Change (Jan. 14, 2019), https://bthechange.com/allbirds-quickly-soars-to-success-as-it-aims-to-make-better-things-in-a-better-way-dffae809b14e.

[17] Rob Copeland, Trendy Sneaker Startup Allbirds Laces Up $1.4 Billion Valuation, Wall St. J. (Oct. 11, 2018), https://www.wsj.com/articles/trendy-sneaker-startup-allbirds-laces-up-1-4-billion-valuation-1539281112; Gilbert, supra note 16.

[18] Del. Code Ann. tit. 8, § 362(b) (West 2020). These effects can include "effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific or technological nature." Id.

[19] Lemonade Prospectus, supra note 2, at 14.

[20] See Mary Ann Azevedo, Casual Shoe Maker Allbirds Ties Up $50M In Series C Round, Crunchbase News (Oct. 11, 2018), https://news.crunchbase.com/news/casual-shoe-maker-allbirds-ties-up-50m-in-series-c-round/ (describing Allbirds' public benefit as environmental protection).

[21] About Lemonade, Lemonade, https://www.lemonade.com/faq (last visited July 16, 2020).

[22] Chernova, supra note 10.

[23] Lemonade Prospectus, supra note 2, at 11.

[24] Michael B. Dorff, James Hicks, & Steven Davidoff Solomon, The Future or Fancy? An Empirical Study of Public Benefit Corporations, Harv. Bus. L. Rev. (forthcoming), available at SSRN: https://ssrn.com/abstract=3433772.

[25] See id. at 55; Chernova, supra note 10.

[26] Dorff, et al., supra note 24, at 5.

[27] Id.

[28] Id. at 55.

[29] Id. at 6.

[30] Id. at 7.

[31] Dorff, et al., supra note 24, at 6, 58.

[32] Del. Code Ann. tit. 8, 365(a)-(c) (West 2020).

[33] Chernova supra note 10; Donna Fuscaldo, Insurtech Lemonade Files for IPO; Seeks to Raise $100 Million, Forbes (June 9, 2020), https://www.forbes.com/sites/donnafuscaldo/2020/06/09/insurtech-lemonade-files-for-ipo-seeks-to-raise-100-million/.

[34] Wallace Witkowski, Lemonade logs best U.S. IPO debut of 2020 with more than 140% gain, MarketWatch (July 2, 2020), https://www.marketwatch.com/story/lemonade-logs-best-ipo-debut-of-2020-with-more-than-140-gain-2020-07-02.

[35] See Dorff, et al., supra note 24, at 6.

[36] See id. at 3 n.5.

[37] See, e.g., McClimon, supra note 1; Eduardo Porter, Charitable Giving by Corporations is Also About Getting, A New Study Finds, N.Y. Times (April 3, 2018), https://www.nytimes.com/2018/04/03/business/economy/charitable-giving-corporations.html.

[38] C. Nivedita, Bank of America pledges $1 billion to address racial, economic inequality, Reuters (June 2, 2020), https://www.reuters.com/article/us-minneapolis-police-bank-of-america/bank-of-america-pledges-1-billion-to-address-racial-economic-inequality-idUSKBN2391NO; Letter from Larry Fink, Chairman and Chief Exec. Officer, Blackrock, to Chief Exec. Officers, available at https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

[39] See Impact Report and Racial Equity Strategy, Warby Parker, https://www.warbyparker.com/impact-report-racial-equity-strategy; Hilary Young, Why Etsy Is Integrating Our Sustainability Reporting With Our Financial Reporting, Medium (Feb. 28, 2019), https://medium.com/etsy-impact/why-etsy-is-integrating-our-sustainability-reporting-with-our-financial-reporting-b137c449271a.

[40] See Dorff, et al., supra note 24, at 3, 7.