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THE ENTREPRENEURS REPORT: Private Company Financing Trends

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Early-Stage Fundraising Advice for Tough Times

By Ken Elefant, General Partner, Opus Capital

Raising capital is never easy for a start-up company, especially now. Valuations, investments and exits have dropped off in recent quarters. Enterprise IT budgets are shrinking, and revenue models for many consumer businesses are still nascent. VCs are nervous, as are their investors.

But the average deal size of $7.7 million is still holding strong, and the dollars invested in certain sectors such as internet software have even increased. What's more, 23% of the venture capital invested in the most recent four quarters went to seed or early-stage deals--higher than in the previous two years (source: PricewaterhouseCoopers/NVCA MoneyTree report).

Bottom line: capital for company building is available, but exit opportunities in the near term are squeezed. But if you're starting a company now, your exit is most likely six to eight years away, when the market is expected to be more stable.

Some of the best companies were built in questionable economic climates. Riverbed Technology secured its Series A funding in December 2002, and had its initial public offering just four years later. In its first day of trading, Riverbed stock closed 57% higher than the opening price. Or take Virsa, a governance solutions provider that was acquired by SAP in 2006, only two years after receiving its first round of financing in a weak enterprise software market.

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Private Company D&O Insurance: Key Considerations

By Priya Cherian Huskins, Partner, Woodruff-Sawyer & Co.

Directors and officers of private companies potentially face unlimited personal liability if they are sued. As a result, when it is time for a start-up company to recruit serious talent to take the company to the next level, the purchase of director and officer liability insurance becomes a priority. In addition, venture capitalists often insist on having adequate D&O insurance in place before they finance the company and join the company's board of directors.

Unfortunately, although the cost of D&O insurance for most start-up private companies is about the same—roughly $5,000 to $10,000 for $1,000,000 to $2,000,000 of insurance per year—not all D&O policies are created equally. To avoid finding yourself insured by a D&O policy that does surprisingly little, consider the importance of:

(1) understanding the appropriate coverage limit to purchase;
(2) securing key policy terms and conditions; and
(3) using an insurance broker who specializes in D&O insurance.

Limits. Most early stage companies purchase $1,000,000 to $2,000,000 of D&O insurance, and most later stage private companies purchase $5,000,000 to $10,000,000 of D&O insurance. Some companies decide to select a certain amount in limits because that is what their venture capital backers have requested. Others purchase limits based on requests

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Without a doubt, entrepreneurs with passion, vision and a terrific concept should be starting companies, and shouldn't hesitate to seek out venture capitalists to fund their ideas. There's no reason not to.

Do, however, expect fundraising to be harder this year than it has been in recent years. While the capital is there, VCs are being more cautious. Nonetheless, enterprises still have key technology problems that they need help addressing, and consumers show no signs of slowing down use of the Internet and mobile devices.

A few things to keep in mind while fundraising: First, pursue venture firms that are lead investors and have a demonstrated interest in Seed and Series A investments—those with a portfolio to show for it. These are investors who will understand the challenges you face and be patient in helping you through them. With an average time-to-exit of 6.7 years (VentureSource), you want investors that will stick with you for the long haul.

When approaching VCs, you need all the outside support you can get. Work to get introduced through a business partner of your company—a law firm like Wilson Sonsini Goodrich & Rosati or a contact at another technology firm with whom you have a partnership. In addition to the benefit of an introduction, you're offering a prospective investor a built-in reference. In fact, have references prepared prior to any VC meetings—customers or business partners who can attest to the problem you're solving in the market.

Once your financing has been secured, start planning for the next round. Begin working immediately against the milestones that a follow-on investor will be looking for. These may include mediating the technology risks, ensuring successful, repeatable customer pilots and honing in on the right distribution model. Most important, focus on hitting real revenue targets that prove a scalable model.

There's no doubt it's a tough time to be starting a business. But if you focus on the long-term, and on building a successful, sustainable company, capital is readily available for you, both now, and when you're ready for an exit.

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from their boards of directors, and often as an inducement to help solidify a highly-sought after board candidate's decision to join the board. To get a handle on how much insurance to purchase and to avoid purchasing too much insurance, it is helpful to first understand the types of suits that are covered by D&O insurance, and then consult with your outside counsel to understand the expected cost associated with defending and settling each type of suit.

Broadly, there are two types of plaintiffs that can proceed against directors and officers: the government and private party plaintiffs. Although it is highly unusual for a governmental agency to pursue private company directors and officers, it does happen. One example is when the government investigates and perhaps prosecutes directors and officers for securities fraud in the context of a private placement offering to raise capital. Experienced outside litigation counsel will be able to provide guidance on what it would cost to defend against this type of suit, and the expected defense cost should be included in the D&O insurance limits calculation. Because the government will not allow a director or officer to use insurance proceeds to settle a dispute, the company purchasing insurance should not include the potential cost of the settlement itself when calculating appropriate D&O insurance limits.

By contrast, insurance proceeds can be used both to pay for defense costs and to settle the claim when directors and officers are sued by private party plaintiffs, such as a company's shareholders, employees or competitors. For example, private plaintiffs might sue the directors and officers of a company for breaching their fiduciary duties in the context of a dilutive financing that washes out earlier investors or the sale of a company for a price that the plaintiffs believe to be inadequate. Experienced outside litigation counsel will again be able to provide guidance on what it would cost to defend as well as settle this type of suit (as opposed to allowing it to proceed to trial). The settlements of this type of suit are generally small relative to comparable suits brought against public company directors and officers, but they are never insignificant for the directors and officers who potentially face personal liability.

Employees are a notable source of claims against directors, officers and the private companies they serve—approximately one-third of all such claims. These suits concern employment-related matters. Private company D&O insurance policies can be expanded to respond to these employee claims. If a company elects to expand coverage in this way, it should consider raising the total amount of insurance limits it is purchasing to accommodate the employment practice claims that may be brought against the policy. In the alternative, these employee claims can be addressed through a separate Employment Practices Liability insurance policy with its own separate insurance limit. For an

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early-stage company that has less than 30 employees, the cost of a stand-alone EPL policy is about $5,000 to $10,000 for $1,000,000 to $2,000,000 of insurance per year. Compared to having two stand-alone polices with separate limits, combining the EPL policy and the D&O policy into a single policy with a shared limit is one way a company can reduce its premium.

Key Terms & Conditions. D&O insurance policies are highly negotiated risk transfer contracts; there can be enormous differences in the quality of insurance policies, even when issued by the same insurance carrier. Counterintuitively, a better negotiated, broader private company D&O policy is generally not more expensive than a poorly negotiated one when negotiated by a skilled broker.

A D&O insurance contract is normally divided into three separate insuring agreements known as Side A, Side B, and Side C. From an individual director's or officer's perspective, the most important insuring agreement is the one that agrees to indemnify directors and officers when the company cannot, such as when the company is insolvent. Referred to as Side A of a D&O insurance policy, this part of the contract provides first dollar (no deductible) insurance coverage and should be obtained in a manner that makes it difficult if not impossible for an insurance carrier to deny payment later. Specifically, a private company should obtain Side A on a "non-rescindable" basis, meaning that the insurance carrier cannot revoke the insurance contract for any reason.

From the company's perspective, an important function of a D&O insurance contract is to reimburse the company for its obligation to indemnify its directors and officers. Referred to as Side B, this part of the insurance contract is most likely to respond when a company's directors and officers are sued. The vast majority of claims in the United States that are brought against directors and officers are indemnifiable by the corporation so long as the company is solvent. Lastly, Side C of the insurance contract pays for the company's own defense and settlement when it is named in a covered suit. Side B and Side C are together referred to as "Balance Sheet Protection" and are normally subject to a deductible, also known in this context as a "self-insured retention."

Among the most important terms that a skilled insurance broker will negotiate when brokering the D&O insurance policy is "full severability." This means that in the context of a claim, the intentional bad acts of one insured director or officer cannot cause an innocent director or officer to lose the benefit of this insurance coverage. Without this clarifying language, innocent directors and officers can find themselves without insurance coverage as a result of another officer or director having been a bad actor.

Private, high-growth companies whose business plan includes routinely raising capital should pay special attention to whether the D&O insurance contract covers this activity. Some highly reputable insurance carriers routinely place caps on the amount of money that can be raised before the activity is excluded from insurance coverage. Other insurance carriers go so far as to exclude this activity altogether, unless it is negotiated back into the D&O insurance policy contract.

Using a Specialist. D&O insurance should be purchased through an insurance broker who specializes in D&O insurance. Both the background legal landscape against which these policies are written as well as the available policy terms are constantly evolving. A D&O insurance specialist will be able to guide a company toward insurance carriers that are able to provide the most comprehensive coverage at competitive prices. Moreover, even beyond placing a solid contract, there is the issue of actually getting a claim paid under a D&O insurance policy. Claims management for D&O insurance claims is a specialty in and of itself. The key to a good D&O insurance outcome—i.e., getting a claim ultimately paid—is placing the D&O insurance policy through an experienced broker who also has significant D&O claims management experience.

Of all the mistakes that a company can make when placing D&O insurance, the worst mistake from a risk management perspective is relying on an insurance broker who does not specialize in D&O insurance. The unfortunate, yet all too predictable, result is that when a claim against directors and officers is made, the claim turns out not to be covered by the D&O insurance. Private, high-growth companies are well advised to work with an insurance broker that frequently works with similar companies and has the ability to look around the corner when it comes to avoiding or mitigating risks on behalf of the client.

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