

Insurance as Enabler of a PE/VC-Firm's Strategy

Key assets such as market share, first mover advantage, share price and reputation are real exposures for PE/VC-firms and their portfolio company, but cannot be insured. Yet, for the protection of the PE/VC-firm's balance sheet and the value of an investor's assets, insurance can play a vital role.

As in years past, institutional investors (respectively the limited partners) continue to pressure the AIFM¹ (the general partner) for greater transparency, enhanced governance and more performance-based compensation structures. More recently, they are also making demands in what would appear to be an unlikely area: insurance coverage.

Why Investors Prefer the AIFM to be Insured

Regulatory scrutiny, aggressive tactics from plaintiffs' counsel and pressures to unwind flagging funds at a faster pace are creating a need for fund managers to better manage inherent risks. As the AIFM and their funds find themselves entangled 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?

From a compliance standpoint, since the revised regulation on collective investment schemes² came into force, the fund manager has the option of covering the professional liability risk

either by means of additional own funds or by a PI insurance³.

With this choice, when considering how to cover the exposure to professional liability an AIFM should intuitively prefer the 'insurance option' rather than adding capital to 'own funds'. That is why the European Private Equity and Venture Capital Association EVCA⁴ 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 of the AIFM) 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."⁵

Still, the smaller size AIFM may opt to cover its liability risk with additional 'own funds' purely for cost reason. The argument is simple: the regulation requires a much lower amount of coverage if the risks are backed by a cash equivalent instead of by insurance. The mid-size and larger AIFM, however, should consider the institutional investor's perspective of getting much higher amount of protection by way of insurance and balance that argument against the lower cost of the 'own funds'-option.

How the AIFMs is Insured

Professional indemnity and management liability⁵ insurance have been part of the risk management strategy of most medium-sized or larger AIFMs regardless of the minimum coverage required by regulation. The primary reason is not the protection of investors, even though

¹ Alternative Investment Fund Manager, investing, for instance, into assets of private equity and venture capital (PE/VC).

² The partial amendment of the Federal Act on Collective Investment Schemes (CISA) and the Implementing Ordinance on the Collective Investment Schemes (CISO) came effective 1 March 2013. The recent changes aimed at adapting provisions to the new international standards, in particular to the Alternative Investment Fund Managers Directive - AIFMD (2011/61/EU).

³ Professional indemnity insurance, also called professional liability insurance; in the US the term 'errors and omissions' (E&O) insurance is commonly used instead.

⁴ The former EVCA is succeeded by Invest Europe, which is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

⁵ Also known as directors' and officers' liability insurance, or more commonly D&O insurance.

they might also benefit from it. It is rather the own interests of the AIFM's directors and officers protecting their personal assets in the event of investors' claims.⁶

PE/VC funds face a unique exposure in the area of professional indemnity and management liability. While these risks seem to be fewer in an era of increasing returns and outperforming funds, the new regulatory framework requiring an increased focus on corporate governance and risk management has nonetheless added to a rising rate of claims against funds (and the individuals therein).

The potential exposures of PE/VC-firms to management and professional liability come from a variety of sources:

- Alleged misleading offering documents or mismanagement of the fund.
- Alleged negligence by the PE/VC firm with regards to the management of its investments, specifically:
 - Poor due diligence prior to acquisition of a target company.
 - Indemnification provisions in portfolio companies.
 - Employment-related issues in the management of portfolio companies.
 - Corporate governance issues in the portfolio companies.
 - Insolvency of a portfolio company.
- Exits from investments, including dealing with minority shareholders of portfolio companies, or conflicts of interests.
- Administrative errors in distribution of proceeds including 'in-kind' distribution.
- Internal fraud⁷.

⁶ Even if an indemnification agreement in a service contract with the AIFM can protect the directors and officers to a certain extent, such clause may become invalid, e.g. in case of gross negligence.

⁷ Fraudulent schemes of employees with or without assistance by third parties often operate undetected for many years and can cause potentially high losses. Criminal prosecutions as well as civil and regulatory actions have a direct impact on the AIFM's operation.

- Corporate governance issues in the PE/VC firm.

For most directors and officers of an AIFM, when buying or renewing an insurance policy, the key decision items are the sum insured and its cost. Because solutions are often tailored to the AIFM's risk profile, it is difficult to compare premium rates with peers⁸. Even differences in the pricing of insurance offers for the same risk can be significant. The below table provides a rough benchmark for a Swiss based AIFM.

Holistic Insurance Solution covering the AIFM's exposure to D&O and PI liability (combined) considering 'best market standard'					
AuM (CHF Mio)	Sum insured	as % of AuM	Chosen deductible	Premium rate	Cost of insurance
50	2 000 000	4,00%	25 000	0,90%	18 000
100	5 000 000	5,00%	50 000	0,75%	37 500
250	10 000 000	4,00%	100 000	0,60%	60 000
500	15 000 000	3,00%	150 000	0,55%	82 500
1 000	20 000 000	2,00%	250 000	0,50%	100 000
2 500	30 000 000	1,20%	500 000	0,45%	135 000
5 000	50 000 000	1,00%	500 000	0,42%	210 000

Table: D&O-Liability and PI-Insurance

Source: Walker Risk Solution Ltd

Far more important for the insured, but more challenging to assess than price, are the terms and conditions of the policy, the insurer's understanding of the insured's risk and his capability to offer tailored cover, the ability and willingness of the insurer to pay claims, as well as the impartial advice, service quality and competence of the insurance broker. The AIFM's need for advice and bespoke insurance solutions is typically high.

'Off the Shelf'-Insurance Policies

In the market, there is a wide variety of policy forms, terms and coverage offered. As a result, the AIFMs (and sometimes also investors) are now asking questions about the quality of the coverage provided.

The standard, 'off the shelf' insurance policy for investment or fund managers is a good starting point, but is never adequate. Because each fund

⁸ The cost of insurance depends on the desired limit insured, the level of excess, and the specific coverage extensions required, including the carve-back or elimination of certain exclusions.

manager has a unique structure and investment focus, adaptations of the 'off the shelf' form are always necessary to reflect the business model. If drafted appropriately, insurance can provide coverage for most risks associated with the fund and the related investment activities.

Professional indemnity insurance⁹ and D&O liability insurance¹⁰ can be bought each as a separate policy or as combined insurance program. Sometimes, the directors of an (offshore) fund purchase their own insurance. If the coverages are bought from different insurers, the insured may find insurers arguing among themselves as to which (if either) of the two policies will respond. Thus, in case of multiple policies, the insurances should be well coordinated to avoid gaps or duplicate coverage. To respond to these particular needs, the insurance industry has developed insurance solutions specifically for investment fund managers. Such insurance protects the equity of the AIFM's and its controlled or managed entities, as well as the personal assets of the directors and officers.

Sometimes there are misunderstandings as to which type of liability insurance covers which type of claim. For an AIFM it is therefore crucial to build a sound understanding with directors, officers and partners about the connection between its D&O liability insurance and the indemnification clauses in the investment agreement or similar contractual documents.

When obtaining liability insurance, it is particularly important for the AIFM to carefully identify the kinds of entities that need to be covered, explain the relationships of those entities among one another and the portfolio companies and discuss who the individual insureds must be under the policy. Then, those entities and rela-

tionships should be covered through express provisions that reflect those risks specific to the fund and its investment practices.

Generally, risks relating to litigation from investors are covered. Also, with some careful drafting and negotiation, 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 regulatory investigations. And, insurance can mitigate loss to the AIFM caused by employee fraud.

Should the AIFM choose insurance as a means to cover its professional liability risk as stated in the revised regulation, the policy has to meet the PI insurance's contractual prerequisites of the FINMA ordinance and cover the specific risks mentioned therein¹¹. Indeed, since the AIFMD came into force in 2013, insurance brokers required and likewise insurers readily offered to amend the AIFM's insurance solutions with a so-called AIFMD-extension. These policy endorsements would usually list the type of risks covered as well as insurance contractual obligations following the Directive word for word. While such an approach would be a condition for the insurance policy to become compliant, it is not sufficient¹².

Contractual Risks of Insurance

Insurance policies come with contractual risks, and, in the event of a dispute with the insurer, there might even be litigation risk. The reason for this is not so much because of any unclear or ambiguous wording of the policy (although this can be the case too), more likely the reason for contract uncertainty is simple oversight and handling errors of the insurance applicant, respectively the policy holder, the broker or the

⁹ The professional indemnity insurance responds to the AIFM's loss from a claim from professional wrongful acts of the AIFM or an insured person for which the AIFM is legally liable.

¹⁰ The D&O liability insurance indemnifies the insured persons' loss (or the AIFM to the extent it has indemnified that insured person) arising from a claim for wrongful acts of insured persons in their capacity as directors and officers of the AIFM, the fund or of the portfolio companies.

¹¹ Art. 75 and 76 CISO-FINMA.

¹² Discussed in more detail in Dirk A. Zetzsche (ed.), *The Alternative Investment Fund Managers Directive*, Second Edition, 2015, Chapter 10 - The AIFM Liability Insurance, Gregory Walker (auth.).

underwriter at the time of concluding or renewing the insurance contract, or when having to meet the several contractual obligations as precondition to a successful claim under the policy.

Surprisingly, 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, sometimes 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 insured 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 AIFM's investment activities. For example, many liability policies have an investment banking exclusion that 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 removed. Furthermore, the definition of 'professional services' needs to be modified to specifically list all investment activities of the AIFM, general partner, managers and advisors, as it relates to the funds and any portfolio company, special investment vehicle, joint venture, third party supplier, client, investor, or otherwise.

All this said, a properly designed and carefully maintained insurance contract is an effective means of risk transfer.

Insurance as a Strategy Enabler

Other cost efficient risk mitigation opportunities for the AIFM arise from corporate finance transactions: legal litigation exposures and counterparty risks from breach of contractual

warranties and representations can be insured. Sometimes an M&A deal is not closed and the target might claim for lost financing opportunities or for breach of confidentiality agreements.

In some situations, investments abroad can cause significant loss related to credit risk or political risk from confiscation and the like.

Further, the AIFM or the investors might consider the financial consequences of a loss of key persons. The initial catalyst for key person insurance is often an MBO or M&A transaction where the purchaser is motivated, or mandated, to ring-fence this exposure within the acquisition target.

Fortunately, major perils materialize only rarely. If they do, the ability of the AIFM to protect its investments, settle justified claims by investors and successfully defend against unjustified claims might be greatly impaired. Taking this into consideration, Invest Europe (the former EVCA) recommends its members to align their insurance requirements regularly with the own risk profile¹³. The objective of insurance is to protect the AIFM, the fund and ultimately the investors from unexpected and significant loss.

From the AIFM's perspective, it is about optimizing the risk-based deployment of capital while taking well calculated risks.

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13. Invest Europe Handbook of Professional Standards (2015), www.investeurope.eu/media/431779/Invest-Europe-Professional-Standards-Handbook-2015.pdf / (accessed 17 February 2016).