

RISK EXPOSURES TO VENTURE CAPITAL FIRMS



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Understanding the magnitude of risk associated with fund management is imperative in today's litigious society. Lawsuits can be founded or frivolous to which plaintiff attorneys do not discriminate. Venture capital firms are vulnerable to litigation, which can be costly to defend and even more expensive to settle.

Consider the following questions this article will attempt to answer:

- What are the liability exposures?
- What are typical allegations against venture firms?
- Are the fund's investment returns at risk?
- How do individual general partners and partnership management groups transfer liability risk?

William Gallagher Associates, a leading provider of insurance brokerage, risk management and employee benefits services to firms with complex risks, within industries that include high technology, life sciences, financial risks, healthcare services, energy, and environmental services. WGA has offices in Boston, MA; Princeton, NJ; Columbia, MD; Atlanta, GA; and Paris, France.

Typical Allegations & Exposures to Litigation

Board Representation:

Claims filed against portfolio company board members can originate from various sources: company, competitors, suppliers, vendors, governmental/regulatory agencies, company employees and management as well as other board members. An individual can be sued in his capacity as a board member of a portfolio company or in his capacity as an investment advisor. Also, under the "control person" legal theory, board representation presents liability exposures for the general partner and the fund.

Fund Management:

Limited partners expect general partners to manage the fund according to guidelines outlined in private placement memorandums. Investors expect due diligence, good faith, loyalty, care and other fiduciary duties from general partners. Lawsuits can be filed when it appears that any of these responsibilities have been breached. Although partnership agreements provide protection for the general partner, such indemnification can be circumvented by lawsuits alleging general partner gross negligence.

Employment Practices:

Employment-related claims rear their ugly heads. Members of the portfolio company's management team may have been replaced post-deal, creating potential claims for wrongful termination. These claims can also implicate the "controlling" investors or venture capital firms and their representatives.

Deal Evaluation:

When a prospective deal collapses, portfolio companies assert allegations seeking damages from lost financing opportunities and the misuse of their proprietary and confidential information, i.e. the portfolio company was “strung along” by the venture capital firm.

Fund's Investment Returns – At Risk?

Consider the fund's risk. As previously stated, general partner liability is almost always guaranteed by the partnership agreement's indemnification provision (except for gross negligence). However, when third-party suits are filed against the general partner and/or the partnership, the fund is ultimately responsible for defense/legal costs, judgments and settlements. Such claim expenses would reduce the fund's investment returns.

Transfer the Risk – How?

The insurance industry has responded to venture capital/private equity business risks by creating an industry-specific coverage transferring these liability exposures.

Coverage is provided for the following:

- Directors & Officers Liability
- Company Reimbursement (D&O)
- Professional Liability (Errors & Omissions)
- Outside Directorship Liability (on portfolio boards)
- Employment Practices Liability

Transfer the Risk – How Much?

The cost and amount of insurance protection needed is based on:

- Total assets under management
- Number of Board seats represented by the fund
- Ability/Desire to self-insure
- Investment Focus
- Fund manager experience

Exposure is increased or decreased by the factors listed previously. So how much limit should be carried?

Recommended guidelines are as follows:

Assets under management

- < \$10M: \$1-3M limit
- \$10M to \$50M: \$3-5M limit
- \$50M to \$200M: \$5-10M limit (minimum)
- > \$200M: \$10+M limit (minimum)

Typical market cost for a \$5M limit of liability, with \$50M of assets under management ranges from \$55,000 to \$75,000 considering the factors listed above. Minimum deductibles are \$100,000. Policies will name all necessary entities for coverage, i.e. partnerships, general partners, management companies, advisory boards, etc., ensuring coverage for all potential targets of litigation.

Conclusion

No matter how well a fund is managed, litigation can be brought by many possible sources. The costs to defend and/or settle these claims will reduce the fund's returns, leaving investors to pay these costs. Transferring this risk for a known, fixed cost will eliminate the risk of unexpected loss from liability claims. If you do not currently purchase this protection or are interested in more information on the inherent risks facing venture capital firms, please contact Michael Andersen at (609)228-1601.