

How Private Equity-Firms and their Directors Protect themselves in Case of Liability Claims

Private Equity-firms are known to be calculated risk takers; and this approach has rewarded many of them and their investors. But how much risk are they willing to take when it comes to their firm's liability? Or their own personal liability?

Many partners engaged in Private Equity-firms (PE-firms) take comfort knowing they will be protected by indemnification from the fund, the fund management company or a portfolio company if they are sued while serving on its board. But even if the fund can indemnify the individuals, PE-firms may be reluctant to do so, as settlements divert money from the fund and negatively impact internal rate of return. This could lead to disputes with fund investors. Such disputes are fairly seldom in the PE/VC community, but when they happen, they rarely arise early during a fund's life; rather they materialise when the fund is later stage and there is little capital left in the fund to satisfy indemnification obligations.

Following the AIFMD¹ (and its Swiss equivalent) the liability exposure for PE-firms from their operational risks needs to be backed either by additional equity or by insurance. Having a choice, taking out insurance may be better aligned with the investors' interests: Invest Europe² noted during the consultation process of the AIFMD, that *'professional indemnity insurance should be a far better policy instrument to meet the risks to investors from professional negligence than additional own funds. Requiring additional own funds reduces the ability of the owners of the AIFM (typically the senior management) to invest in the AIF. This has traditionally been a key mechanism, insisted on by private equity and venture capital AIF investors, for aligning the interests of investors and AIFM.'*

The insurance market has responded to the needs of the PE/VC business by creating an industry-specific coverage (in the following called 'Venture Capital Liability Insurance' – VCAP insurance) in order to transfer these liability exposures. A properly structured VCAP policy not only can provide for defence of certain claims up to final adjudication but can also keep things from getting to that point by providing a funding source for a settlement that doesn't impact the fund. Most importantly for those persons holding director positions within the investment structure, VCAP insurance can protect individuals in situations where they would not have the benefit of indemnification from the fund (e.g. when the lawsuit is a derivate suit initiated by the investors or a regulatory agency or when the partnership agreement does not permit indemnification).

Liability claims against a PE-firm and its directors fall typically into one of the two categories: (1) 'Fund Management', creating an exposure to professional indemnity (PI) along

¹ Alternative Investment Fund Manager Directive. For an analysis of the AIFMD's requirements and its implementation for PE-firm please refer to the paper 'Insurance as Enabler of a PE-firm's Strategy' published in SECA's Yearbook 2016, respectively the paper 'Weshalb Vermögensverwalter kollektiver Kapitalanlagen eine Haftpflichtversicherung ihrer beruflichen Risiken benötigen' published in SECA's Yearbook 2015. The articles can be downloaded at www.seca.ch.

² Invest Europe, formerly known as EVCA - European Private Equity and Venture Capital Association, is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

the four stages of PE-investing as outlined below in section 1, and (2) 'Board Representation', a directors' & officers' liability exposure, which is examined in section 2.

Next, section 3 illustrates how VCAP-insurance addresses these exposures and tells which pitfalls need to be avoided when implementing such insurance.

Section 4 concludes.

Liability Exposures During the Investment Phases

Investors (the 'limited partners') expect the PE-firm (the 'general partner') to manage the fund according to guidelines outlined in private placement memorandums. When describing a typical investment process for direct investments, four stages with different core activities and their associated risks can be detected:

Stage 1 - Fund Raising

The solicitation process of institutional investors is started by presenting the investment strategy of the fund. It is key that all information needed to get a full and clear picture of the investments and the associated risks is presented to the potential investors. This presentation is done via road shows and outlined in writing in the prospectus or private placement memorandum (PPM). The main exposure of this first stage is the actual or alleged fraud or misrepresentation and incorrect or incomplete risk disclosure in the PPM or other information provided during the solicitation process.

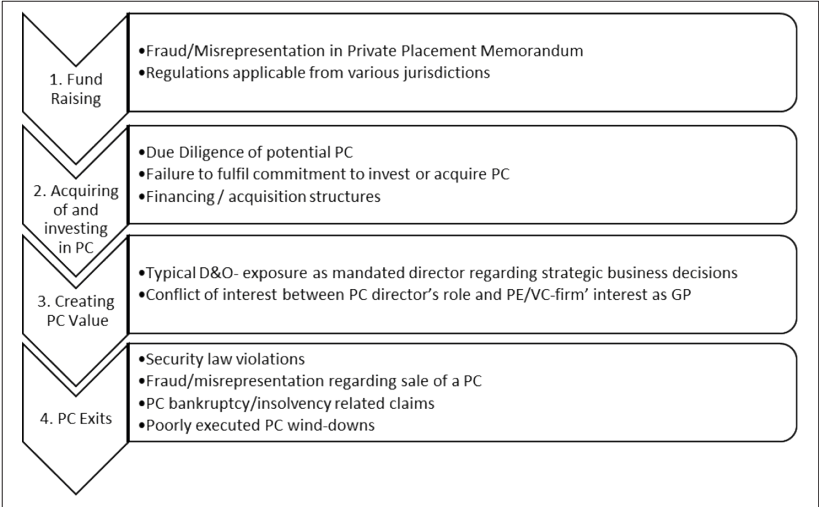


Figure 1: Exposures during the Four Stages of the Investment Activities

Stage 2 - Investing and Acquiring of Portfolio Companies (PC)

Once the investors are on board and the necessary commitments have been received in the first closing, the fund manager enters into the stage of performing due diligence re-views of potential target companies. The selection of a PC as such, the chosen struc-

ture, the type of financing of the acquisition and other decisions taken in the context of the acquisition can be grounds for complaints by the investors. Whereby these allegations will be made by investors there is also a risk coming from another side: potential or future portfolio companies can claim compensation from the PE-firm or the fund manager for the failure to fulfil commitments to invest or acquire the portfolio company.

Claim Example 1: *A fund manager entered into a share purchase agreement (SPA) with a potential PC on behalf of a fund. The agreed price was paid by the fund manager without sufficient security but the target PC did not honor its obligation under the SPA to transfer the relevant shares but transferred them to a third party. The proceedings for recovery of the paid amount were only partially successful and investors claimed against the fund and the fund manager for compensation of the loss and the costs incurred for the recovery of the amounts.*

Stage 3 - Creating PC Value

The focus of the investment is to increase the value of the PC. The PE-firm will intend to do so by gaining influence on the business model of the PC sending employees to sit on the different board of directors. One person may hold between four to eight board seats. The PE-mandated directors are often directly engaged in strategic management decisions with the aim to make the PC more profitable and enhance their value. And, as directors, they are personally liable for wrongful management decisions. When the PC does not show the expected development and increase in value the range of potential allegations claiming wrongful management decisions or omissions is wide. The PE-mandated director can consequently be facing allegations like any 'regular' board member.

An additional risk, specific to the role as PE-mandated director, arises out of their 'double role' which can lead to a potential conflict of interest: Being sent by the PE-firm to act as director to the PC, the employee is requested to act in the interest of the PE-firm (or the GP) whereas in the position as board member of the PC, the director has to act exclusively in the interest of the PC. In fact, allegations of conflicts of interests are widely seen in claims.

Claims filed against board members of a PC can originate from various sources: the original founders of a PC, other members of the management, creditors, shareholders, competitors, suppliers, vendors, governmental/regulatory agencies or company employees. Even the PC itself can be the claimant and in such cases will not indemnify the director for the damages they claim.

Claim Example 2: *A group of venture capital firms provided bridge financing to a portfolio company (PC) through their respective funds and had each appointed one of its partners to the PC's board of directors. When the PC went into insolvency procedure a group of minority PC shareholders filed a lawsuit against the funds and their respective general partners, alleging they had conspired to defraud the PC's common shareholders. They also alleged that the partners appointed as directors by the group of venture capital firms never intended to act in the best interest of the PC. In addition, the PC shareholders sued each of the PC directors (including the individual general partners representing their respective venture capital firms), alleging they should have pursued more favourable financing that could have avoided an improper takeover of the PC by the group of venture capital firms. In a settlement, the lead venture capital firm paid EUR 2 million, with the other firms settling for lesser amounts.*

Stage 4 - Portfolio Company Exits

There are a number of options available how the PE-firm can exit a PC: sale, IPO or - in case the investment did not develop well – ‘close the doors’ (write down, liquidation, bankruptcy) – only to name a few. In the course of the divestment various aspects need to be monitored by the management of the PC. A potential breach of obligations can occur in different areas: a violation of applicable securities laws, misrepresentation or fraud in respect of the sale of a PC (potentially in a prospectus), non-fulfilment of contractual obligations of an M&A contract, duties of notification related to a bankruptcy proceeding of the PC, poor execution of the PC wind-down, negligence in respect of general reporting and information duties towards regulatory bodies or investors etc.

***Claim Example 3:** A PE-firm executed an in-kind distribution shortly after taking a portfolio company (PC) public. The shares designated for distribution, as a matter of normal business practise, were placed in the custody of a third party. Due to a processing error, several limited partners were not notified about the stock distribution and that the PC shares were available for trading. The error was discovered several months later, by which time the stock value had dropped significantly. In order to recoup the lost value of the stock, the limited partners sued the management company of the firm and the fund through which the PC investment had been made, alleging they had failed to provide notification of the in-kind distribution. The case settled for more than USD 7 million.*

Liability Exposures arising from ‘Board Representation’

The Directors’ & Officers’ Liability Exposure

The investment process described above is only one part of the risk a PE-firm is exposed to. Besides, the company itself has to be managed diligently. The executive management and the board members are exposed to managerial liability claims just to the same extent as the management of other firms in other industries. Management obligations comprise *inter alia* the duty to take reasonable strategic decisions, to set up a good risk management system, to comply with legal and regulatory requirements and reporting duties and to respect further industry specific rules and standards. As compliance with these rules is controlled by regulators or other official bodies directors and officers can also personally be targeted by investigations initiated by these institutions. Especially PE-firms with branch-offices and subsidiaries abroad, advising or managing offshore funds that hold SPVs and PCs in a variety of jurisdictions, and their directors have to comply with several legal and regulatory frameworks. Regulatory investigations and criminal prosecutions are often followed by civil law claims for compensation.

In times when the company has financial problems, needs to be liquidated, a receiver is appointed or the company has already gone bankrupt, the management is facing a larger risk of being held personally liable for losses that shareholders, the entity or third parties have suffered. As the members of the management are thus putting their private assets at risk³, such scenarios can turn into a very threatening situation. Even if the claimant has to prove that a wrong managerial decision or omission is the cause of such loss

³ Art. 754 Swiss Code of Obligations provides that the members of the board of directors and all persons engaged in the business management or liquidation of the company are liable to the company, the individual shareholders, and the creditors for any losses or damage arising from any intentional or negligent breach of their duties. In addition, corporate directors also may have a significant liability arising out of tax or social security obligations.

the manager will most probably defend him or herself immediately and incur substantial legal defence costs.

Claims filed against board members of the PE-firm, of a fund or of a PC can originate from various sources: investors, competitors, suppliers, vendors, the PE-firm, the fund or the PC itself, its employees and management as well as other board members.

Risks on the Horizon: Cyber Security Exposure to Directors' & Officers'

As the number of cyber-attacks and threats is increasing across all industries, there is no doubt that cyber security moves up the agenda also amongst most PE-fund managers. However, few may really understand the true nature of the threats they are facing as PE-fund managers rank low on the maturity scores to manage this issue. According to an industry-wide survey run by EY, cyber-security⁴ is the top priority of the regulatory and compliance agenda for the next 24 months as regulatory fines for insufficient risk management measures against cyber security attacks have and will further increase, concerning both the PE-firm and their PC.

How to Insure these Exposures

Claims experience shows that lawsuits are often directed against various parties including the PE-firm, the fund, the fund manager and the individuals in their different roles. In many cases it is difficult to clearly allocate the allegations to either the professional liability or the management liability of the individuals. A VCAP-type of insurance solution offering a combined coverage for both D&O liability and professional indemnity enables the PE-firms to transfer various risks to an insurer.

The standard, 'of the shelf' VCAP-insurance policy for investment or fund managers is a good starting point, but should be reviewed and in some cases adapted to reflect the individual structure and business model of each PE-firm.

PE-firm's Professional Indemnity Insurance

A PI policy⁵ part will cover primarily the PE-firm and the other insured legal entities in case of a claim for damages allegedly caused while executing their contractual duty to provide the agreed professional services. These claims will often be made when a fund and therefore the investors of the fund have suffered a loss. Legal fees, expenses and damages will be covered in case of a valid claim. Typically, the PI insurance also pays the defence costs for unfounded claims.

What are the pitfalls?

- The definition of 'professional services' needs to match the activities and services provided by the PE-firm and the other insured entities of the PE-group.

⁴ Source: 2017 Global Private Equity Survey Ernst & Young, page 33 and 34

⁵ Professional indemnity insurance is also called professional liability insurance; in the US the term 'errors and omissions' (E&O) insurance is commonly used instead.

- The policy should cover all funds, its SPV and investment holding entities. This can be done via listing all funds in the contract or by adding a general definition including coverage for newly created or acquired funds, SPV or Investment Holding Companies. The latter will avoid gaps in case of changes during the policy period and reduces reporting obligations.
- PI-insurance is protecting the management entities and the funds against claims made by a third party which is not insured under the policy. If the fund is named as insured entity in the policy a claim made by this fund against e.g. the GP will not be covered under a VCAP-policy as there will be a so-called ‘insured versus insured’ exclusion. Certain important exemptions to this exclusion should therefore always be sought.

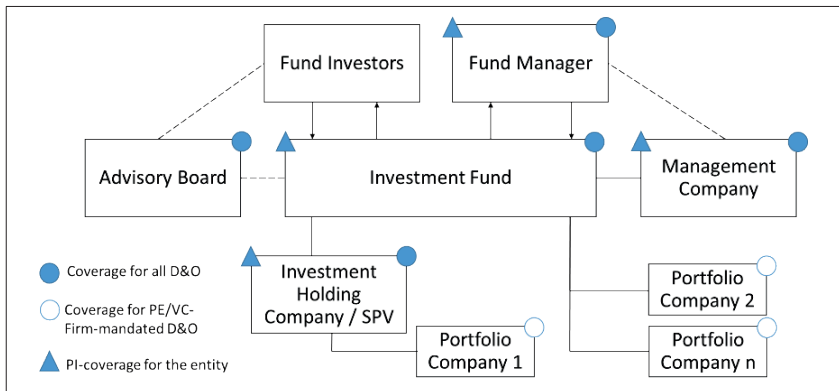


Figure 2: Visualisation of VCAP-Insurance Coverage

PE-firm's D&O Insurance

A VCAP-policy will typically provide coverage for the board of directors and the executive management of the policyholder, the subsidiaries, the funds of the group, and for the PE-mandated board positions held within PC companies.

What are the pitfalls?

- Stand-alone D&O insurance products (as opposed to VCAP-insurances that combine D&O and PI-coverage) are designed for single entity or holding structures but not for a more complex structure of PE-investments (see figure 2). Hence, a stand-alone D&O insurance generally does not protect the board members of the funds, the GP, the SPV or investment holding companies and the outside director positions (i.e. outside of the PE-firm). This potential gap in the protection of the management can easily be closed by choosing a VCAP-type solution.
- When exercising positions such as PE-mandated director in a PC the director should not rely on the PC's D&O policy. They might not even have bought such an insurance or only one with insufficient coverage in respect of insurance limit and coverage terms. Additionally the terms can vary widely between the different PC, different insurance carriers and the different jurisdictions in which PC are located. An easier solution might be to protect all PE-firm's mandated directors in the various PC via the

PE-firm's own VCAP-insurance. The advantage of such an approach is that all their mandated directors will benefit from the same level of protection – in terms of conditions and in terms of insurance limits – independent of the fact whether the PC has concluded its own D&O policy and in which industry the PC is active in. The PC can still consider buying its own policy to also protect the other management members which will not be covered under the VCAP policy of the PE-firm.

- Today many regulators are looking very closely at financial institutions especially investment managers. This has resulted in a substantial increase of regulatory investigations against the entity and also the individual management members. However the coverage extension seen in standard VCAP-policies will likely only cover investigations directed against individuals, as opposed against the entity.

The PE-firm's Cyber Insurance

Cyber threats within the PE-industry are varied and spread between the possibility of confidential information leakage, compromised intellectual property, denial of service attacks as well as advanced threats arising from malware, ransomware or CryptoLocker.

This in mind, we may find that the most significant part of the cyber insurance for the asset management sector may actually be the emergency response and rectification coverage giving the insured access to immediate emergency services of IT firms in case a cyber-attack occurs. Careful selection of a suitable solution and the coordination with other existing insurance policies to avoid both gaps and overlaps is essential.

Conclusions

The liability risks a PE/VC-firm or their directors can be exposed to are many. As part of an enterprise-wide risk management, the directors of a PE-firm or a fund should evaluate how to mitigate these risks. This can be done by setting up a state of the art IT system, enhancing internal procedures and protection measures, training employees or adding audits. With respect to the residual risk after such mitigation efforts, a decision will have to be made on how much of the risk shall be transferred to external parties by e.g. concluding an insurance.

For a director it is crucial to establish if the portfolio company, which he/she is joining as director, has D&O coverage in place. If in place, it is sensible to get specialist advisors to review and determine the coverage and the limits of liability provided. Alternatively, the director should request the PE-firm to arrange D&O insurance coverage extending to all mandated director positions on the board of multiple PC.

With complex contracts, the devil is in the detail. Expert advice from an independent insurance broker is recommended. It is essential to have the terms of the insurance contract, definition of terms, exclusions, as well as obligations of the parties to the contract carefully reviewed in respect of the specific situation of the PE-firm. In addition to reviewing the policy terms and conditions, the board should take into consideration the insurer's financial strength, underwriting expertise and claims-paying reputation.

Annette Wolff

Senior Underwriter Financial Lines

annetewolff@chubb.com

Chubb Insurance (Switzerland) Limited

Bärengasse 32

CH-8001 Zürich

Gregory Walker

Managing Director

gregory.walker@risksolution.ch

Walker Risk Solution AG

Baarerstrasse 112

CH-6302 Zug



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Walker Risk Solution AG
Baarerstrasse 112, CH-6302 Zug

+41 41 511 78 88
anfrage@risksolution.ch

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