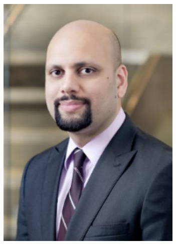
HUNTON ANDREWS KURTH

Lawyer Insights

Considerations In Structuring Private Equity D&O Coverage

By Geoffrey Fehling, Syed Ahmad and Rachel Beck
Published in Law360 | September 10, 2021


Private equity firms provide critical financial backing and investments into companies with the dual goals of providing important sources of capital while also creating value for their investors.

Deals can take many forms — from early-stage financing and growth equity transactions to leveraged buyout transactions and industry consolidations — all of which require special attention and present a host of transactional, regulatory and corporate governance hurdles.

Those transactions do not come without risks, however, especially when the operating companies in which the private equity firm invests are unsuccessful or become insolvent, a reality accentuated by the recent pandemic.

A general partnership liability, or GPL, policy, which at its core is a blend of directors and officers and professional liability policies, provides critical protection for the investment firm and its managers, officers and directors, as well as for exposure emanating from the portfolio company, either directly against the operating company or through the outside directors.

Further, a separate and distinct directors and officers, or D&O, liability policy should be maintained at each portfolio company, and the interplay between these insurance contracts is critical to understanding and addressing the unique and intertwined risks.

Insurance policies at all levels can and should be reviewed and negotiated to maximize potential recovery and minimize troublesome provisions that often lead to coverage being restricted or outright denied.

With the recent surge in investment activity, including through special-purpose acquisition companies, or SPACs, and economic growth driven by the ongoing pandemic recovery, the importance of these policies cannot be understated.

This article discusses key issues at the private equity and portfolio company levels that firms should understand and address when structuring D&O insurance programs.

GPL Insurance Considerations for Private Equity Firms

Industry-specific GPL insurance is available to provide specialized coverage to private equity firms. A good starting point for evaluating those policies is understanding the myriad challenges that firms and their directors, officers and affiliates encounter in the marketplace, which can include:

- Issues arising from transactions, such as inadequate due diligence or conflicts of interest;
- Issues arising from insolvency at the portfolio company level, including fiduciary duty claims or fraudulent conveyances;
- Government investigations, or enforcement actions, by federal or state regulatory agencies, like the U.S. Securities and Exchange Commission, the U.S. Department of Justice, the Consumer Financial Protection Bureau, and U.S. attorneys' offices and state attorneys general;
- Alleged neglect or mismanagement of portfolio companies; or
- Claims by minority shareholders or limited partners accusing the firm of misleading investors or mismanagement of funds.

While each GPL policy should be constructed to fit the specific structure, size and scope of a particular firm, most private equity firms face a number of insurance-related risks that should be evaluated and considered when placing or renewing policies.

Bump-Up Exclusion

Litigation against private equity firms arises frequently following an M&A transaction. Often those lawsuits allege a flawed sale process led by the company's directors and officers, who are said to have breached their duty of loyalty, good faith and full disclosure to the company.

Directors and officers sued for alleged fiduciary breaches may assume that the company's GPL policy will respond and reimburse all legal fees and expenses associated with these shareholder actions, but that is not always the case if policies contain a broad bump-up exclusion.

The wording of these exclusions varies, but generally, they exclude coverage for claims alleging inadequate consideration paid — a "bump up" in purchase price — in acquisition of a company.

However, the scope can vary widely, and some broadly worded exclusions are enforced in a variety of situations involving shareholders of both the purchaser and the acquiring company.

For example, while most bump-up consideration disputes involve claims against a purchaser for paying inadequate consideration, in Onyx Pharmaceuticals Inc. v. Old Republic Insurance Co.,[1], decided in October 2020, a California Superior Court enforced a bump-up exclusion to apply to claims by shareholders of the acquired company, alleging that they were not compensated adequately for their shares.

The Onyx decision, like many GPL coverage disputes, turned on the specific wording of the exclusion at issue, which failed to clearly distinguish between types of claims — unlike other exclusionary language available in the market. Firms should carefully evaluate the wording of any bump-up exclusion, and clarify or limit its reach, well before any deal takes place to determine how it may be applied.

Outside Director Coverage

In addition to covering fund managers directly in their capacities on behalf of the funds, GPL policies issued to private equity firms often cover managers in their capacity as outside directors of the portfolio companies in which the firm invests.

Subject to possible coverage issues caused by these dual roles, like the capacity exclusion discussed below, this outside director coverage extension can be critical to protect the firm's managers where protections at the portfolio company level are insufficient for any reason — e.g., the company is insolvent and cannot indemnify or the company's D&O limits are exhausted. This coverage is included in the GPL policy on a double excess basis, meaning that the policy will only respond to protect the outside directors if there is no indemnification or insurance available from the portfolio company.

But what if insurance coverage is theoretically available from the portfolio company insurer, but the extent of that coverage is disputed and the insurer refuses to pay? And what if the outside director coverage is only excess of the portfolio company's indemnification obligations that it is unable to satisfy?

Understanding how this coverage may apply to different claims and modifying the GPL contract to clearly define nonindemnifiable loss in a favorable manner is important to ensure that the firm-appointed outside directors are protected when the underlying indemnification and insurance fails or is exhausted.

Other Insurance

Most GPL policies have other insurance provisions that address situations where a policyholder may have multiple sources of recovery for a particular claim or loss. Given the existence of coverage at both the private equity and portfolio company levels, consideration must be given to how those policies interact for claims potentially covered under both policies.

For claims that are covered by a portfolio company policy, the private equity investors should confirm that the firm's GPL policy would be considered excess to the company's policy. Even where an "other insurance" clause may apply, however, certain states may not enforce such clauses against the insureds as a means to limit or bar recovery under the policy.[2]

Government Investigations

Regulatory exposure by state and federal agencies is one of the biggest risks firms may face, and policyholders are often surprised to receive a letter denying coverage for a claim arising from cooperation with government officials investigating possible misconduct, producing witnesses for interviews, or collecting and submitting extensive documentation in response to subpoenas or similar documents.

GPL policies vary widely with respect to potential coverage for government investigations and, where coverage is available, it is often subject to restrictions, like distinguishing between formal and informal investigations or limiting coverage to a very small sublimit. This has become a significant point of contract negotiation, as the breadth of coverage for regulatory matters is heavily dependent on very nuanced policy language and a thorough understanding of what actually triggers a claim under the contract.

Process-Related Disputes

While private equity firms should rightly focus on the substantive insuring agreements, exclusions and potential gaps in coverage, many claims can be derailed by process-related disputes, such as a failure to provide timely notice, failure to obtain insurer consent to incur defense costs or engage in settlement negotiations, or a failure to cooperate or allow the insurer to effectively associate with the defense of a covered claim.

Paying close attention to these and similar provisions — especially with respect to timely notice, which often is required well before a lawsuit or other formal proceeding is initiated — can help ensure that the policyholder's action or inaction does not adversely impact the availability of coverage.

Firms may also be surprised to find their policy includes a requirement that limits their choice of preferred counsel or caps the rates that insurance carriers will reimburse for covered counsel, effectively creating a second retention that firms themselves must fund in order to work with preferred counsel. Similarly, if a coverage dispute arises, the policyholder may be limited in seeking judicial intervention if the policy has a mandatory arbitration or other dispute resolution provision.

Additionally, even if coverage is available, the policy may specify that coverage disputes may only be brought in a particular forum or be subject to a particular state's law, possibly proving more favorable to the insurer than what would have applied in the absence of such a provision. However, choice-of-law or forum selection provisions may not be enforced in all circumstances.[3]

Regardless of whether explicitly addressed in the GPL policy, distinctions in state law can be critical in whether a claim is covered or not covered.[4] Understanding limitations placed on defense and dispute resolution before a claim arises and, if needed, modifying or removing those provisions, can place the policyholder in a stronger position.

D&O Insurance Considerations for Portfolio Companies

While a private equity firm should always have a robust GPL insurance program in place to protect the firm, its investment funds, and its officers and directors, the firm may also benefit from coverage available at the portfolio company level.

These policies may provide a significant source of balance sheet and personal asset protection, which is a critical risk mitigation tool covering the portfolio company's managers, directors and officers, as well as its investors, in the event of a lawsuit or government investigation.

Capacity Exclusions

Individuals involved in private equity firms and the portfolio companies in which they invest can wear many hats and, as a result, can be brought into suits against both private equity firms and the portfolio company such that the same individuals are sued in different capacities — as an outside director of a portfolio company, as a partner of the investment firm or as an officer of an affiliated company involved in the deal.

Policyholders should be aware of broad capacity exclusions that could be invoked to exclude coverage if those individuals are not sued solely in their capacity insured under a particular policy.

The case of Goggin v. National Union Fire Insurance Co. of Pittsburgh, PA, decided in November 2018 by a Delaware Superior Court,[5] serves as a reminder of the draconian manner in which capacity exclusions can be applied against private equity sponsors.

In Goggin, a lawsuit named two members of a private equity firm who also served as outside directors of a portfolio company. When the company entered bankruptcy and the members were alleged to have breached their fiduciary duties, they sought coverage under the portfolio company's D&O policy.

Even though the insurer agreed that the directors were insureds under the policy, it denied coverage on the grounds that the fiduciary claims arose from capacities other than as directors of the portfolio company, i.e., as members of the private equity sponsor. The court agreed, finding that the capacity exclusion unambiguously barred coverage where the claims arose out of capacities on behalf of the investment companies, even though the claims also related to their coexistence as directors.

Eliminating a similarly broad capacity exclusion is critical to avoiding potential disputes where private equity sponsors also sit on the board of a portfolio company. Or even better, policyholders can affirmatively clarify that private equity representatives serving as outside directors at the portfolio company specifically have coverage in their capacity as such, eliminating another potential carrier claim defense of allocating costs between the GPL and portfolio D&O policies.

Ongoing Review and Coordination Among Policies

Firms should take a direct and meaningful role in negotiating portfolio company D&O policies to avoid any gaps in coverage. Given the unique exposures presented by private equity structures, firms should frequently assess D&O protection during the due diligence process in an acquisition, and take steps to adequately protect and minimize risk at each investment.

That diligent level of monitoring should continue as policies are procured, modified and renewed each year to ensure that the portfolio company coverage is adequate and appropriately covering the risks at all levels of the organizational structure. Key issues include:

- Has the company's risk profile changed such that policy language should be modified to include new or changed exposures? Do the limits or sublimits need to be modified as a result?
- Which insured persons are covered and in what capacities?
- Does the policy extend coverage to investment funds and private equity affiliates if those entities are sued as co-defendants due to their ownership in or management control of the portfolio company?

- Does the company's indemnification obligations to its officers and directors line up with the assumptions for indemnifiable versus nonindemnifiable loss under the D&O policy? What happens if the company becomes insolvent or files for bankruptcy?

Addressing these and similar questions on an ongoing basis will help maximize coverage and protect the firm's investment.

Change in Control

As firms consider selling their stake in a portfolio company, coverage under the portfolio company's D&O policy may be impacted by a change-in-control provision, which is triggered when majority ownership or control of a company transfers through a merger, acquisition or potentially even a majority asset sale. Once triggered, coverage typically only insures claims for wrongful acts that occurred prior to the effective date of the transaction giving rise to the change in control.

In order to properly structure coverage for the target company and its officers and directors, coverage should be extended through runoff or tail coverage, either as an extension of the existing D&O policy or through a stand-alone policy.

The benefit of runoff coverage is twofold — it protects the directors and officers of an acquired company for subsequent claims asserted against them for conduct prior to the effective date of the transaction, and it also protects the post-closing portfolio company and private equity firm from claims made against the company being acquired or merged into the acquirer or its affiliate entities.

Beyond substantive coverage grants, policies may also have notice requirements and other prerequisites to coverage continuing at all for entities involved in the deal. Ignoring this stark change in going-forward coverage can have disastrous consequences.[6] Understanding when and how these provisions operate is critical to ensure continuous D&O coverage and avoid coverage gaps once a transaction closes.

While the provisions discussed above are important, they are by no means exhaustive. Other key provisions to evaluate in any portfolio company D&O policy include "insured versus insured" and criminal acts exclusions, priority of payment provisions and severability clauses, all of which can and should be reviewed and assessed at the portfolio company level.

D&O Coverage Is Only One Piece of the Risk Mitigation Puzzle

Directors and officers liability coverage is often viewed as the centerpiece of a private equity firm's insurance program because it most clearly inures to the benefit of the managers, investment funds, and the directors and officers at the companies in which the firm invests. D&O liability insurance, however, is only one piece of the risk mitigation puzzle, and many other coverages can be implicated:

- Errors and omissions coverage, which often fills critical professional liability gaps related to claims arising from the rendering or failure to render professional services that may be excluded from coverage under a D&O policy.

- Cyberinsurance is critical to protecting firms throughout all stages of the deal process, including, for example, during the acquisition of portfolio companies, which can expose vulnerabilities not identified or resolved during the due diligence process.

- Representations and warranties insurance provides meaningful benefits to both the buyer and seller in acquisitions to mitigate the risk of litigation and other losses.

- Other first- and third-party policies, such as property and business interruption coverage, general liability coverage, and workers' compensation coverage.

Negotiating and obtaining strong D&O cover is often an iterative process that requires ongoing attention to nuances in policy language in light of a company's business operations, exposures and emerging risks.

Private equity firms looking to avoid surprises and maximize recovery in the event of a claim should carefully consider the best practices and common issues discussed above to better understand — and modify, if necessary — the scope of protection afforded by their current GPL programs and how that coverage fits into the firm's overall risk mitigation strategy.

Notes

1. Onyx Pharmaceuticals Inc. v. Old Republic Ins. Co., No.CIV 538248, 2020 WL 9889619 (Cal. Super. Ct. Oct. 1, 2020).

2. See, e.g., Michelin N. Am., Inc. v. Fed. Ins. Co., No. CV 6:17-1599-HMH, 2017 WL 11458023, at *3 (D.S.C. Nov. 7, 2017) ("[O]ther insurance clauses govern the relationship between insurers; they do not affect the right of the insured to recover under each concurrent policy").

3. See Hagstrom v. Am. Circuit Breaker Corp., 518 N.W.2d 46, 48 (Minn. Ct. App. 1994) (enforcing the parties' right to agree to contractual choice-of-law provisions unless a party acted in bad faith or exhibited an intent to evade Minnesota law); Land O'Sun Mgmt. Corp. v. Com. & Indus. Ins. Co., 961 So. 2d 1078, 1080 (Fla. Dist. Ct. App. 2007) (mandatory forum selection clause may not apply if it is the result of unequal bargaining power, contravenes strong public policy in excluded forum, or transfers a local dispute into a foreign forum).

4. See RSUI Indem. Co. v. Murdock, 248 A.3d 887, 900-01 (Del. 2021) (applying Delaware rather than California law on insurability of alleged fraud because Delaware law should govern interpretation of D&O insurance issued to a company incorporated in Delaware).

5. Goggin v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA, No. N17C-10-083, 2018 WL 6266195 (Del. Super. Ct. Nov. 30, 2018).

6. See American Forest Holdings, LLC v. Marsh & McLennan Cos., Inc., No.653815/2013 (N.Y. Sup. Ct. filed Oct. 31, 2012) (addressing disputed coverage claim where D&O policy lapsed after a merger was completed due to lack of required notice to insurer under policy's change-in-control provision).

Geoffrey B. Fehling *is Counsel in the firm's Insurance Coverage group in the firm's Washington D.C. office. Geoff represents corporate policyholders and their officers and directors in insurance coverage disputes involving directors' and officers' (D&O), errors and omissions (E&O), and other professional liability claims, cybersecurity and data breaches, representations and warranties, employee theft and fidelity claims, government investigations, breach of fiduciary duty, environmental liabilities, and property damage. He can be reached at +1 (202) 955-1944 or gfehling@HuntonAK.com.*

Syed Ahmad *is a partner in the firm's Insurance Coverage group in the firm's Washington D.C. office. Syed represents clients in connection with insurance coverage, reinsurance matters and other business litigation. He can be reached at +1 (202) 955-1656 or sahmad@HuntonAK.com.*

Rachel L. Beck *is a senior vice president at CAC Specialty.*