

By Pamela W. Mason, AAI

How Solid Is Indemnification?

Venture capitalists are calculated risk takers; and this approach has rewarded many of them and their limited partner investors. But how much risk are they willing to take when it comes to their firm's liability? Or their own personal liability? Many VC partners take comfort knowing they will be protected by indemnification from the fund, the fund management company or a portfolio company if they are sued while serving on its board. But how far does that indemnification protection go?

If the individual was grossly negligent, chances are the partnership agreement offers no protection.

Indemnification is also unavailable if the individual did not act in good faith, engaged in willful misconduct or committed a criminal act. Additionally, limited partner suits, while rare, are often brought as "derivative actions," for which indemnification is limited or prohibited by law in most states. As for suits against partners serving as directors of their portfolio companies, no indemnification is available from the portfolio company for allegations of wrongdoing in their capacity as a partner or control person. "When a partner serving on a portfolio company board gets sued, it's fairly common for that partner to be sued in a dual capacity, meaning, allegations are brought against that individual in his or her capacity as both a portfolio company director AND partner of his or her firm," says Ric Duenaz, Venture Capital & Private Equity Professional Liability Worldwide Manager for the Chubb Group of Insurance Companies. Not only doesn't the portfolio company indemnification respond to the partner-specific charges, neither does its D&O policy, if one is in place.

Most partnership agreements afford indemnification for actions a partner takes serving the fund or while serving on a portfolio company board. Such indemnification includes funding for legal defense until it is "finally adjudicated" (in a suit, action or proceeding, including arbitration) that the person was grossly negligent, did not act in good faith or committed a criminal act. But if that happens, the individual has to pay the fund back for their defense costs, not to mention the actual damages owed.

A "final adjudication" usually happens after years of litigation, depositions and other time spent not focusing on the business of identifying promising companies and investing in them. One way to avoid this is to settle the matter quickly. But even if the fund can indemnify the individuals (e.g., the lawsuit is not a derivative suit or indemnification is not precluded by the partnership agreement), VCs are hesitant to do this, as settlements divert money from the fund and negatively impact IRR. This could lead to disputes with fund investors. Such feuds are rare in the VC community, but when they happen, they rarely occur early during a fund's life;

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rather they happen when the fund is later stage and there is little money left in the fund to satisfy indemnification obligations. This forces VCs to choose between calling on LPs for cash when LPs are already upset with investment returns or digging into their own pocket to fund a settlement.

Many VC firms buy Venture Capital Liability Insurance (VCAP) as an alternative to paying for indemnification obligations out of the fund. But VCAP insurance can also protect individuals in situations where they would not have the benefit of indemnification from the fund, such as derivative actions or when the allegation is “gross negligence.” A properly structured VCAP policy can provide for defense of certain claims even after a final adjudication, but it can also keep things from getting to that point by providing a funding source for a settlement that doesn’t impact the fund. “VCAP insurance can provide an important firewall of protection for VCs against the risks of personal liability,” says Carl Metzger, a partner at Goodwin Procter LLC, who specializes in VC litigation and risk management.

The National Venture Capital Association and TechAssure have partnered to provide unsurpassed management liability insurance (VCAP) protection to VC firms. Through consultation with NVCA members, reputable legal experts and insurers, TechAssure has designed comprehensive coverage solutions that a VC firm 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 enjoying significant premium savings over what they’ve paid in the past.

Litigation against venture firms, their partners and employees is not common, but has been increasing recently and is usually significant when it happens. Ask your legal counsel for advice on avoiding litigation and consider VCAP insurance to protect fund performance, firm assets and personal liability.

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