GUEST ARTICLE

TOP FIVE RISK MANAGEMENT TIPS FOR VENTURE CAPITALISTS

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The modern U.S. venture capital industry had its first flowering in the 1970s, in fields that lay fallow after a stiff recession. Since that time, by many accounts, the U.S. economy has been in nine more recessions, of varying magnitude and duration, including the one that we're told we're presently recovering from.

As corporate litigation and risk management lawyers, it's not our place to assess the most recent recession relative to others, except to note the obvious: It has been severe, and asset values have been materially reduced across the board. Signs of a recovery are emerging, but any recovery is still expected to be gradual and halting.

Our job in this context is to look ahead and identify practical protective steps that venture capital firms can take to reduce litigation risk, and to better position themselves for the favorable disposition of any disputes that may nonetheless arise from corporate finance and other transactions undertaken in this environment. The simple fact is that deals done in downturns are far more likely to result in stockholder disputes and lawsuits down the road—after asset values have recovered and hindsight and second-guessing have set in. How do VC firms best protect their interests?

Here are our top five suggestions for reducing that risk:

1. Migrate ... to Delaware

All of a firm's portfolio companies should be Delaware corporations. In our view, there is no advantage to incorporating elsewhere that withstands thorough analysis. This is an exceedingly simple point, but it is of key importance from a risk management perspective.

There are four basic reasons that support this statement: Delaware corporate law is far better developed than that of any other state; the judiciary is of consistently high quality; legal outcomes, while never guaranteed, are consequently more predictable and more certain; and, the personal assets of individual directors and stockholders are better protected.

So, if the firm has portfolio companies that are not Delaware-incorporated, and a significant transaction is anticipated, such as a debt or equity financing, recapitalization or restructuring, consider also conducting a migratory merger to Delaware. For experienced counsel, a migratory merger is a relatively simple exercise, particularly if the firm can fairly anticipate a favorable stockholder vote. In addition, in the context of a significant transaction, the incremental effort is relatively modest. The benefits, however, can be substantial.

One detail, all too often overlooked, is that from a risk management perspective, an effective migratory merger consists of more than the adoption of a Delaware corporate charter. In addition, the various stockholder agreements also need to be amended in parallel—to call out Delaware as the governing law, and its Court of Chancery as the forum for resolving disputes. Otherwise, there is risk of having pointless "sideshows" about what law actually governs a particular dispute, what court has authority to resolve that dispute, and so forth.

2. Invite Everybody to the Party

The basic rules of childhood once again prove their durability. If a portfolio company is undergoing a down-market financing or recapitalization, consideration should be given to inviting all accredited investors to participate on the same terms—regardless of whether they have express contractual rights of participation.

Offering such participation protects venture firms and corporate directors in two ways. If a stockholder cannot confirm accredited investor status, it is difficult to blame anyone when the law does not permit that stockholder to play. In addition, it is far more difficult for disgruntled stockholders to claim unfair dilution if they were invited to participate on the same terms as others and, for whatever reason, they elected not to do so. In most instances, the marginal dilutive effect on the professional investors who

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are providing the bulk of the new money will be immaterial.

3. Upgrade Company Infrastructure

"Infrastructure reinvestment" is one of the hallmarks of the current administration's plan for the nation's economic recovery. The concept applies to portfolio companies, as well. There is no better time to inspect and upgrade infrastructure than right now.

Two elements of portfolio company infrastructure stand out as having the most meaningful impact on risk management: an adequate finance and accounting function, and a properly composed board of directors.

The entire process of seeking portfolio company liquidity—be it an IPO or, more likely, an M&A transaction—will be significantly enhanced if the company has consistently maintained an accounting and finance function adequate to meet its needs throughout its development.

The term "enhanced" does not simply mean that the process will go more smoothly. It also means a significant reduction in the risk of uncovering errors, omissions and irregularities that can negatively impact valuation, derail negotiations altogether, or cause the company to miss a market window.

Literally months can be consumed in "diligencing" accounting issues after the fact and preparing fresh financial statements. Inquire into the adequacy of these functions at your more mature, revenue-generating portfolio companies, where the issue is most likely to have a material impact: Does the company have personnel with the requisite knowledge and experience for the tasks at hand? Is the accounting and finance function adequately staffed? What do the auditors say?

Similarly, review the composition of the boards of directors of the firm's more mature portfolio companies. Does each board have at least two independent, outside directors? Are the boards of the companies that are closest to a liquidity event composed of a majority of independent outside directors? If not, are candidates available, or can they be found?

Why the preoccupation with board composition? Because corporate transactions and events undertaken in a recession—down-round financings, recapitalizations, executive terminations and the like—are often driven by, or at least perceived to be driven by, existing investors holding one or more board seats, who are then invariably claimed to have acted out of self-interest.

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Risk management in this context, where corporate and stockholder interests may diverge and conflict, is about vesting the corporation's authority and decision in the hands of competent and disinterested fiduciaries. Two or more disinterested outside directors can comprise an independent board committee, or a majority of disinterested directors can act for the board, provided that each is truly independent and has no material personal interest in the challenged decision.

4. Swim in the Mainstream

Terms of VC financings, like any commercial terms, evolve through economic cycles. In the most recent recession, there has been renewed or expanded use of multiple liquidation preferences, participating preferred, and preferred stock redemption terms; an increased reluctance to waive anti-dilution rights; and an increased use of "pay-to-play" provisions. Venture firms and their advisors will have differing views on the positive and negative aspects of such provisions, the details of their terms, and counter-balancing pro-company and pro-management terms.

However, all of these lie within the mainstream of the current deal-making dialogue. In this context, firms should be cautious if they wish to step substantially beyond existing market terms, at least absent a company-specific business or finance rationale. Terms that are substantially beyond market norms are more likely to draw complaints in the first instance, as "outliers," and may prove more difficult to defend for the same reason.

5. Don't Blow Your Cover(age)

Last but not least, the liability protection provided to a venture capital firm and its personnel via indemnification provisions and insurance coverage should be reviewed at both the portfolio company and fund level. Each portfolio company should, as a matter of course, provide its directors with indemnification. Given the present litigation environment, we believe that each company should also maintain a directors' and officers' liability policy to back-up those indemnification obligations. In addition, those D&O policies should be reviewed by competent personnel to ensure their adequacy, because fundamental errors can be made in such policies.

Further, if you have not done so, consider whether your firm should have its own professional liability insurance policy. Coverage for venture capital firms is not cheap, but it has proven worthwhile for firms with large portfolios and mature portfolio holdings. Finally, consider whether to seek fund indemnification. Your firm's money has been invested in its portfolio companies, and it is not unreasonable to request that a part of those funds be available for indemnification if claims later arise. VC liability policies often come with substantial retentions (i.e., deductibles), and fund indemnification is one means of financing that retention.

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