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AN UNDERRATED PRIVATE EQUITY RISK:
When Portfolio Company Board Seats Get Hot

PART II: Getting the Right Director and Officer Liability Insurance Coverage

Part I of this article discussed the unique director and officer (D&O) liability risks associated with private equity fund representation on portfolio company boards, and it proposed some board practices designed to avoid or minimize shareholder claims. That risk will perhaps be magnified during a recessionary cycle.

Of course, successful claims can be made whether as a result of "bad" court decisions or "nuisance" settlements, notwithstanding attention to best practices. Where best practices and portfolio company indemnification obligations fall short, D&O liability insurance coverage becomes the last wall of protection.

The following summarizes some of the major pitfalls in negotiating D&O policy terms and conditions, as well as mistakes commonly made by insured parties that can impact coverage. It will also describe a newer form of coverage that insurers have tailored for private equity fund managers.

The many variations in D&O products, including from traditional or primary policies to excess or "umbrella" policies, are beyond the scope of this article, but should be carefully reviewed and tailored to each portfolio company's circumstances.

Portfolio Company Charter Provisions: Indemnification and Expense Advancements

Most portfolio company charters or bylaws provide for indemnification of officers and directors from certain claims – provided they adhere to some minimum standard of conduct, and provide for legal fees and cost reimbursement. However, the company's indemnification obligation will only be as good as its ability to pay, which may be limited in the case of an early-stage company or one experiencing down rounds or bankruptcy.

A policy's "Side A" coverage steps in where the company cannot fund its indemnification obligation to the director or officer. "Side B" coverage makes the company whole, if it makes good on its indemnification obligation. Experienced legal counsel can ensure that a portfolio company's charter and bylaw provisions will work in concert with a particular D&O policy. Each should be designed with the other in mind.

Negotiate D&O Coverage with Litigation in Mind

It is critical for private equity funds to review and understand the liability policies being purchased for their portfolio company boards well in advance of any actual claim. The specific provisions of D&O policies are being more closely scrutinized than ever before. As with many things, you get what you pay for, and the focus should be on maximizing insurance coverage when and to the extent a director is mostly likely to need it.

Rather than rely solely on the judgment and advice of the portfolio company's in-house and outside counsel, private equity funds should have portfolio company D&O policies reviewed by independent legal counsel experienced in both shareholder litigation against boards and insurance companies.

1. **"Bad Actor" Exclusions, Triggers and Attribution**

   Most policies contain "conduct" exclusions for dishonesty, fraud, illegal profit or advantage. Such exclusions appear in all policies, but vary widely. The conduct exclusions are implicated in virtually every D&O claim, as most every suit alleges that the defendant director or officer acted in self interest or without full disclosure. To preserve their right to deny claims based on these conduct exclusions, insurers issue "reservation of rights" letters allowing them to defend the claim without being bound to the outcome, and also providing an escape if new facts surrounding the director or officer's conduct are uncovered in the discovery phase.

It is important to determine if the "trigger" for enforcing the exclusion is a "final adjudication" (which would be preferred, as it requires a finding of misconduct), or a "finding of fact" or "admission of fact" (which is too ambiguous and open to interpretation).

It is also critical to confirm the circumstances under which the conduct of one director or officer can be imputed to the portfolio company or other directors or officers. For example, many policies impute the conduct of a senior officer to the company coverage, but may uphold the personal coverage.

2. **Securities Law Claims and Issues**

It is important to consider whether the D&O coverage under a policy extends to investor claims for violation of applicable securities laws, which can apply to private placements and public offerings. While private equity funds invest in private placements of equity or debt, it is possible (and will often be claimed by portfolio company founders or other investors) that the offering violating the filing or anti-fraud requirements of the Securities Act of 1933 or applicable state laws.

Such claims may be uninsurable as a matter of public policy, so it is critical to understand how securities law violations, claims or damages are defined or addressed by the D&O policy. Thus, whether a claim for coverage can be denied as a securities claim or as counter to public policy, will depend on the language of the policy and also the law.

For this reason, notwithstanding how director or officer-favorable a policy may be, it is critical that experienced legal counsel manage any litigation, including any settlement or drafting of any settlement agreements or orders, with this potential exclusion in mind. "Side C" coverage within a policy covers securities claims.

3. **What's a "claim" requiring notice to the insurer?**

Insurance companies frequently claim prejudice when they do not receive "proper and timely" notice of any claim. Most private equity fund executives know to report any potential claim to the insurer as soon as possible. Particularly in smaller private companies where officers, directors and shareholders are active in the business, complaints and informal "claims" are more frequent, but formal notices of potential claims to the insurer are not.

The definition of a "claim" in most D&O policies is much broader than a formal "complaint" initiating a lawsuit. "Demand" letters for certain company or board actions may be received, discounted, and then ignored. Or the company may assume the demand was acted upon, and mistakenly conclude that the complaint was addressed. If the relevant legal jurisdiction does not require a showing of "prejudice" by the insurer, D&O coverage can frequently be lost through failure to notify.

Therefore, the "claim" definition should be negotiated and tailored to the particular portfolio company, ownership and management circumstances. Many insurers will accept a prerequisite of notice to the general counsel (if one exists); others may agree to a defined prejudice clause; and still others may demand notice within 30 days, and accept it up to 120 days when there is no actual prejudice.

4. **"Insured Plaintiff" Problem in Closely Held Companies**

Every policy should be reviewed to determine the existence and breadth of any "insured versus insured" exclusion. In many portfolio companies, it is possible that a plaintiff shareholder (e.g., a company founder who continues to hold equity and a company office, and who sues the board) may also be an insured (i.e., as an officer).

Surprisingly, a claim brought by a current insured, or even a former officer or director who continues to be insured, can be excluded under many policies. However, this exclusion can be negotiated so as to apply only to claims by the company under Side B coverage, or at least to limit the exclusion to certain types of shareholder claims.

New Product for Private Equity Funds

Insurers have seen the growth in private equity (PE) investing as an opportunity to expand their product offerings to offset the unique potential risks facing PE firms. These PE management liability policies are unique in that they combine "D&O liability" coverage with "Errors and Omissions" (E&O or professional liability) coverage into one single policy to address risks unique to private equity fund managers sitting on portfolio company boards.

Under the old "dual policy" system, where separate D&O and E&O coverage was purchased from different carriers, a claim is filed with both carriers. The resulting diversity of interests between the two would lead to debate, and ultimate reservation of rights. Less certain about coverage, insured directors or officers have more incentive to hire their own counsel at their own expense.

Insuring Personal Risk

PE funds are experts at analyzing portfolio company risk and accounting for that risk in their pricing decisions. When a company downturn or other circumstance leads to shareholder claims against the personal assets of a director or officer appointed by the PE fund, however, indemnification from company assets is not ideal and may not even be available.

Services to portfolio companies through a management company, and to limited partner investors through a general partner entity, allow fund executives to safeguard their personal assets. But when the fund executive serves as a portfolio company director, the liability exposure becomes personal, making careful selection and negotiation of D&O and E&O insurance imperative.

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