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6 Questions PE Sponsors Must Ask About Their GPL Policies

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Private equity fund sponsors are facing increased litigation risk from regulators and private parties, including limited partners and stakeholders in portfolio companies. As a result, private equity firms should re-examine their professional liability insurance policies to ensure that their coverage is properly aligned with this increasing risk.

Put simply, private equity sponsors must treat their professional liability insurance as a critical component of their operational risk management. Most private equity firms have some form of a professional liability program in place, typically in the form of a general partner liability — or "GPL" — policy. In some cases, however, fund sponsors purchase "one size fits all" form policies that are not sufficiently tailored to meet their evolving business needs or risks, particularly as litigation and regulatory activity in this area continues to increase.

In reviewing GPL coverage, these are some of the key questions that fund sponsors should ask:

Are activities by regulators covered "claims," and if so, what specific types of activities are covered by the policy?

Given the intensifying scrutiny of private equity by the U.S. Securities and Exchange Commission and other regulators, fund sponsors should consider obtaining insurance coverage for regulatory investigations, enforcement actions and other activities. Sponsors also should evaluate the precise triggers for coverage. For example, some coverage is triggered only by certain "formalities" of the enforcement process (e.g., receipt of a Wells notice, notice of a formal investigation, or a receipt of a subpoena from the SEC). However, responding to a regulator's "informal" or "voluntary" requests for broad categories of documents — which is not uncommon — can cost well into the six figures.

Are the exclusions from coverage for "insured versus insured" claims too broad?

Professional liability policies typically exclude from coverage claims brought by one insured against another insured. The reasoning behind this exclusion is, in part, to protect the insurer from two or more insureds "colluding" to bring a lawsuit that would trigger coverage. In the private equity context, however, it is important to consider whether this exclusion should be "entity versus insured" rather than the broader "insured versus insured," and whether certain claims should be clearly carved out from this type of exclusion. For example, it is essential that the insured-versus-insured exclusion not negate coverage for claims by limited partners against the general partner or the management company. In assessing this risk, it also is important to consider whether "derivative" claims brought by limited partners on behalf of the fund are subject to these exclusions. Finally, sponsors should consider obtaining a policy with express language stating that whistleblower actions are not excluded insured-versus-insured claims.

Does the policy provide coverage for claims relating to failed portfolio company transactions?

While claims related to a private equity fund's portfolio companies typically are subject to coverage, the definition of "portfolio company" should be closely examined to ensure that it includes prospective portfolio companies. Otherwise, claims arising out of failed portfolio company transactions may not be covered.

Is there a clear order of priority between and among insurance policies and indemnification rights?

Sponsors also should evaluate the "priority" of the GPL coverage relative to other insurance coverage, whether at the portfolio company level or the management company level, as well as the priority of the insurance coverage relative to indemnification obligations of the fund (i.e., the limited partnership that the sponsor advises), the management company, and the portfolio companies.

Are the "defense and settlement" provisions too onerous?

Professional liability policies typically include a provision giving the insurer certain rights vis-a-vis the defense and settlement of a claim, including, for example, the right to consent to any settlement entered into by the insured. Here, to streamline the settlement process, fund sponsors should consider requesting that this provision be scaled back to allow the sponsor to enter into settlements within the retention amount (i.e., the deductible) without the insurer's consent.

Should the sponsor obtain stand-alone "cyberliability" insurance?

Private equity firms manage significant amounts of sensitive information, including financial statements and projections for portfolio companies, deal documentation (including for prospective and passed-over deals), and limited partners' financial information. In addition, their portfolio companies potentially manage a much larger universe of sensitive information. As such, it is important that fund sponsors carefully consider the risk that such information could be compromised through a breach in their network security or by the theft or accidental loss of hardware such as laptops and flash drives. And recent data breaches in the hedge fund, private equity, and venture capital industries have proven these risks to be more than theoretical.

To mitigate these risks, private equity firms have begun purchasing "network security and privacy liability" (also known as "cyberliability") policies with much more frequency. These policies typically

supplement the GPL policy’s coverage for potential third-party claims (such as lawsuits by limited partners concerning alleged damages from disclosure of confidential financial information) with “first-party” coverage for regulatory response costs, notification costs, business interruption loss, data and network rebuilding, and recovery costs. Fund sponsors should carefully evaluate how they manage sensitive information and whether this type of coverage is appropriate.

A comprehensive review of a professional liability insurance program may uncover numerous other issues including, for example, vague “conduct” exclusions from coverage for things like “dishonest acts” or violations of “public policy” by insureds, or a definition of “defense costs” that does not include work performed before a lawsuit is filed. Suffice it to say that what may appear to be very minor drafting decisions can have real and significant effects on the scope of the coverage, and we recommend that private equity sponsors work with insurance brokers and outside counsel who are familiar with the private funds industry and insurance issues in assessing their existing coverage.

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