Risk Exposures of Private Equity and Venture Capital Firms

Understanding the risk associated with fund management is imperative in today's litigious society. Lawsuits can be founded or frivolous to which plaintiff attorneys do not discriminate. Private equity (PE) and venture capital (VC) firms are vulnerable to litigation, which can be costly to defend and even more expensive to settle.

Consider the following questions this information brief will attempt to answer:

- What are the liability exposures?
- What are typical allegations against PE/VC firms?
- Are the fund's investment returns at risk?
- How do individual general partners and partnership management groups transfer liability risk?

Board Representation

Claims filed against portfolio company board members can originate from various sources: company, competitors, suppliers, vendors, governmental/regulatory agencies, company employees and management as well as other board members. An individual can be sued in his capacity as a board member of a portfolio company or in his capacity as an investment advisor. Also, under the "control person" legal theory, board representation presents liability exposures for the general partner and the fund.

Fund Management

Limited partners expect general partners to manage the fund according to guidelines outlined in private placement memorandums. Investors expect due diligence, good faith, loyalty, care and other fiduciary duties from general partners. Lawsuits can be filed when it appears that any of these responsibilities have been breached. Although partnership agreements provide protection for the general partner, such indemnification can be circumvented by lawsuits alleging general partner gross negligence.

Deal Evaluation

When a prospective deal collapses, portfolio companies assert allegations seeking damages from lost financing opportunities and the misuse of their proprietary and confidential information, i.e. the portfolio company was "strung along" by the VC/PE firm.

Crime / Financial Fidelity

Criminal schemes can last for years and cost an organization dearly. Financial fidelity risk exposure includes employee dishonesty, forgery, theft, destruction and disappearance of property.

Employment Practice

Members of the portfolio company's management team may have been replaced post-deal, creating potential claims for wrongful termination. These claims implicate VC/PE firms especially in Common Wealth and EU Countries.

Fund's Investment Returns – At Risk?

Consider the fund's risk. As previously stated, general partner liability is almost always guaranteed by the partnership agreement's indemnification provision (except for gross negligence). However, when third-party suits are filed against the general partner and/or the partnership, the fund is ultimately responsible for defence/legal costs, judgments and settlements. Such claim expenses would reduce the fund's investment returns.

Transfer the Risk – How?

The insurance industry has responded to venture capital/private equity business risks

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by creating an industry-specific coverage transferring these exposures. Coverage is provided for the following:

- Directors & Officers Liability and Company Reimbursement (D&O)
- Separate legal protection for Directors & Officers (in addition to a D&O policy)
- Professional Liability (Errors & Omissions)
- Outside Directorship Liability (on portfolio boards)
- Fidelity insurance to protect against occupational fraud and theft
- Employment Practices Liability

Transfer the Risk – How Much?

The cost and amount of insurance protection needed is based on: Total assets under management, number of board seats represented by the fund, ability/desire to self-insure, investment focus, and fund manager experience

So how much limit should be carried?

Exposure is increased or decreased by the factors listed previously. Typical market cost for a CHF 5M limit of liability, with CHF 50M of assets under management ranges from CHF 15,000 to CHF 35,000 considering the factors listed above. Minimum deductibles range from CHF 25,000 to 50,000.

Recommended guidelines relative to assets under management are as follows:

- < CHF 10M: CHF 1-3M limit
- CHF 10M to CHF 50M: CHF 3-5M limit
- CHF 50M to CHF 200M: CHF 5-10M limit (minimum)
- > CHF 200M: CHF 10+M limit (minimum)

Policies will name all necessary entities for coverage, i.e. partnerships, general partners, management companies, advisory boards etc., ensuring coverage for all potential targets of litigation.

Conclusion

No matter how well a fund is managed, litigation can be brought by many possible sources. The costs to defend and/or settle these claims will reduce the fund's returns, leaving investors to pay these costs. Transferring this risk for a known, fixed cost will eliminate the risk of unexpected loss from liability claims. If you do not currently purchase this protection or are interested in more information on the inherent risks facing VC/PE firms, please contact Gregory Walker.

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