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Got insurance?

Popping up on more investors' list of demands is quality insurance coverage, writes private equity lawyer Heidi Lawson, who outlines some common mistakes GPs make when purchasing their policies.

As in years past, investors continue to pressure fund general partners for greater transparency, enhanced governance and more performance-based compensation structures. However, they are now also making demands in what would appear to be an unlikely area: insurance coverage.

Increased regulatory scrutiny, more aggressive tactics from plaintiffs' counsel and pressures to unwind flagging funds at a faster pace is creating a need for fund managers to better manage inherent risks. As general partners and their funds find themselves embroiled in litigation or government investigations involving a host of issues, they often discover serious gaps in their insurance coverage, which may leave them, and the funds they manage, with significant exposures. If such exposures must be met with the use of fund assets, investors start to ask – why isn't this covered by the fund's insurance?

When obtaining fund management insurance, it is extremely important for the fund manager to carefully identify to the insurance broker and underwriter the kinds of entities that need to be covered, explain the relationships of those entities among one another and the portfolio companies and discuss which individuals must be insured under the policy. Then, those entities and relationships should be covered through express provisions that reflect those risks specific to the fund and its investment practices.

In the market, however, there is a wide variety of policy forms, terms and coverage offered. As a result, investors are now asking questions about the quality of the coverage provided. The standard "off the shelf" fund management policy is a good starting point, but is never adequate. Because each fund manager differs in structure and investment focus, revisions to the "off the shelf" form are always necessary to reflect the business model.



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If drafted appropriately, insurance can provide coverage for most risks associated with the fund and the related investment activities. Generally, internal risks relating to limited partner litigation and employment litigation are covered. Also, with some careful drafting and negotiation, external risks such as securities claims, outside director liability claims (where fund representatives are serving as portfolio company directors or officers, for instance), public offering claims, controlling shareholder claims and suits by buyers, targets and their management can be covered. Insurance can also cover certain compliance risks, such as Securities and Exchange Commission and Department of Justice investigations that may arise from time to time.

Surprisingly, though, the most common mistake with insurance policies is that all fund entities are not properly covered. Often brokers or insurers add each fund name and other affiliated entities by listing them in an endorsement. Nonetheless, many times the list is not updated on a periodic basis, and any newly acquired or created entities will be at risk of significant financial exposures should a claim arise.

The more prudent approach, rather than listing each individual insureds by endorsement, would be to draft the policy in such a way that all entities and individuals are automatically covered by definition. That way, going forward, an administrative error would not result in a loss of coverage.

Another common mistake is that the scope of coverage is severely limited and does not cover the fund manager's investment activities. For example, many fund management policies have an investment banking exclusion which excludes "financial activity," or a contract exclusion, which excludes "anything arising out of a contract." In both cases, these exclusions need to be closely reviewed and either severely watered down or deleted in their entirety. Furthermore, the

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definition of “Professional Services” needs to be modified to specifically list all investment activities of the general partner, managers and advisers, as it relates to the funds and any portfolio company, joint venture, third party client or customer or otherwise.

Because fund managers, portfolio company board members and investors are increasingly concerned about the potential for deal litigation, insurance coverage has also become a key element in deal transactions, particularly during the due diligence process. Insurers, through narrow definitions or express exclusions, usually try to exclude or significantly limit coverage for deal litigation. Fund managers need to be on high alert, because without coverage for these exposures, individuals and the fund are at high risk. In fact, any provisions that do not fit the particular needs of the deal should be negotiated out, and any ambiguous language should be clarified. It is also important to obtain specific comfort from the insurer regarding the interpretations that will be applied in a particular context to ensure that coverage will be provided whenever it is needed.

Years ago, fund agreements did not generally contain provisions for insurance. Now limited partners are taking much greater interest in the quality of the coverage because insurance ultimately protects the limited partner against financial loss and potential clawback obligations. When a fund manager and portfolio companies have spent money on insurance, but have not focused on the quality of that insurance, investors ultimately pay the price. With a little effort, properly tailored fund management insurance can be an asset, as well as a powerful shield for individuals and the fund.

Heidi Lawson is a risk-focused private equity and corporate lawyer with Mintz Levin where she splits her time between Boston, London and New York.

For a review of some of the more niche insurance products now catering to the private equity industry, including keyman disability insurance, look out for the August edition of PE Manager.

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