Understanding VCAP:
Venture Capital Liability Insurance and Its Role In The Rising Tide of Private Shareholder Litigation

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What are venture capital and private equity?

- Venture capital investing
  - Generally for relatively early stage companies → high risk
    - Investments are known as “portfolio companies”
  - VC firm receives stock in portfolio company exchange for its investment
    - Usually take a board position of some type
    - May also extend loans to the portfolio company
  - General Partners vs. Limited Partners
  - Investments structured within funds, which are raised with contributions from the limited and general partners
  - Goal is to make a profit upon a liquidity event (sale, IPO, etc.)
What are venture capital and private equity?

- Other types of private equity investing
  - Similar structure and goals, but involving mature (sometimes troubled) companies
  - PE often acquires 100%, rather than investing alongside other VCs
- PE Firms are required to fully registered with the SEC, with complete Form ADV filing
- Venture Capital firms are exempt from SEC filing requirements and will file only a truncated ADV I
VC / PE Structure

Private Fund (GP, LP, or LLC)

Fund Investors (Limited Partners)
- 99% of Capital
- 80% Carry

Fund Manager (GP or LLC)
- 1% of Capital
- 20% Carry

Advisory Board (Limited Partners or Managing Members)

Management Company (Corporation)
- 2%-2.5% Mgmt Fee

Investment Holding Company

Portfolio Company
- 80% Carry

Portfolio Company
- 20% Carry

Portfolio Company
- 2% Mgmt Fee
Unique Risk Profile of VC / PE Firms

• Personal risks associated with principals’ investing activity, firm management, and portfolio company management – indemnifiable and non-indemnifiable
• Errors & omissions – liability to the limited partners or PE investors
• Outside director liability – service on portfolio company boards
• Regulatory/governmental oversight exposures (they do exist)
Claims to which VC / PE are susceptible

- State law tort claims, including breach of fiduciary duty, fraudulent/negligent misrepresentation, fraud (and aiding and abetting)
  - Founder disputes

- Private securities litigation / derivative actions
  - Co-investor claims by other VC firms (largest investor had superior knowledge)
  - Claims by individual participants in smaller investors
  - Claims against board member and board observers, including re: insider trading
Claims to which VC/PE are susceptible, cont’d

- Larger Context: securities claims and derivative actions are on the rise, generally
- PSLRA cases have been at record-high levels over the past two years
  - 100% increase securities class action filings in 2018 (as compared to the 1997-2017 annual average)*
  - In 2018, more companies on U.S. exchanges were sued than in any previous year.
  - Derivative cases are also on the rise due to #meToo and privacy/data breach allegations**

* Source: Cornerstone Research, Securities Class Action Filings: 2018 Year in Review
Claims to which VC/PE are susceptible, cont’d

- New securities exposure: large IPO/secondary offering cases (1933 Act) in state courts in CA, NY and other states
  - 1933 Securities Act claims impose strict liability where prospectus/public offering materials include material misstatements or omissions
  - 30 state court filings of 1933 Act claims in 2018, a sharp increase over 2017
Claims to which VC/PE are susceptible, cont’d

• Other types of claims
  • Trade secret misappropriation
  • Gray area: representations and warranties
  • On the rise: employment practices liability
    • Criticisms of responses to #metoo complaints
Policy Form: Who and what is covered?

• Intended to provide coverage for all of the firm’s:
  • Entities
    • Management company, subsidiaries, funds, entity fund managers, and investment holding companies
  • People
    • General partners, directors and officers, employees, board members, shareholder reps*
  • Activities
    • “Private Equity Venture Investing” / “Professional Services” (defined term encompassing all investments out of the fund and services to portfolio companies)
    • “Outside Director Liability”
### Private Equity / VCAP Insuring Agreements

<table>
<thead>
<tr>
<th>PERSONAL VC/PE (Non-Indemnifiable)</th>
<th>PERSONAL VC/PE (Indemnifiable)</th>
<th>ERRORS &amp; OMISSIONS E&amp;O</th>
<th>OUTSIDE DIRECTOR ODL</th>
<th>EMPLOYMENT PRACTICES EPL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provides protection when indemnification is not available.</td>
<td>Transfers the fund’s indemnity obligation to insurance.</td>
<td>Transfers professional liability risk to insurance.</td>
<td>Provides additional coverage to outside board members.</td>
<td>Transfers risk from employee suits to insurance.</td>
</tr>
<tr>
<td>Losses arising from activities when indemnification from the fund is not available.</td>
<td>Losses arising from activities when indemnification from the fund is available.</td>
<td>Claims alleging an insured has done something wrong or has failed to do something he or she should have.</td>
<td>Claims involving your investing professionals in their capacity as a board member of a portfolio company.</td>
<td>Claims asserting the failure of the firm to hire or promote or alleging wrongful termination, sexual harassment and discrimination.</td>
</tr>
<tr>
<td>No deductible.</td>
<td>Deductible applies</td>
<td>Deductible applies</td>
<td>No deductible, but responds after any other insurance or indemnification is exhausted at the portfolio company.</td>
<td>Deductible applies</td>
</tr>
</tbody>
</table>

- The personal VC/PE coverage noted above will usually include entity coverage comparable to D&O “Side C.”
Key Coverage Issues: Similarities to D&O

• Insured v. Insured Exclusion
  • Should be converted to Company v. Insured, if possible
  • Exceptions to I v. I can include an exception for claims by a Fund against a general partner(s) for mismanagement

• Conduct exclusions
• Disgorgement/restitution exclusions
• Duty to pay defense costs: no cap on rates
• Allocation language
• Claims-made-and-reported (sometimes possible to negotiate for a prejudice standard on late notice)
• Some coverage for investigations/regulatory proceedings
Unique coverage issues

• Complex ownership structures require a broad definition of “Insured” under all coverages
  • Definition works from the bottom-up, not top-down (unlike D&O policies, which cover the “Organization” and any “Subsidiary”)
• Shareholder representative exposures (natural person vs. institutional shareholder representative)
• ODL coverage and its “drop-down” requirement
  • Sits excess of both PortCo insurance and indemnification
  • Ideally, should include a “reasonable efforts” standard
Unique coverage issues: EPL

- “Duty to defend”-type coverage
  - Can be a poor fit for VC / PE policyholders
  - If modified, allocation of 100% of defense costs to covered Loss?
- Recoverability of various kinds of damages on employment claims (owed income – e.g., salary, carry – not covered)
- “Customer” coverage in EPL policies an awkward fit for VC / PE firms → can be modified to be more effective
Underwriter’s Perspective: Claims Trends

- Portfolio company related claims
  - Exit-related issues (e.g., bankruptcy, misrepresentation, valuations, etc.)
  - Outside director liability
- Regulatory actions
  - Impact from registration
  - Fee actions
- Internal conflict
  - Partner disputes
  - Lift-out claims
  - Employment practices
Questions?