

White Paper



A Holistic Approach to Insuring Venture Capital Firms and Their Portfolio Companies



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From the moment the CEO of a startup signs a Term Sheet offered by a venture capital company, the futures of both entities are inextricably linked at least until the venture firm “cuts the cord” on their investment. In most cases, their large investments grant the lead venture firm full or partial control of the start-up’s Board of Directors, thereby allowing them to install outside directors and also to replace members of the management team for failure to meet specific milestones. This contractual arrangement aligns both companies risk profiles much as a parent company and subsidiary are. As their risk profiles overlap, properly insuring a portfolio company should recognize the overlap and attempt to create a seamless layer of protection much as granting Additional Insured status does to a wholly owned subsidiary. ***In non-insurance terms, both the venture capital (VC) firm and their portfolio company should be insured by the same agency and if possible by the same carrier with the utmost care that accommodates the unique relationship between these two entities.***

Nowhere is this overlap more important than with the portfolio company’s Directors and Officers, D&O, policy. The outside directors in portfolio companies, appointed by the VC firm need special indemnification and coverage provisions not normally part of a standard D&O policy. For example, as most D&O policies have defense costs inside the limits of the policy, it is possible during litigation that C-Level Executives, other insureds, can burn through policy limits leaving little protection for the outside directors. A common saying is “the first to spend is the first to be defended.” High-profile cases involving suits against Dennis Kozlowski from Tyco, and Jeffrey Skilling from Enron, made it apparent that the needs of outside directors maybe significantly different from inside directors as they are usually corporate officers. In Enron for instance, outside directors had to pay \$13 million out of their own pockets for defenses costs.¹ These situations have led to the adoption of the terms: “White Hats” and “Black Hats” where criminal action by one or more of the directors make headlines. In most every instance, the “Black Hats” are inside directors holding high level corporate offices.



To further the “Hats” analogy - every D&O policy has conduct exclusions for executive conduct such as breaching fiduciary requirements to obtain illegal personal profits. Typical policy language excludes illegal profits “based upon, arising from or in consequence of an insured having gained in fact any personal profit, remuneration or advantage to which such insured was not legally entitled as an insured.” This wording could have the effect of excluding an innocent outside director or “White Hat” from coverage because of the actions of another “Black Hat” director or officer. Look for language in the D&O policy that clearly states the wrongful acts of one insured person shall not be imputed to any other insured person, and the insurer can only rescind coverage for an individual that has actual knowledge of material facts.

Another conduct exclusion is for intentional dishonesty. What constitutes dishonesty and how it affects the other insured parties depends on the specific policy language. Obviously, any criminal or fraudulent act would trigger this exclusion, but so might a material misstatement of facts and supporting documents submitted with the application like financial statements. Whether these action would cause the carrier to totally rescind the policy or just sever the coverage for the “Black Hat” depends again on policy language. As in most contracts the devil is indeed in the details.

Along the same line, most D&O policies require insureds to cooperate with the carrier and defense counsel which if not followed will possibly allow the carrier to rescind coverage for all insureds. Ask your agent if a “Black Hat” decides to become uncooperative will an outside director still be covered.

Another possible exclusion that must be avoided is the Insured v. Insured Exclusion in many D&O policies, which excludes coverage when an insured sues another insured. Who is an insured varies by contract also - so whether or not coverage is available depends upon that definition. In some policies, Directors, Officers and Employees are defined as Insureds. As the venture firms usually have the authority to replace an officer of the corporation such as the CEO or CFO for cause, if litigation

¹ Why “Side A” Matters to You, The Ins and Outs of D&O Liability Insurance, February 11 ,2005, Wilson, Sonsini, Goodrich & Rosarti PC, from their web site 1/10/12.

results and the outside director is sued and Employment Practices Liability is part of the portfolio company's D&O, the Insured v. Insured exclusion could potentially exclude coverage for the outside director to defend his or herself. Once again, a carefully crafted Severability Clause should be part of the policy. The bottom line is that if possible, every conduct exclusion in the D&O policy should have a severability clause to protect innocent officers and directors.

Bankruptcy can also spell trouble for an outside director as not every portfolio company is going to survive. In fact, most won't succeed, so bankruptcy is always a real possibility. As it is possible that a corporate officer or director is appointed as the bankruptcy trustee, the Insured v. Insured Exclusion could exclude coverage. Look for language that clearly states that there is an exception to the Insured v. Insured Exclusion for claims by bankruptcy appointed trustees of the company.

Unfortunately, these are not all the ways that a venture firm may find themselves with denied D&O claims. D&O and Professional Liability policies are complicated manuscript contracts that must be read carefully and understood by experts with an intimate knowledge of the needs of the various parties to the contracts. The first priority for a VC firm should be to obtain a D&O/Professional Liability policy(s) that protects all of their outside directors placed in their portfolio companies. These type of policies are readily available. Additionally, as the typical VC firm is in a position to specify with their Term Sheet the insurance coverage requirements for their portfolio companies, they should be more explicit in their insurance requirements. At a minimum, the Term Sheet should specifically require the purchase of a D&O policy that addresses all of the issues regarding covering an outside director properly that we have discussed in this article.

SUMMARY

Insuring Venture Firms and Their Portfolio Companies--

- Always use specific insurance language in the Term Sheet
- Use one carrier to insure both VC firm and portfolio companies if possible
- Every conduct exclusions needs a severability clause
- Utilize ironclad indemnity agreements for each outside director
- Insist that Insured v. Insured is waived for Employment Practices claims



This piece was written by **Stewart V. Nelson, Client Executive, Kapnick Insurance Group**, and is for informational purposes only. If you would like to have Mr. Nelson review your Term Sheet for proper insurance provisions, or to review the D&O and other policies of portfolio companies to see if there are any holes that could be used to deny coverage that might financially damage outside directors, he can be contacted at:

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How do we do this? We continuously invest in **cutting edge products and technology** which provide our insurance professionals with an impressive range of resources. Each client's unique needs and goals are examined closely by a dedicated service team who put their combined knowledge and industry experience to work. Piece by piece, they break down the many complex facets of insurance into easy-to-understand components and present a simplified insurance program.

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