

By Pamela W. Mason, AAI

Questions Every Outside Director Should Ask About Their Portfolio Company's D&O Insurance

Venture capital and private equity partners are being sued in their capacity as directors of portfolio companies. The lawsuit against Benchmark Capital earlier this year is just a single, very public example of the type of litigation that directors of public and private portfolio companies are experiencing. These claims are expensive for the firm itself and create a personal liability for the individual serving as director. Directors may take some comfort in the fact that the portfolio company buys Directors and Officers (D&O) Liability insurance but, more likely than not, this comfort will be fleeting if the director is ever sued. The fact is that most D&O Liability policies of this type provide far less protection against individual liability than venture capital or private equity firms often attribute to them.

Avoiding the risk by not taking a board seat is probably not an option. Serving as a director of a portfolio company is not an elective decision, but instead is often a core part of the value a firm brings to its investment. So for most firms, this risk of personal liability arising out of outside directorships is simply a necessary part of the business. Accordingly, here's some fairly inexpensive and easily implemented techniques that can be used to better manage the risk to liability arising out of outside directorships:

Be Specific and Look at the Details

Unfortunately, many board members fail to inquire if the D&O policy purchased by a portfolio company provides more than minimal protection. Not only is it possible, but it is critical for a director to be proactive at the outset and take the necessary steps to negotiate the terms and requirements of a portfolio company's D&O policy. Venture capital and private equity firms and their management face a variety of exposures at the portfolio company level. The overall success of the investment is a business risk that cannot be insured. However, a D&O policy purchased by the portfolio company can provide coverage for certain actions and decisions that were made by the portfolio company and its management that contribute to the business's overall success or failure.

Most venture capital and private equity firms require the purchase of D&O insurance on the term sheets negotiated with their portfolio companies. Some of these term sheets are more specific than others, but most term sheets merely state that the portfolio company must purchase D&O coverage. No further specific or detailed coverage requirements are stated. An enormous amount of time and due diligence goes into investing in a certain

Mason & Mason Technology Insurance Services, Inc.

458 South Avenue | Whitman, MA 02382 | T: (+1) 781-447-5531 | F: (+1) 781-447-7230 | www.masoninsure.com

portfolio company. Shouldn't the same, detailed consideration be given to the term sheet requirement that the portfolio company buy D&O coverage, especially with your personal liability at stake?

Astute outside directors should establish a protocol relative to the D&O coverage purchased at the portfolio company level.

Term Sheets

To the extent possible, basic D&O coverage requirements should be outlined in the term sheet between the venture capital or private equity firm and the target investment. Content of this section should, at a minimum, include

- **Coverage to be Provided:** Make sure the coverage fits the exposure. Differing from public company D&O coverage, coverage for private companies typically includes coverage for employment related matters (i.e. discrimination, wrongful termination, harassment) or other management liability coverages (i.e. fiduciary liability, crime or professional liability). Claims involving other coverage components can impair or exhaust limits available for outside directorship protection for D&O claims.
- **Required Limits of Liability:** Don't leave this open to interpretation. The existence of the different coverage sections mentioned above, the many parties considered "insureds" and expenses incurred to defend the portfolio company and its directors and officers all contribute to impair or exhaust policy limits. Make sure the required limit is enough to protect you, and request "split limits" endorsements in private company coverages so that the D&O coverage has its own dedicated limit in the policy.
- **Quality of Insurer:** Is the insurer your portfolio company chooses to do business with going to be solvent in the future to pay claims? Make sure the insurer is AM Best rated A or better. Also, consider how the insurer will handle different insured party's requests to use their own defense counsel. Complicated claims scenarios involving many defendants can arise. Make sure you're not in a position where you're forced to use the insurer's counsel, as it may or may not be your first choice.

Be Involved in the Portfolio's D&O Coverage Decision

Although this is frequently easier said than done, outside board members can influence the D&O buying decisions of their portfolio companies. D&O policies differ from one insurer to another, so there is no "standardized" approach to buying D&O insurance, which creates a potentially hazardous situation for outside board members. How do you know that the coverage purchased reflects the best terms and conditions available to the portfolio company? Without beginning a new career as a D&O specialist, you can make an assessment by considering some of the most important, negotiable elements of a D&O policy.

Mason & Mason Technology Insurance Services, Inc.

458 South Avenue | Whitman, MA 02382 | T: (+1) 781-447-5531 | F: (+1) 781-447-7230 | www.masoninsure.com

- **Representations, Severability and Non-rescindable A-Side Coverage:** An insurer can completely void a policy if the application it relied upon from the portfolio company is determined to contain misrepresentations (whether you're aware of them or not). It should be noted that insurers vary on their approach, but to the extent possible, make sure the policy is fully severable for insured persons. With this provision, the knowledge of one insured person cannot be imputed to another relative to the granting of coverage under the policy. Keep in mind that severability does not mean the insurer cannot rescind a policy. Therefore, it is equally important to make sure that the insurer provides "non-rescindable A-side coverage," which means that an insurer cannot take away coverage for innocent directors or officers where no other indemnification is available to them.
- **Personal Conduct Exclusions:** All D&O policies contain exclusions for fraud and for personal profit to which one wasn't legally entitled, but how these most important exclusions are worded forms the basis of whether coverage would apply in the event of a claim. Forms that address these exclusions with "in fact" wording are perilous as the insurer could negate coverage based upon the mere allegation of such personal conduct. The policy should be amended so the personal conduct exclusions would only apply once it has been determined through "final adjudication in the underlying action" that fraud or personal profit actually occurred. As most cases will settle prior to any judicial proceeding, an insurer is then unable to deny a claim based upon such personal conduct exclusions.
- **Important Policy Definitions:** What constitutes a "Claim" under a D&O policy is critical, as it is the gateway to the rest of the policy. This definition needs to be broad enough to trigger coverage as early as possible to catch matters that may not be elevated enough to be a "written demand for monetary or non-monetary relief" or "civil, criminal, arbitration or administrative proceedings." An example of this would be investigations against insured persons. If at all possible, obtain coverage for investigations against the company as well.

Make sure that the definition of "Loss" incorporates coverage for punitive and exemplary damages to be determined by the laws in the "most favorable venue", in addition to the standard components of damages, judgments, settlements and defense costs. Depending upon the nature of a specific claim, punitive damages can be an expensive aspect of settlement.

- **Be Careful of Other Policy Restrictions:** There are a myriad of other issues that you need to be wary of. Some of these might be built into the policy form; others are sometimes added by endorsement. Here are some that are noteworthy.

Mason & Mason Technology Insurance Services, Inc.

458 South Avenue | Whitman, MA 02382 | T: (+1) 781-447-5531 | F: (+1) 781-447-7230 | www.masoninsure.com

Many insurers will exclude claims relating to “professional services” that a portfolio company may provide. Depending upon how it is written, the existence of this exclusion could effectively negate any coverage provided by the portfolio company’s policy. Ideally, no such exclusion should apply, but if it is a requirement, make sure it carves out claims brought by shareholders or for securities claims.

Be aware of any “Failure to Maintain Insurance” exclusion as it could negate coverage for claims associated with the portfolio company’s failure to (1) buy certain types of coverage to address aspects of its risk profile or (2) buy “adequate” coverage to address such risk profile. Don’t accept these exclusions.

D&O policies for private companies will likely contain an Initial Public Offering exclusion. Make sure the exclusion isn’t broad enough to negate coverage if a scheduled IPO fails to go off.

Insolvency is a significant source of claim, typically brought by the appointed trustee against former management. An insolvent company doesn’t have money to indemnify so the policy proceeds are extremely important. But isn’t the trustee now considered an insured as “the company”? Amend the policy to state that claims brought by a bankruptcy trustee will specifically covered.

Put yourself at the head of the line. If there were a claim involving insured persons as well as the insured entity, the policy should specify that the insured persons would receive policy proceeds first, followed by the insured entity.

Backstop with Venture Capital Asset Protection (VCAP) Coverage

The best belt and suspenders approach to protection of your personal wealth is solid D&O coverage at the portfolio level, supported by a VCAP policy purchased by the firm.

In the event that the portfolio company does not have insurance in effect to protect you and cannot indemnify you, a VCAP policy will provide coverage for your capacity as a portfolio company outside director. VCAP also provides significant protection relative to litigation involving “control person” liability. This would not be covered by the portfolio company’s D&O insurance.

Mason & Mason Technology Insurance Services, Inc.

458 South Avenue | Whitman, MA 02382 | T: (+1) 781-447-5531 | F: (+1) 781-447-7230 | www.masoninsure.com

Find a Qualified Broker

Many portfolio company D&O programs are insufficient because the insurance professionals working on behalf of the portfolio company may not have expertise in D&O insurance. Simply put, it is hard to negotiate the best possible D&O terms when you don't know what to ask for. If necessary, assist your portfolio company in choosing a qualified insurance broker, not one who is their neighbor, friend or brother-in-law.

Every portfolio company presents a different risk profile. D&O underwriters provide their best terms when they fully understand all elements of a company's operations and financials. More information is best.

Following the recent release of the VCAP program for members of the National Venture Capital Association (NVCA), TechAssure, an association of specialty brokers endorsed by the NVCA, will soon be releasing a Portfolio Company Management Liability Program. This program will provide very comprehensive coverage (addressing items outlined above, and more) as well as the most competitive pricing available.

Pamela W. Mason, AAI, is VP and Management Liability Practice Leader at Mason & Mason Technology Insurance Services, Inc. and a founding member of TechAssure, the endorsed broker of the National Venture Capital Association. She specializes in risk assessment and coverage solutions for private equity and venture capital liability, corporate securities liability, directors and officers liability, portfolio liability programs, and other management liability coverages. She can be reached at pammason@masoninsure.com or 781-447-5531 X132.

Mason & Mason Technology Insurance Services, Inc.

458 South Avenue | Whitman, MA 02382 | T: (+1) 781-447-5531 | F: (+1) 781-447-7230 | www.masoninsure.com