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GPL Insurance for Private Equity Firms – What Questions To Ask

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Many private equity firms are concerned about their liabilities, including exposure to lawsuits for breach of fiduciary duty, claims for wrongful acts or omissions, and regulatory or securities investigations. One of the best ways to minimize and protect against these liabilities is general partnership liability ("GPL") insurance. In this article, we identify some key questions a private equity firm thinking about purchasing GPL insurance should consider.

Why Get Coverage?

One of the leading reasons for getting GPL insurance is to insure the indemnification obligations of the funds and protect fund assets. The typical fund indemnity covers the fund manager and general partner and their respective officers, directors, employees, partners, and agents. This indemnity is usually funded by the liquid assets of the fund, or by calling capital contributions or a return of distributions through clawback obligations. Limited partner clawback obligations are often subject to limitations on the amount that can be clawed back and/or the time during which the clawback can be required. When a claim or investigation occurs requiring payment, carefully drafted GPL insurance, designed to cover such indemnification obligations, can reduce or eliminate the need for such capital calls or limited partner clawbacks. Also, there is often a gap between the scope of liability and the scope of indemnification. Fund indemnification does not usually occur to the extent the loss arises from the gross negligence, recklessness, or willful malfeasance of the indemnitee. GPL insurance (which usually needs to be modified to specifically address this issue) can help close coverage gaps in indemnification arrangements, and protect the fund manager, general partner, and other entities or individuals from non-indemnifiable loss.

Many in the private equity industry are also concerned with whether the insurance and indemnities at the portfolio company level will be sufficient to cover funds, their general partners, managing members, and the management company for exposures at such level. Unfortunately, a portfolio company's D&O insurance is fairly limited, and does not provide much coverage beyond its own board of directors. For example, a portfolio company's D&O insurance will cover a principal only to the extent that principal is a director of the portfolio company and a claim is made against that principal for a wrongful act committed in his or her capacity as a director for that portfolio company.

When a portfolio company cannot or will not indemnify, and the portfolio company's D&O insurance is exhausted or fails to respond, individuals and the fund can be exposed. Careful drafting is required to make sure the portfolio company's D&O insurance and indemnification pay first, and then that the appropriate GPL insurance is in place to protect individuals and the fund when all else fails. Therefore, indemnification arrangements at the portfolio company and fund level need to be prioritized. Prioritizing indemnification and insurance between the portfolio company and the private equity firm doesn't happen automatically. Rather, it takes time and effort to coordinate coverage among the various documents; otherwise, coverage may not be available.[1] Also, certain terms must be in both the portfolio company's D&O insurance and the private equity firm's GPL insurance to ensure seamless coverage between the two levels of insurance.

What and Who Are Covered?

When securing GPL insurance, it is extremely important to identify to the insurance broker and underwriter the kinds of entities that need to be covered, to explain the relationships of those entities among one another and to the portfolio companies, and to discuss who the individual insureds must be. Then, those entities and relationships should be covered through express provisions in the GPL insurance that reflect those particular risks. The defined terms in the GPL policy should be modified so that they are specifically applicable to the private equity firm.

Unfortunately, many brokers and insurers in the market still do not fully understand private equity structures or their business. Some private equity firms end up with mutual fund, venture capital, or D&O insurance, each of which is fundamentally and legally different from GPL insurance. Also, many hedge funds end up with a limited policy form that doesn't provide adequate coverage for those particular investments that are more akin to private equity. The most common problem is that certain entities within the firm structure are not even covered by such policies. Even with significant modification, it is nearly impossible to change these policy forms to properly cover the risks associated with private equity structures and investing. At least with a GPL policy form as a starting point, the required modifications are usually fairly straightforward. For example, the definition of "insured" still needs to be modified to cover the relevant private equity funds, general partners (including foreign, onshore, and offshore entities) and managers. If there are co-investment entities, including those which are used to facilitate, among other things, the principals' estate planning, those entities are usually not covered unless they are specifically included by definition. With appropriate revisions, coverage may also be extended to non-principal professional employees, such as advisers or consultants. Most of these structural modifications are done to a GPL policy for no additional premium.

What Key Risks Can Be Covered?

In the market there is a wide variety of policy forms, terms, and coverage offered. Coverage ranges from "above average" to "not worth buying" – *so let the buyer beware*. The standard "off the shelf" GPL policy is a good starting point, but is never adequate. Because each private equity firm differs in structure and business focus, revisions to the "off the shelf" form are always necessary. If drafted appropriately, GPL insurance can provide coverage for most risks associated with the business 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. GPL policies can also cover certain compliance risks, such as Securities and Exchange Commission and Department of Justice investigations that may arise from time to time.

What Are Other Issues to Look For?

Careful review of the proposed GPL policy and all of the endorsements is warranted, including the definitions, requirements for coverage, and exclusions as they apply to the manager, general partner, fund, and its principals. Insurers, through narrow definitions or express exclusions, usually try to exclude or severely limit coverage for government investigations and deal litigation. Private equity firms need to be on high alert, because without coverage for these significant exposures, individuals and the fund are at risk. Upon the insured's request, many insurers will modify language to address these particular risks. In fact, any provisions that don't fit the private equity firm's particular needs should be negotiated, and any ambiguous language should be clarified through endorsement. 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 when it is needed.

In addition to negotiating manuscripted language to cover the business activities of the particular firm, there are certain exclusions and coverage enhancements that the insured should push for with the insurer. GPL policies generally exclude claims brought by or on behalf of one insured against another insured, subject to certain exceptions (such as shareholder derivative actions.) This is commonly referred to as the "insured vs. insured" exclusion. Since the limited partners are, of course, partners of the fund and could, therefore, be deemed an "insured" under firm GPL insurance, this may exclude from coverage claims by the limited partners against the general partner or manager, particularly if the suit is brought as a derivative action in the name of the fund. In such instances, the insured vs. insured exclusion should be modified to cover these risks, along with others relating to employment practices claims, foreign claims, and claims relating to a change in control, among others.

Another endorsement that should be negotiated relates to coverage for directors in the event of bankruptcy. This is particularly important coverage when a portfolio company investment does not turn out as planned. In the case of bankruptcy, in order to maintain the GPL policy for the benefit of the private equity firm and those individuals that serve on the portfolio company board, express language must be included in the GPL policy to make sure those directors are immediately covered in the event the portfolio company is financially unable to indemnify them. In addition, suits brought by a bankruptcy trustee or creditors' committee against the directors or private equity firm should expressly be included as covered.

Conclusion

Private equity firms thinking about purchasing firm GPL insurance should closely evaluate their exposures and make sure that the policy is crafted to address their particular needs, taking into account their organizational structure. Properly tailored firm GPL insurance can be an asset, as well as a powerful shield for individuals and the fund. It is imperative to review the proposed firm GPL insurance form and endorsements thoroughly to ensure that the private equity firm is properly covered and to aggressively negotiate with the potential insurer – with the help of an informed lawyer and broker – any provisions deemed unacceptable.

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Endnotes

[1] See *e.g.*, *Levy v. HLI Operating Company Inc.*, 924 A. 2d 210 (Del. Ch. 2007) (denying indemnification to directors because they received separate indemnification payments from investment fund, which they represented on corporation's board of directors, when there was no contractual provision addressing relative priority of indemnification obligations of corporation and investment fund).

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