

Introduction

Managing venture capital investments on an enterprise-wide basis is complex and the risk of liability can be significant. Most venture capital (VC) firms use classic methods to transfer the personal liability risk of their general partners, but these methods are often not adequate. Many VC firms miss opportunities to mitigate risks on an enterprise-wide basis leaving them vulnerable. In many instances these often-overlooked risks are easily managed with affordable insurance products that are designed to preserve capital and maintain business continuity. This article addresses: (1) additional risks associated with portfolio companies; (2) reasons why many VC firms fail to develop complete risk-management programs; (3) reasons why VC firms should expand their risk management programs; and (4) steps that can be taken to mitigate risks associated with portfolio companies.

Background: Classic Risk Transfer

Classic risk transfer techniques utilize contracts and insurance to shift the personal liability risks of the general partner (or those individuals controlling the general partner). Techniques include: (1) providing for specific indemnification of the general partner as an aspect of the terms of the investment in a particular portfolio company; (2) requiring the general partner (or an individual controlling the general partner) to serve on the board of the portfolio company; (3) requiring the portfolio company to maximize indemnification requirements in the bylaws; (4) requiring the directors and officers of the VC firm's underlying portfolio companies to individually purchase Directors and Officers (D&O) liability insurance; (5) mandating the purchase of appropriate Venture Capital Liability Insurance; and (6) insisting that the lives of key individuals in their portfolio companies are appropriately insured.

Additional Risk Associated with Portfolio Companies

Although most VC firms utilize classic risk transfer techniques, many miss opportunities to control and transfer other types of risk faced by their portfolio companies. Commonly overlooked risks can be surprising. One example of an opportunity to mitigate risks of portfolio company investments on a broader, enterprise-wide basis is the potential catastrophic exposure faced by emerging growth companies in connection with liability arising from the operation of motor vehicles in the course of business. A serious loss in this area could cripple a business strategy and its future value by absorbing significant capital intended for investment purposes. Moreover, the officers and directors of a portfolio company that suffered an uninsured loss of this nature may also face additional liability for failure to adequately address the investment's need for insurance. In the event a particular D&O policy has an exclusion for "failure to maintain insurance" and there are not enough assets for a remedy at the portfolio level, then the VC firm faces a risk of the liability flowing back to the VC general and limited partners. The oversight of this type of manageable risk may be very poorly received by the VC's investors, and could adversely impact the firm's ability to conduct business as well as adversely impact the firm's long-term reputation.

Reasons Why Many VC Firms Fail to Develop Complete Risk-Management Programs

Implementing a broader risk mitigation and risk transfer regime among a VC firm's portfolio companies may be challenging and many, therefore, fail to do it. The first challenge is resources. Many VCs have few internal resources available to manage additional oversight in this arena. Second, many VC firms have traditionally preferred to leave decisions related to insurance purchases and risk management directly in the hands of the senior managers of their portfolio companies. The last challenge is misperception. There have been relatively few public examples of these types of losses to illustrate the criticality of a comprehensive risk management strategy. Hence, many VC firms do not see the importance of dedicating resources toward devising, implementing and monitoring an effective and efficient strategy for addressing catastrophic losses.

Reasons Why VC Firms Should Expand Their Risk Management Programs



There are many important reasons for VC firms to assert greater influence over how their portfolio investment companies manage their insurance and risk control programs, such as:

- ensuring that personal liability is addressed by state-of-the-art D&O liability coverage, which requires far more diligence and scrutiny than checking a box on a list of term sheet requirements (D&O insurance is highly negotiable and the quality of coverage in D&O insurance policies varies widely and;
- protecting invested capital for the growth and development of a portfolio company by maximizing relatively affordable insurance transfer opportunities;
- installing effective mechanisms that allow for meaningful business continuity planning at the portfolio level;
- reducing unnecessary investment risk;
- providing more certainty to the ongoing viability of portfolio investments;
- minimizing financial damage from claims against venture funds by providing an alternative source of payment for losses; and
- preserving the reputation of the venture firm among LPs and the investment community.

Steps That Can Be Taken to Mitigate Risks Associated with Portfolio Companies

Some of the insurance coverages that address risks typically associated with a portfolio risk management program include:

- property insurance, including business interruption and coverage for research and development documentation;
- automobile insurance for liability exposures anywhere the company may be operating motor vehicles (including rented cars overseas);
- Commercial General Liability (CGL) coverage including products and completed operations (a very common deficiency in programs for emerging growth companies);
- Workers' Compensation as mandated by state law and a requirement for subcontractors and contract workers to document their own coverage;

- umbrella liability insurance at a level that is appropriate to cover catastrophic exposures;
- professional Errors and Omissions (E&O) insurance for the exposure created by a product or service offering that could cause financial losses and the associated liability to third parties (if applicable);
- international insurance coverage for any overseas operations or travel where the domestic policies have territory limitations; and
- management liability insurance including properly negotiated D&O, Employment Practices Liability (EPL) and Fiduciary Liability coverages.

Strategies that can be employed to assure portfolio company compliance and effective risk transfer may include:

- mandating more insurance coverage specifics in term sheets;
- requiring a current Certificate of Insurance from the portfolio company summarizing the mandated coverages and naming the venture fund and firm as additional insureds and loss payees as their interests may appear; and,
- working with an insurance broker that specializes in emerging growth companies and venture capital liability to craft a program that will provide certitude and consistency across the portfolio. In most cases, the premiums associated with such an approach can be leveraged in negotiations with insurers and can actually reduce the upfront costs for the entire portfolio as well.

Conclusion: New Strategies for a New Era

Venture capital firms should alter their approach to past portfolio risk management strategies to address the new era of business scrutiny and regulation. The financial well being of emerging growth companies is threatened more now than ever before by greater prospects of significant liability and other types of losses that may adversely impact them. Portfolio risk management and insurance programs should be viewed as an extension of the VC firm's own program. A first step for adopting this strategy is to elevate corporate awareness of the risks associated with failing to exercise thoughtful management of portfolio exposures. Insurance brokers who specialize in advising and

insuring emerging growth companies and venture capital firms can provide clear and effective strategies that will reduce risk, reduce costs and provide more security to all parties involved.

The detail and complexity inherent in implementing comprehensive programs can also be simplified by retaining a trustworthy insurance expert to assist in the development and implementation of a portfolio enterprise risk program. Additionally, there are new technology solutions available to assist venture firms with the internal administration and management of their mandated portfolio insurance requirements. In the end, the commitment of time and resources is an appropriate investment that will greatly reduce risk within a VCs portfolio. Most uninsured or underinsured losses can easily be prevented with good discipline and expert assistance. The sooner a VC adopts a strategy of thorough risk transfer across its entire portfolio, the sooner it can focus on what it does best: gaining a return on invested capital.

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*David Schaefer is the leader of AH&T's technology and management liability practice groups. His accomplishments include building one of the largest independent technology insurance and risk management practices in the nation and being the principal architect of [Ensuring Integrity](#), an innovative D&O loss prevention program for public companies. Mr. Schaefer advises venture capital and private equity firms as well as their portfolio companies on a variety of risk management and insurance issues. As the chairman of [TechAssure](#), a consortium of insurance and risk specialists focused on technology exposures, he serves as the relationship manager with the National Venture Capital Association (NVCA) and manages the association's endorsed insurance program, *VentureInsure*, for members and their portfolio investments*

