

By Pamela W. Mason, AAI

## IPO Exits: With the Assets, Watch the Liabilities

The recent class action lawsuits filed against Sourcefire, Inc., the firm's investors (including Sierra Ventures), directors (including Sierra Venture's Managing Director) and underwriters is a concise example of IPO disclosure-based liability. The complaints allege that the Registration Statement failed to disclose material facts, principally that one of Sourcefire's main customers, the US Federal government, had significantly reduced its purchasing of the company's products. This news was disclosed one week after the Sourcefire's IPO; and plaintiffs contend that this information was known by the defendants and could have been properly disclosed before the IPO launch. News of the disclosure resulted in very disappointing quarterly results and the stock plummeted 30% on heavy trading volume.

Disclosures made in a company's prospectus and registration statements are regulated by federal securities laws. Of significance are Section 11, Civil Liabilities on Account of False Registration Statement, and Section 12, Civil Liabilities Arising in Connection with Prospectuses and Communications, of The Securities Act of 1933 (The '33 Act). Under these Sections, in the event the prospectus or registration statement "contained an untrue statement of a material fact or omitted to state a material fact" that mislead any person who acquired securities, strict liability is imposed upon every person who signed the registration statement as well as every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted.

This case will likely be litigated for years to come, drawing financial and human resources from all of the firms and individuals involved. However, looking at the circumstances surrounding it presents a good time to evaluate the comprehensiveness of Directors & Officers Liability (D&O) coverage available to VCs and their portfolio board representatives.

The first line of defense for a VC representative serving as a director on a portfolio company board is indemnification by the portfolio company to its director. If the portfolio company cannot indemnify its directors due to financial insolvency, D & O coverage purchased by the portfolio company should pay the individual director on a first-dollar basis. Important points for consideration include:

- In what capacity have you been sued? A portfolio company's D&O coverage will cover a person sued in their capacity as a director or officer. It will not automatically cover an outside board member in his/her capacity as a selling or controlling shareholder.

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- Are the portfolio company’s D&O limits sufficient? Securities litigation can be very expensive to defend and with multiple defendants drawing from the same source, limits can be exhausted quickly.
- How will the proceeds of the policy be distributed? Will the costs of defending the corporate entity leave individual directors without coverage?
- If you’re sued under Section 11 and Section 12, will the D&O policy exclude a portion of the settlement if the loss is considered as “ill gotten gains”?
- Will the mere allegation of fraud or personal profit negate coverage for you?
- Will the wrongful act of another insured person be imputed to you relative to the policy’s exclusions (i.e. if one person is accused of fraud, will that negate coverage for you)?
- Similarly, is one insured’s knowledge or representation in the D&O application severable between all insureds? Can the insurer rescind the policy?
- Can you choose your own counsel?
- Are SEC inquiries considered a covered “Claim”?
- How is the overall D&O program structured? Is there any dedicated “A-Side” coverage, such that your personal liability is addressed if there is no indemnification available to you (either via financial insolvency, derivative action or some other event that is not indemnifiable by the portfolio company charter)?

What if the portfolio company is unable to indemnify and no recourse is available via any portfolio company D&O insurance due to its non-existence or exhaustion by payment of claims? There is likely indemnification available from the Fund, but what if the Fund is in its later stages: Will LPs be happy to contribute more capital to fund defense? A sound option for a VC representative serving as a portfolio company director is coverage from the “Outside Directorship” extension of a Venture Capital Asset Protection (VCAP) policy purchased by the VC firm itself. Claims made directly against a venture fund would also be covered under this policy. But the devil is in the detail in that these policies are not standardized and vary significantly from one form to another. In addition to the issues raised above for portfolio company D&O coverage, some additional items that need to be contemplated are:

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- Will the VCAP cover claims arising out of public portfolio companies? Many policies will only cover public portfolio companies on a scheduled basis.
- Will the “Outside Directorship” coverage cover you on a “first dollar” basis, or do you need to personally fund a deductible?
- If covered by the same insurer, is there any “stacking of limits” provision between the VCAP policy and the portfolio company D&O policy capping the overall amount of coverage available for one claim?
- Is there any “crisis fund” coverage to address any PR expenses that the VC might incur arising out of such litigation against it?

The bottom line is that if you have a portfolio company targeting an IPO exit strategy, the VC firm should employ the same level of inquiry to its own exposures as is executed at the portfolio company level. Don’t leave the decision to the portfolio company exclusively as your needs and exposures may vary significantly. Consider the how the firm’s VCAP coverage applies and engage outside counsel and insurance professionals to conduct this review. Understanding and anticipating exposure to risk for IPO exits is a fundamental necessity in the design of Directors and Officers Liability coverage for portfolio companies and their VC investors.

The National Venture Capital Association and TechAssure have partnered to provide unsurpassed Directors & Officers protection to VC firms and their portfolio companies. Through consultation with NVCA members, reputable legal experts and insurers, TechAssure has designed comprehensive coverage solutions that a VC firm and its portfolio companies would expect from policies of this type. The programs offered by TechAssure to NVCA members are also making this coverage more affordable, with many NVCA members and their portfolio companies enjoying significant premium savings over what they’ve paid in the past.

Following several years of less than ideal market conditions, the IPO exit strategy has been resurrected in 2007 with 115 launched in the first half of the year, of which more than one third are generated by venture-backed portfolio companies. Successful IPOs are certainly a win-win for venture firms and their LPs, but those that miss the mark can leave the venture firm back-peddling to determine what went awry. It can also leave the venture firm and its portfolio company board representative embroiled in securities litigation.

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](mailto:pammason@masoninsure.com) or 781-447-5531 X132.

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