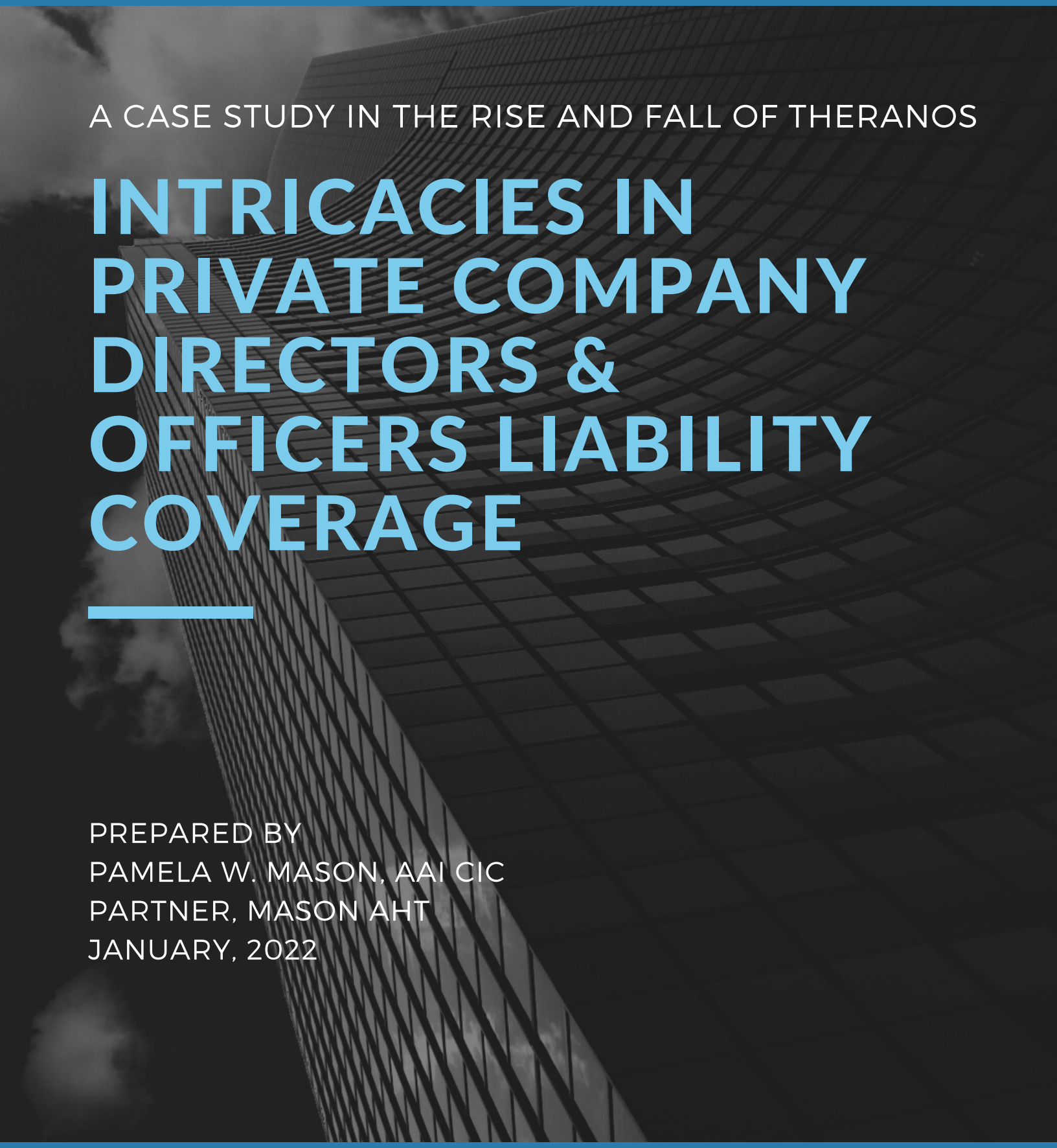

A CASE STUDY IN THE RISE AND FALL OF THERANOS

INTRICACIES IN PRIVATE COMPANY DIRECTORS & OFFICERS LIABILITY COVERAGE

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ELIZABETH HOLMES TRIAL

AN INSURANCE PERSPECTIVE

The Elizabeth Holmes trial has provided for months of interesting viewing, given the extraordinarily high-profile circumstances surrounding the case. It's rare to have such an extensive view into private company litigation that reaches the level of public company implosions, such as Enron. With all the twists and turns, the case provides a unique opportunity to perform a deep dive into key mechanics of Directors & Officers Liability (D&O) coverage.

For the purposes of this overview, our focus will be on some notable areas that would have significant impact on determining coverage for Ms. Holmes under a D&O policy. To clarify, this commentary is provided without any knowledge of the extent of coverage that Theranos or its directors and officers had (or didn't have). Nor are we privy to the carriers who may have offered coverage to Theranos and its directors and officers, or any coverage positions taken by same. The analysis is based upon how coverage might apply to the four charges tied to investor fraud that were made against Ms. Holmes in the June 14, 2018, Indictment, The United States of America vs. Elizabeth A. Holmes and Ramesh "Sunny" Balwani.

The Indictment can be viewed here.

PRIVATE COMPANY DIRECTORS & OFFICERS LIABILITY COVERAGE

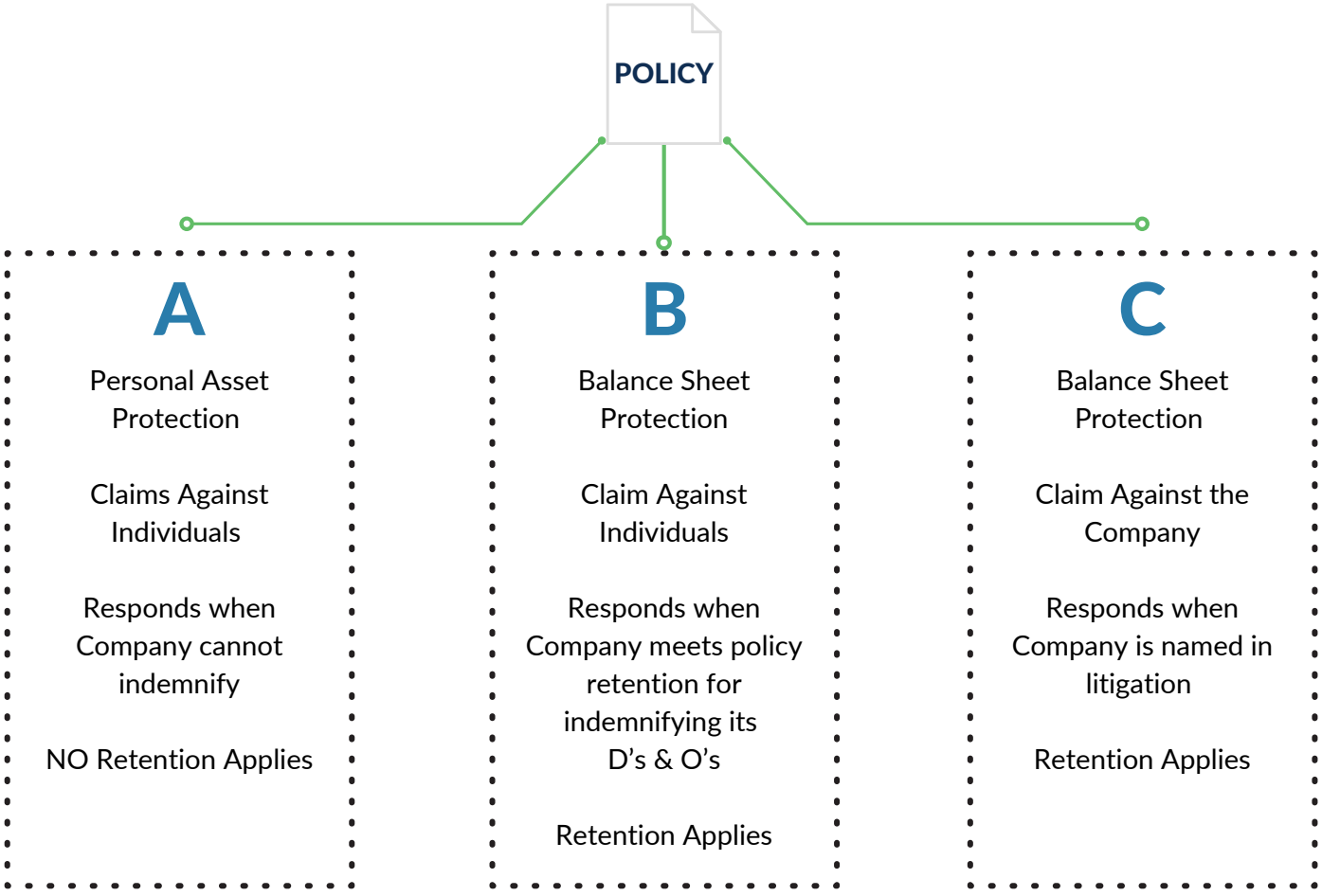
Let's start with basics. Private Company Directors & Officers Liability (PCD&O) coverage is designed to address the liability of an insured person and/or insured organization arising from allegations of wrongful acts in the overall management or operation of the business. For a private company, such as Theranos, coverage is typically structured as a combination of individual personal asset protection and preservation of the corporate balance sheet. This is accomplished by the three main insuring agreements, which are commonly referred to as:

3 MAIN INSURING AGREEMENTS:

Side A - (direct personal asset protection in situations of non-indemnifiable loss)

Side B - (corporate reimbursement for monies spent to indemnify insured persons)

Side C - (coverage for claims made against the entity itself)



PCD&O policies are comprised of numerous sections, including, but not limited to:

- Insuring Agreements
- Definitions
- Application of Limits of Liability and Retentions
- Exclusions
- Claims Reporting
- Defense and Settlement
- Representations and Severability as respects imputation of knowledge
- Policy Endorsements

Would Private Company Directors & Officers Liability Coverage Apply to The United States of America vs. Elizabeth A. Holmes and Ramesh "Sunny" Balwani?

Determination of Coverage:
The analysis of the allegations made in D&O litigation to arrive at a coverage position is a seemingly very straightforward process. In reality, it is fraught with complexity due to the intricacies of how a PCD&O policy is structured. PCD&O policies are complicated contracts, and the interplay of the coverage sections need to be scrutinized to arrive at a coverage conclusion. While an Insuring Agreement grants coverage, policy terms, conditions, and exclusions may ultimately limit or negate coverage in its entirety. On top of that, there is no uniform PCD&O policy in the insurance industry. Commonalities exist, but each carrier has its own policy form and underwrites to specific risk profiles.

To streamline the process in the Holmes case, let's use the questions below, then dissect from there.

1. Does the matter constitute a "Claim" under the policy?
2. Was proper notice of claim given to the carrier?
3. What coverage section(s) applies to this claim?
4. What important policy terms and conditions apply?
5. How do the policy's exclusions affect coverage?
6. How would defense and settlement in a case like this work?

1 IS IT A CLAIM?

PCD&O policies typically define a Claim with a core basis of a written demand for monetary or non-monetary relief. A Claim must be for a Wrongful Act, as defined in the policy. From there, definitions vary to different degrees about the inclusion of the following:

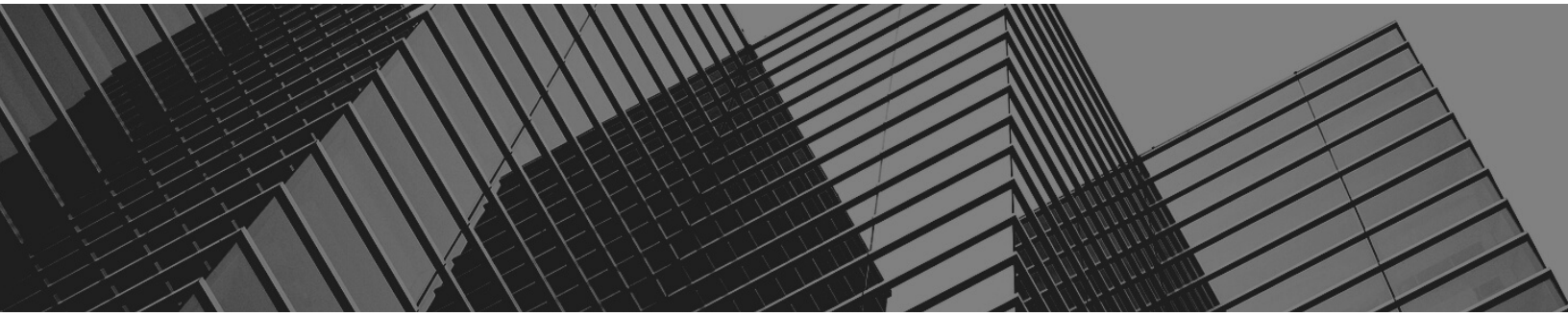
- Civil proceedings
- Criminal proceedings commenced by arrest, return of indictment or other information/similar documents
- Formal administrative or regulatory proceedings commenced by filing of notice of charges or formal investigative order
- Arbitration or mediation proceedings
- Requests for extradition
- Regulatory investigations or interviews, including service of target letters (typically applies to coverage for insured persons only)
- Tolling or waving statute of limitations
- Service of subpoena upon an insured person (with some extension for the insured entity)
- Some carriers will include a specific definition for Securities Claim specific to violation of securities laws

A Wrongful Act is generally a broad definition in a PCD&O policy, essentially constituting an actual or alleged error, misstatement, misleading statement, act, omission, neglect, or breach of duty while acting in the capacity of an insured person or any insured entity.
With this, the June 14, 2018, indictment would meet the definition of Claim.

2 WAS PROPER NOTICE OF CLAIM GIVEN TO THE CARRIER?

Most PCD&O policies dictate that a Claim needs to be given "as soon as practicable" within the policy period, or within 60 days post policy period, once certain individuals within the company become aware of the Claim (typically CEO, CFO, COB). While most insureds understand and adhere to this policy provision, it's interesting to note that "late notice" coverage denials are becoming more frequent. Carriers take this stance if they can justify that their rights have been prejudiced because of a company not providing proper notice of claim. As a rule of thumb, any written demand for damages should be reported to your insurance broker. In addition, discussions should be had regarding any circumstances that could reasonably become a claim to properly position the company as such matters evolve.

We're not privy to any detail about how Theranos handled its notice of claim, but we'll presume they provided it within the terms of the policy.



3 WHAT COVERAGE SECTION APPLIES?

The government's case is brought against individual insured persons, namely Ms. Holmes and Mr. Balwani. As such, the applicable Insuring Agreements would be A and B. However, given the fact that Theranos was dissolved in 2018 and distributed all remaining assets to investors, the claim would fall exclusively under Insuring Agreement A, as Theranos has no means to indemnify. In and of itself, this is favorable to Ms. Holmes as there is no applicable retention (i.e., deductible) that she needs to fund personally. Further, in many instances, coverage under the policy may be broader for Insuring Agreement A losses.

4 WHAT IMPORTANT POLICY TERMS AND CONDITIONS APPLY?

A PCD&O policy contains General Policy Terms and Conditions, along with D&O specific Terms and Conditions. There is a lot to unpack here, so let's dive into some main considerations.

DEFINITIONS

While we identified the importance of the definitions of Claim and Wrongful Act previously, other definitions within the policy also deserve attention. **Here are a few:**

LOSS

PCD&O policies standardly cover defense costs, compensatory damages, and settlements. From here, individual carrier policies differ. Specific to the Holmes case, important extensions would include:

- Punitive, exemplary, or multiplied damages with the important qualifier that the coverage applies in the jurisdiction most favorable to the insurability of such damages. As some jurisdictions, like California, do not allow coverage for these damages, these qualifiers can assist to obtain coverage depending upon where the company is located, where the claim was brought, etc.

- Civil fines and penalties

APPLICATION

Many times this is an overlooked part of the policy, but we'll reference its importance below. It typically includes the application itself, any attachments, or other written detail or materials provided by the company to the carrier.

INTERRELATED CLAIMS

Generally defined as all Claims for Wrongful Acts with a common nexus based upon, arising out of or attributable to the same related facts, circumstances, situations, transactions, or events.

REPRESENTATIONS AND SEVERABILITY

This is where the importance of the definition of Application comes into play. PCD&O policies contain a Representations and Warranties section (sometimes referenced as Warranty) that confirms the carrier has accepted the company's risk based upon the information provided in the Application. Most PCD&O policies consider the Application as severable between each insured person and that the knowledge of one insured person shall not be imputed to another. However, if the Application contained misrepresentations that may have been material to the carrier's acceptance of the risk, or if the misrepresentations were made with intent to deceive, the carrier will not afford coverage to those who knew of the misrepresentations, and some insurers will extend this to insured persons even if they didn't know the Application contained such misrepresentations.

Further, some less favorable PCD&O policy wordings give the carrier the right to rescind the policy, ab initio, in the event of misrepresentations in the Application.

Without knowledge of the actual wordings in the Theranos policy, we can only speculate that this condition could have impacted coverage for Ms. Holmes. For a company of Theranos' size at the time, a PCD&O submission to carriers would have included the Application, company financials, details about corporate strategy, and during a time where the company was fundraising, it would not be unusual for a carrier to request the investor presentation deck. To the extent that the carrier believed there were material misrepresentations in the detail provided to them, they could negate coverage for Ms. Holmes.

Finally, if the policy had less than favorable rescission language, the policy could be voided in its entirety.

RELATED CLAIMS

The Indictment brought by the US government against Ms. Holmes was not the first round of litigation against Theranos. In October 2016, one of Theranos' investors, Partner Fund Management LP, brought a lawsuit against the company, Ms. Holmes, and Mr. Balwani. The complaint contained allegations of fraud and deceptive trade practices. Following that, the Securities and Exchange Commission (SEC) filed a complaint against Theranos, Inc., Ms. Holmes, and Mr. Balwani on March 14, 2018, with similar allegations.

PCD&O policies contain provisions that Interrelated Claims are deemed to be one single claim falling under the policy that was in effect when the first claim was made. The three claims mentioned above share the same nexus of facts and it would be hard to imagine that a carrier would not deem these interrelated. Presuming Theranos had PCD&O coverage in effect at the time of the October 2016 claim, all three claims would be subject to the overall program limit, retention, and policy terms and conditions of that policy.

Aside from the coverage challenges outlined above, the other obvious question is the adequacy of limit for all three claims. Defense costs alone likely approach eight figures and it is questionable if Theranos would have ever bought that much limit.

5 HOW DO THE POLICY'S EXCLUSIONS AFFECT COVERAGE?

There are a handful of typical policy exclusions that would have impact on coverage for the Holmes case:

A: PERSONAL MISCONDUCT

Every PCD&O policy contains an exclusion for allegations based upon, arising from, or in consequence of fraud (better policies use "deliberate fraud") or willful violation of statutes or regulations. In a nutshell, carriers are not seeking to provide coverage to bad actors. However, a qualifier exists in these policies that the exclusion will only apply following a final adjudication that establishes such fraud (better policies will narrow wording to "final, non-appealable adjudication in the underlying action"). The importance is that the mere allegation of fraud will not serve to exclude coverage under the policy. As most litigation is settled and never goes to trial, the fraud exclusion is not triggered. Specific to Ms. Holmes, her trial resulted in guilty verdicts levied against her. If the PCD&O coverage for Theranos did not contain "final, non-appealable" language, the carriers will seek repayment of defense costs that were advanced on her behalf. If the non-appealable language is part of the policy, it remains to be seen if she will be successful with an appeal and the defense cost advancement will remain on hold.

B: SECURITIES LIABILITY

Such exclusions in PCD&O policies largely center around the public offering of securities and provide affirmative coverage for offerings not subject to securities that do not require registration under the Securities Act of 1933, or other similar offerings. Additional affirmative coverage grants extend to failure to undertake an IPO along with road show coverage. However, astute D&O underwriters are weary of unicorns and dragons that are increasingly on the radar of the SEC. The language of any PCD&O coverage obtained by Theranos is unknown. But if the wording was more broad than typical and excluded violations of securities laws, the carrier could seek to deny coverage.

C: PRODUCT LIABILITY/PROFESSIONAL LIABILITY

These are examples of exposures that are better insured elsewhere but can impact a PCD&O claim. A Product Liability exclusion relates to claims associated with a product's inability to perform in a manner for which it was designed relative to defects in its design or manufacture. A Professional Liability exclusion applies to the rendering or failure to render professional services to others for a fee. How these two exclusions apply in a PCD&O policy vary widely from insurer to insurer. The best policies would eliminate them all together, but barring that, limiting the exclusion to Insuring Agreement C would be preferable, along with "for" preamble language and coverage carve backs for shareholder claims and shareholder derivative actions. If the Theranos policy had an exclusion for either that applied to Insuring Agreement A, the carrier could seek to deny coverage given the litigation was tied to the professional services that Theranos rendered, along with the defect in its product.

6 HOW WOULD DEFENSE AND SETTLEMENT IN A CASE LIKE THIS WORK?

PCD&O policies are unique in that the carrier typically has the duty to defend the company in the event of a claim. This means that the carrier will choose counsel, likely a pre-approved panel counsel firm with expertise in the specific area of litigation, and effectively run the defense of the litigation. This would also include the direct payment of defense costs to counsel. The carrier's duty to defend also provides 100% of the defense cost allocation. This is beneficial to the company because in circumstances where there are covered and uncovered components of a Claim, the carrier will pay 100% of the defense costs for the entire claim if one component of Loss is covered.

For large unicorn private companies, like Theranos, carriers would likely change the duty to defend to rest with the company (non-duty to defend). Here, the company would control its own defense and, in its choice of counsel, be subject to approval by the carrier along with the imposition of rate caps. The company bears the cost of defense and is reimbursed by the carrier following the submission of legal invoices. This can become contentious when carriers challenge the reasonableness of certain charges incurred by the company. Non-duty to defend also changes the allocation of defense costs between covered and uncovered matters to resolution on the relative legal and financial merits of loss.

We would surmise that the Holmes case was handled on a non-duty to defend basis. Aside from the fact that the actual hourly rates of her expensive legal counsel were likely capped to perhaps 1/3 of the charge, the allocation of defense costs would be challenging. As outlined above, it can be concluded that policy restrictions would leave much of this case uncovered.

OUR VERDICT ON COVERAGE

In the final analysis, the severity of the allegations against Ms. Holmes, combined with the guilty verdicts handed to her, can only lead to the conclusion that little to no coverage was available to her under a PCD&O policy that Theranos may have had. There are many suppositions to our position without the benefit of knowing specifics, or the insight of legal counsel. But the trail we have been able to piece together suggests no silver bullets are available.

KEY TAKEAWAYS

The collapse of Theranos will be a focal point in the study of business and corporate governance for years to come. It also provides the backdrop to some vital issues that private companies need to pay attention to in the purchase of their D&O coverage.

- Directors & Officers Liability policies are complicated contracts, and the purchase of the policy does not guarantee that coverage will apply. Work with an insurance broker that is a specialist in the space and can guide you in making an educated decision.

- Prior to the onset of any litigation, understand how your PCD&O policy's defense and settlement provisions work. Not every carrier will move outside the lanes of their pre-approved panel counsel, but it is possible to negotiate. Gain an understanding of your carriers claims paying history and again, work with an insurance broker with significant expertise in D&O claims.

- Be cognizant of claim reporting requirements in your policy. If there are looming circumstances that could give rise to a claim, discuss options with your insurance broker to protect your rights under the policy.

- New and renewal applications for PCD&O coverage are important, as they form the basis of acceptance of risk by the carrier, and form part of the policy itself. To the greatest extent possible, ensure the accuracy of the application and materials attached to it.

- Private companies are not below the radar screen of the SEC or other regulatory agencies. While more focus may be given to larger unicorn type companies, even smaller private companies with complicated operations can garner attention. Companies need to ensure that their PCD&O policies are written without coverage limitations in this area.

- Where possible, align your PCD&O policy with a carrier that understands your industry. This typically lends itself to broader coverage and more favorable pricing.

KEY TAKEAWAYS

Consider adequacy of overall limit of liability. There are many factors that influence appropriate limit determination including but not limited:

- The limit is an annual aggregate and includes defense costs
- Coverage extends to all insured persons and the company
- Stage of funding
- Valuation
- Business sector
- Where company is in its lifecycle
- Pre-IPO/M&A
- Board profile
- Location
- Benchmarking data

Buy separate A-SIDE Only coverage for greater personal asset protection

Venture and private equity firms need to be mindful of the level and quality of D&O coverage purchased by their portfolio companies. It is as much about their protection as outside board members as it is protection of investment.

Venture and private equity firms need to consider Theranos-like investments relative to claims under their Private Equity Liability polices brought by LP's surrounding their provision of professional services.

It will be interesting to see what is next for Ms. Holmes and the impact of the "fake it until you make it" mentality in the startup space. This is especially noteworthy given the several hundred SPACs that are looking for targets in 2022. Hopefully, the fall of Theranos will impart wisdom that will support entrepreneurialism, corporate culture, and proper corporate governance.

ABOUT THE AUTHOR

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Pam specializes in risk management solutions for Venture, Angel, and Private Equity firms, and the innovative portfolio companies in which they invest.

Because of her strong technical understanding of the insurance products that facilitate risk transfer, Pam's focus with her clients centers on risk assessment. She has extensive experience with complex litigation, including securities fraud and other shareholder rights matters, bankruptcy matters, M&A indemnity claims, and employment actions. In addition to her position at Mason AHT, Pam was a past Chairperson of TechAssure (www.techassure.com), a not-for-profit, global association of insurance professionals that Mason co-founded. Pam has led the firm's relationships with strategic partnerships, such as the New England Venture Capital Association, the National Venture Capital Association, and the Angel Capital Association. Pam frequently lectures and writes about risk management and insurance topics. She has spoken at Venture and Angel Group association meetings both nationally and locally. Pam's articles have appeared in Venture Capital Journal, Red Herring, Risk and Compliance Magazine, and other publications.

Prior to joining Mason AHT, Pam was a Senior Vice President of Marsh, Inc., a global insurance broker, where she led the company's regional FINPRO management liability practice. Pam is a CertifiedInsuranceCounselor, Accredited Advisor in Insurance, and holds a B.A. degree from the University of Vermont.