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Practical D&O Insurance Considerations For PE Firms

Law360, New York (April 13, 2015, 10:45 AM ET) --

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Private equity firms are best known for generating strong returns for their investors and providing an important source of capital. Behind the scenes lies a complex operation, balancing regulatory compliance, accounting and legal considerations — all amidst an environment of increasing public scrutiny. Somewhat lost in the shuffle, but important to firms' long-term health and security, is time spent developing and maintaining a robust directors and officers insurance program for the private equity firm and its portfolio companies. Nonetheless, this remains an important exercise and one best handled with assistance from a firm's insurance broker and/or outside counsel — with the primary goals to assess an adequate amount of coverage tailored to the firm's particular needs and to ensure that the firm's coverage operates in synch with that of its portfolio companies.

We address below several practical insurance considerations for private equity firms:

D&O Insurance at the Private Equity Firm Level

Many insurers market specialized D&O policies to private equity firms. These policies provide coverage directly to the private equity firm and its investment funds as well as to individuals serving on portfolio company boards.

Coverage for Claims Against and Investigations of the Private Equity Firm and Its Investment Funds

Although D&O insurance is most often thought of as providing coverage to individuals in management positions, many D&O policies issued to private equity firms extend coverage to the firm and its investment funds. Private equity firms may find this aspect of their D&O coverage useful when a claim is made directly against the firm or one of its investment funds, or when the firm or one of its funds is the subject of a government investigation.

D&O insurance for private equity firms is particularly important in today's environment, given the heightened level of scrutiny on the industry from the U.S. Securities and Exchange Commission as well as the overall higher public profile of private equity firms. The SEC launched a dedicated group in April

2014 to examine private equity and hedge funds required to register with the SEC under the Dodd-Frank Wall Street Reform and Consumer Protection Act. And, as has been widely reported, the SEC continues to investigate various practices at private equity firms.[1] It is not unusual for private litigation to follow closely on the heels of an SEC or other regulatory investigation or enforcement action.

Not all D&O policies provide coverage for fees and expenses incurred in responding to an SEC investigation or enforcement action, and many D&O policies do not provide coverage for informal investigations. Private equity funds should carefully examine the definition of “claim” in their D&O policies to ensure that it extends to subpoenas and investigative orders issued by government agencies. Ideally, D&O policies should be reviewed with experienced brokers and/or outside counsel before an investigation begins.

Coverage for Individual Private Equity Fund Managers

D&O policies issued to private equity firms generally provide traditional D&O insurance protection to individual fund managers in two ways: (1) in the managers’ capacity as managers of the funds; and (2) in the managers’ capacity as managers of portfolio companies. In most cases, the ideal D&O policy for a private equity fund will provide primary insurance in the first instance and excess insurance in the second. This is because the first line of defense for the managers of portfolio companies should come from D&O policies issued to the portfolio companies rather than from insurance policies issued to the private equity fund.

Accordingly, private equity firms should carefully examine the “other insurance” clauses of the firm’s D&O policies in conjunction with the “other insurance” clauses of portfolio companies’ D&O policies. Private equity firms should also ensure that their D&O policies are directly excess of portfolio companies’ D&O policies rather than excess of portfolio companies’ indemnification obligations — this will help avoid a situation in which the private equity firm’s D&O policy responds as excess insurance only when the portfolio company is bankrupt.

D&O Insurance at the Portfolio Company Level

Overview of Coverage at the Portfolio Company Level

Often, each of a private equity firm’s portfolio companies has its own D&O insurance. These policies provide coverage for claims against the managers of the portfolio companies, and many D&O policies provide coverage for certain claims against the portfolio companies themselves. The portfolio company’s D&O insurance plays a slightly different role in the various stages of the private equity firm’s investment in the company, i.e., during acquisition, operation and sale of the company.

When acquiring a portfolio company, private equity firms should examine the target’s existing D&O insurance policies and take appropriate steps to preserve or purchase insurance for claims that might be made after the transaction for alleged mismanagement before or leading up to the transaction. For example, purchase agreements often require the purchase of a tail policy to provide coverage for six years after closing for any claims made against the former officers and directors of the company. Private equity firms should consider how such insurance policies would interact with any indemnification obligations created by the purchase agreement. Firms should also pay particularly close attention to D&O insurance in connection with any going-private transactions, as any such transactions may draw lawsuits from former public shareholders.

When selling a portfolio company, private equity firms should again take appropriate steps to preserve or purchase insurance for claims that might be made after the transaction for alleged mismanagement before or leading up to the transaction. Such policies should protect those representatives involved in managing the company from claims by new shareholders of the company that the private equity firm representatives misrepresented information concerning the company to the new shareholders. Firms should pay particular attention to D&O insurance when taking a company public, a common exit method for private equity firms.

Coverage provided by D&O policies continues to be important post-acquisition. Although claims against the managers of privately held portfolio companies are less common, they are possible. For example, creditors of an insolvent portfolio company may make claims against its directors and officers. Moreover, some D&O insurance policies provide “entity” coverage for the portfolio company itself.

In the case of publicly held companies, coverage for the company is limited to “securities claims,” which is generally defined to include only claims related to the company’s sale of securities and the like. But in the case of privately held companies, entity-side coverage under a D&O policy may be much broader, protecting the company against various claims alleging wrongful acts by the company. Such coverage can be valuable to the portfolio company and the private equity firm.

Key Features of Portfolio Companies’ D&O Insurance Policies

It is important for private equity firms to conduct D&O insurance policy reviews to ensure that portfolio companies are appropriately covered. While each company may require a uniquely tailored solution, there are several notable general features:

- Pay special attention to the “insured v. insured” exclusion. The exclusion should not apply to claims brought by a bankruptcy trustee or similar person. In some cases, insurers may be willing to modify the insured v. insured exclusion to an insured v. entity exclusion.

- The “fraud and personal profit” exclusions should require a “final adjudication” of fraud or personal profit before applying to bar coverage.

- The policy should have a priority of payments clause, ensuring that in the event of the company’s bankruptcy, the insurer will pay for claims against the directors and officers before paying for claims against the company.

- A portfolio company’s D&O policy should be noncancelable, and the Side A coverage (i.e., coverage for directors and officers where they are not receiving indemnification from the company) should be nonrescindable.

- Ensure that the criminal or fraudulent conduct exclusions are fully severable so that no one director's conduct may be imputed to another insured person for purposes of precluding coverage.

At bottom, developing and maintaining a firm's insurance program — at both the firm and portfolio company level — is important to a firm's long-term security. This effort requires a combination of consistency and creativity, with input from industry experts and a strong sense of the overall direction of the firm.

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[1] E.g., http://www.reuters.com/article/2014/10/29/us-sec-privateequity-idUSKBN0II08K20141029; http://online.wsj.com/articles/regulators-examine-buyout-firms-fees-1404330015; http://www.wsj.com/articles/sec-warns-fenway-partners-of-possible-action-1428073087.