BLOG

Private Equity & Venture Capital Strategies to Mitigate Risk

By The Risk Strategies Private Equity Practice

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With an ongoing hard market for Directors & Officers Liability (D&O) and General Partnership Liability (GPL) insurance, it's important for private equity (PE) firms to understand the key areas of heightened concern for insurers and how these items may affect their renewals. Highlighted below are four key emerging trends and issues in the private equity arena that GPL underwriters are focused on in 2022, along with some recommendations to ensure private equity firm insureds are best positioned to address these concerns and minimize their impact at renewal.

Regulatory

Private equity firms continue to be plagued by regulatory scrutiny. One year after being named SEC Chairman, Gary Gensler has laid out an agenda that will put additional burdens on PE firms and their portfolio companies. For example, the SEC plans to require additional visibility into private equity funds by increasing the amount and timeliness of confidential information reported. Under the proposed changes, PE firms would only have one business day to report certain major events (e.g., removal of a fund's general partner), which could cause logistical complications. The SEC is also reducing the reporting requirement threshold for Form PF from $2 billion to $1.5 billion in assets under management. The intent of these new requirements is to allow the SEC to identify potential risks that are developing in the private markets.

In January 2022, the SEC announced they are beginning to work on a plan to require larger private companies to routinely disclose information about their finances and operations, in a similar disclosure regime as publicly traded companies. The SEC's push for more transparency from private companies is at an early stage. It's unclear as of yet whether private companies of a certain size or number of shareholders will be required to register with the SEC. Requiring additional disclosures will certainly come at an increased cost and burden to growing companies in need of capital. The 2012 Jobs Act raised the number of share- holders a private company can have without registering with the SEC from 500 to 2,000 to allow greater flexibility and reduce the burden for emerging companies going public. This new SEC push for transparency seems to contradict the Jobs Act and likely will receive strong pushback from Silicon Valley who has enjoyed robust funding from PE/VC firms.

Since 2013, the SEC has periodically focused on understanding the fee and expense practices of PE firms. Now it appears that the private equity industry is back under the microscope following Mr. Gensler's recent comments seeking greater insight into the fees charged to investors. Furthermore, Gensler believes that the use of side letters creates an uneven playing field for investors. Private equity firms can expect to have traditional fee structures tested as the SEC looks for more competition and transparency in the industry.

Findings in regulatory audits, exams and investigations can give rise to actions that may trigger coverage under your firm's General Partnership Liability insurance policy. The costs associated with these claims have been the impetus for increasing policies' self-insured-retentions and premiums. Below are some ways to protect your firm and show underwriters you follow best practices.

- Conduct Internal Audits – Many insurers offer Mock Audit Reimbursement coverage to help offset this cost
- Have a fee checklist in preparation for regulatory exams. This can include:
    - List of each fee and expense charged to investors
    - Fee and expense disclosure locations in operating agreements
    - Method of calculation
    - Agreements with third parties for outside expenses
    - Methodology for valuation of portfolio assets
- Take Action – address any errors in the calculation and charging of fees or expenses to investors

Portfolio Company Distress

The financial health of a PE firm's investment portfolio is always a key exposure in an underwriter's evaluation. When a portfolio company declares bankruptcy and its assets are insufficient to pay creditors in full, estate representatives and creditors frequently turn to the sponsors to bridge the gap. This may result in claims against the portfolio company's owners, which may be covered under the PE firm's and/or the portfolio company's D&O policies. Coordinating coverage between the two policies is critical to maximizing cover- age and protecting a PE firm's interests.

Insurers have concerns that we may see increased litigation from portfolio company bankruptcies in the coming years. The global private equity industry recorded an all-time high of $1.81 trillion in dry powder in January 2022. With so much capital awaiting deployment, there is an expectation of fiercer M&A competition leading to higher prices. This, and historically low interest rates offering inexpensive capital, are factors that can potentially create over-valued assets. Underwriters are asking if, at the end of the fund's life, will private equity firms be able to deliver acceptable returns?

Going into renewals, be aware that insurers will be closely reviewing the financial strength of each portfolio company. Be prepared for questions regarding:

- Breach of Debt Covenants
- Signs of Bankruptcy – can the portfolio company fund its operations for the next 12 months?
- Overall leverage of the portfolio
- Dividend Recaps – past and potential

If a company is in distress or has breached a covenant, be forthcoming and show there is a plan in place, talks are in progress with lenders, potential restructuring of debt, and confirm if your firm will provide further capital if necessary.

Venture Capital Concerns

Insurers have typically viewed venture capital firms as lower risk than traditional private equity firms. Venture capital firms tend to have minority ownerships and less involvement in the management of the portfolio company. They may have very diverse portfolios, thereby protecting their returns should one investment fail to deliver. These common attributes have typically allowed venture capital firms to benefit from lower insurance premiums and retentions than their PE firm counterparts, but now insurers are seeing increased claim activity in this sector as well.

One factor contributing to the uptick in claims is inconsistent Directors & Officers Liability insurance at the portfolio company level. Often, many of these smaller assets do not carry D&O insurance. This can be problematic for a venture capital firm's exposure if it has an individual in a director, officer, manager or other position at an uninsured portfolio company, as the costs attributable to a claim against such person would likely fall under the venture capital firm's GPL policy. In such instances, underwriters view the GPL policy as being intended to provide excess coverage and firms that do not mandate or know their portfolio companies' D&O insurance program may be penalized with higher premiums and retentions.

We've also seen increasing claim frequency coming from within venture capital firms, often involving

co-founder disputes. Though GPL policies typically preclude coverage for such claims due to the traditional Insured vs Insured exclusion, in recent years many GPL policies have broadened coverage by limiting the scope of this exclusion to a narrower Insured Entity vs Insured exclusion. This has allowed these otherwise previously excluded claims to trigger coverage under a VC firm's GPL policy.

In addition, there has also been a rising trend in employment practices claims frequency. Venture capital firms' unique informal cultures are often a part of the reason why people love to work there; however, this also often allows for environments where inappropriate conversations, sexual harassment and other employment related wrongdoings can become commonplace.

Venture capital firms can protect themselves by:

- Maintaining a list of portfolio companies' D&O insurance limits

- Checking your policy’s Insured vs Insured exclusion to see if it can be broadened where available
- Implementing a robust employee handbook and schedule employee training

Cyber Liability

In 2021, private equity firms became increasingly aware of the cyber threats to both portfolio companies and their own operations due to a material increase in cyber-attacks and related regulatory oversight.

Throughout the past year, cyber-attacks have filled headlines, as cyber criminals continue to extract billions of dollars in damages from companies globally. These headlines have led to limited partners wanting to better understand what PE firms are doing to protect their networks and address the cyber risks associated with their portfolio companies.

Private equity firms are vulnerable to cyber-attacks due to the large amount of assets at their fingertips and their frequent interactions with third-party vendors and portfolio companies. PE firms are also not exempt from operational challenges that continue to evolve as remote work setups become permanent and technol- ogy footprints expand further into cloud/digital platforms.

Historically, cybersecurity due diligence was not a priority in private equity transactions. However, recent data breaches have brought to light the potential reputational harm and detrimental impact on internal rate of return that a cyber-related event can have on a company. Additionally, if transactional liability programs (such as Representations & Warranties insurance) are purchased in conjunction with an acquisition, many underwriters are mandating the prospective portfolio company to purchase cyber liability insurance with

full prior acts as part of the transactional liability policy requirements. Cybersecurity due diligence can help identify current vulnerabilities and bring awareness to cyber-related exposures which, in turn, will provide unexpected operational improvements throughout the investment lifecycle.

PE firms can proactively address cyber risk by:

- Conduct Cyber Security Assessments at the PE and portfolio company level to address any actionable items (ie. open ports, exposed data and passwords, security flaws) a hacker may exploit.
- Assess and update internal controls. For instance, Cyber insurers are requiring Insureds to have
- Multi-factor Authentication for remote access to the Insured’s network, corporate email, cloud services, and privileged accounts including system administrators.
- Ensure all software that has reached end-of-life or end-of-support has been replaced.
- Confirm a Business Continuity Plan is in place to address a Cyber incident.

- Conduct phishing training for employees to reduce risk of malicious email.
- Confirm Cyber policy will permit use a preferred vendors such as breach counsel, forensics etc.

State of the GPL Market

General Partnership Liability (D&O/E&O/EPL) premium increases that began in 2018 accelerated throughout 2020 and 2021, creating the hardest insurance market in 40 years. Looking ahead in 2022, we expect rates to stabilize in the 5-15% range, assuming similar asset exposures and favorable claims history.

New market entrants and improvements in insurance company profitability have reduced the need and ability for excess carriers to follow primary premium increases. As some insurers have adjusted their increase limit factors, new carriers are available to replace incumbent markets at expiring factors.

In an attempt to reduce volatility, many insurers continue to limit their capacity to $5M. We have generally not seen wide-spread coverage restrictions, except when a private equity firm currently does, or plans to sponsor a Special Purpose Acquisition Company.

Insurers are typically seeking a base retention of $250k for smaller firms and moving to a minimum $500k retention for firms ~ $1B+ in assets under management (AUM).

Recommendations for your GPL renewal:

- Meet with your broker early in the renewal process. Specify any changes in the organization, including structure and strategy, new funds or investment vehicles, or any new contractual insurance obligations. Highlight any possible involvement with SPACs, cryptocurrency or cannabis. A proactive broker should identify insurers that have changed appetite and may need to be replaced along with explaining addition- al coverages available in the marketplace.
- Prepare renewal submission at least 60 days in advance to provide time to market your renewal.
- Check with in-house counsel and senior management team to ensure all claims have been reported timely and talk to your broker about any circumstances that you believe may turn into a claim.

Conclusion

Within the evolving landscape of increased regulatory scrutiny over PE firms and continued premium/retention increases for insurance renewals, it's important to work closely with your broker to ensure your GPL policies are designed to afford the appropriate coverage when needed. In this challenging insurance market, whether or not a private equity firm insured has done its diligence to adequately prepare for renewals will be particularly critical to securing favorable renewal terms and minimizing potential rate hikes and/or coverage restrictions, if any.

If you have questions regarding this article or your current coverage, please contact our Management

Liability Practice Group:

Neil Krauter, Managing Director - nkrauter@krautergroup.com

Stephanie Needham Senior Managing Director - sneedham@risk-strategies.com

Michael McFadden, Managing Partner - mmcfadden@risk-strategies.com

Sara Wice, General Counsel - swice@risk-strategies.com

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