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PRIVATE EQUITY

**Ensuring Equity in Private Equity Insurance Coverage:  
The Top 5 Coverage Issues Private Equity Investors Should Consider**



BY SYED S. AHMAD AND ANDREA DEFIELD

The private equity investment industry is larger than ever. According to Preqin, there are \$2.49 trillion in private equity assets under management as of June 2016, while private equity funds closed 2016 with \$820 billion in “dry powder.” As the industry grows, however, so do the risks facing investors. Indeed, investors and portfolio companies are routinely subject to document requests from and investigations by regulatory agencies—both foreign and domestic—even if a formal regulatory action is never initiated against those entities. Costs associated with responding to Civil Investigative Demands or similar requests can be staggering. Fortunately, a robust insurance program can help mitigate these costs, and others. To maximize coverage and avoid a later dispute with the insurer, here are the top five insurance issues private equity entities should

*Syed S. Ahmad is a partner in Hunton & Williams LLP’s insurance coverage practice in the Washington, D.C. office. Andrea DeField is an associate in the firm’s insurance coverage practice in the Miami office.*

consider when procuring insurance or evaluating their current program at renewal.

**1. Avoid Application Ambiguities**

First, when procuring or renewing insurance, investor insureds should take care to ensure that their insurance applications or warranty letters cannot later be used by the insurer to preclude coverage. Even where an insured has a robust and comprehensive insurance program that appears to provide full coverage for the risk, representations made in its application materials may void coverage.

In most jurisdictions, insurers are permitted to void or rescind coverage where they can prove that the insured misrepresented a term on the application and that the term was material to the risk. *See, e.g., Fla. Stat. 627.409; Griffin v. Am. Gen. Life & Acc. Ins. Co., 752 So. 2d 621, 623 (Fla. 2d DCA 1999)* (“An insurer seeking to rescind or avoid coverage under the statute bears the burden to plead and prove the misrepresentation, its materiality, and the insurer’s detrimental reliance.”). In addition, insureds may be required by their insurers to sign a “Warranty and Representation” letter at renewal. This letter, signed by an insured officer, warrants that there are no pending claims, suits, or actions other than those disclosed therein and/or no knowledge on behalf of the prospective insureds of any potential liabilities that may result in claims. The letters contain a provision allowing the insurer to disclaim coverage for an otherwise covered claim should the insurer discover that the insured knew of potential liability for that claim at the time it executed the letter.

Applications and warranty and representation letters pose unique problems for private equity investors as they require the investor to disclose all known or potential liabilities for not only the investor entity, but all subsidiaries, funds, and portfolio companies. Unless the in-

vestor takes the time to interview those involved at every level, it is virtually impossible for the investor to warrant that it knows of no acts by any entity that may give rise to a later claim.

Although insurers will continue to insist that insureds complete these detailed applications and warranty letters, investor insureds can mitigate these risks by ensuring that the application questions and/or warranty language is not vague, unclear, or ambiguous. For any unclear or ambiguous language, the investor and its insurance broker should request that the insurer revise the offensive language. If the insurer refuses to revise the ambiguous language, the insured will nonetheless be able to argue that the insurer is estopped from denying coverage based on the ambiguous language or question. See, e.g., *Humane Soc. of the U.S. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, CIV.A. DKC 13-1822, 2015 WL 4616818, at \*13 (D. Md. July 30, 2015) (Denying summary judgment for insurer on misrepresentation grounds based on ambiguity in exclusionary language); *Ocean's 11 Bar & Grill, Inc. v. Indem. Ins. Corp. RRG*, 11-61577-CIV, 2012 WL 5398625, at \*13 (S.D. Fla. Nov. 2, 2012), *aff'd sub nom. Ocean's 11 Bar & Grill, Inc. v. Indem. Ins. Corp. of DC, Risk Retention Group*, 522 Fed. Appx. 696 (11th Cir. 2013) (stating that an insurer cannot rely upon responses to ambiguous questions in an application and further that such ambiguities are interpreted liberally in favor of the insured and strictly against the insurer).

## 2. Structure the Portfolio Company's Coverage Separate from the Investor's

Second, investors should structure their comprehensive insurance program so that the portfolio company's coverage is separate from, but primary to the investor's coverage. For example, for claims implicating both coverages, such as where an investor's employee sits on the portfolio company's board, the investor should have the benefit of both policies (and limits). To accomplish this goal, the portfolio company's policy should contain an exception to its "other insurance" clause providing that the portfolio company policy will respond before, and not sit in excess of, the investor's policy to the extent it also insures "loss" covered under the portfolio company policy.

To provide additional coverage, the investor's policy should also provide coverage to its directors, officers, or other insured persons while serving on a portfolio company's board. This is typically referred to in the policy as "outside position" or "outside entity" coverage. This coverage may be standard in the policy—often including an insured's service in an "outside position" within the definition of "insured person"—or can be secured by an endorsement to the policy.

In addition, excluding coverage for portfolio company entities on the investor policy may practically solve certain coverage issues. For example, in the warranty and misrepresentation context discussed above, undisclosed knowledge by a portfolio company should not trigger rescission or otherwise preclude coverage if the portfolio company is not covered under the policy. Also, keeping the coverages separate avoids a situation where claims against the portfolio company erode the investor's policy limits. This allows the investor to have lower limits on their own policy than they would need if

portfolio companies were included, resulting in lower premiums.

## 3. Ensure Maximum Defense Costs Coverage

Third, investors should ensure that both their and their portfolio companies' policies provide for maximum defense costs coverage. While most D&O policies now explicitly include coverage for formal investigations by the Securities and Exchange Commission, many do not extend the definition of "Claim" to cover informal investigations by the SEC or other entities, which may last years and result in significant uncovered defense costs exposure. Other policies may provide coverage for "investigations," but only as to insured directors and officers and not of the insured corporation itself.

Thus, significant defense costs incurred in responding to informal or formal investigations may fall through the gaps in existing policies. To ensure maximum coverage, investors should make sure that the policies provide defense costs coverage for informal investigations either by including same in the definition of "Claim" or by separate provision or endorsement. Investors should likewise ensure that their policies' formal investigation coverage does not require that the investigation be for alleged "wrongful acts" as most Civil Investigative Demands fail to specifically address the wrongful acts giving rise to the demand. In addition, investors should ensure that the policies include coverage for investigations against the investor entity and/or Portfolio Company and not just insured directors or officers.

Finally, investors can avoid disputes with their insurers over defense costs coverage by requesting a 100% defense costs endorsement that requires the insurer to advance 100% of reasonable defense costs for any claim without allocation between covered and uncovered causes of action. In addition, investors can avoid a fight with their insurer over their desired counsel's rates by requesting that the insurer agree, in advance to the investor's selected law firm and rates by endorsement to the policy.

## 4. Beware of Related Claims Provisions

Fourth, investors and portfolio companies should be aware of "related claims" provisions in their D&O policies. These provisions, often referred to as a "single claim" or "related claims," provision, operate to aggregate claims made during the policy period to earlier claims (even if made before the policy period) if the two claims arise out of the same "wrongful acts," transaction, fact, circumstance, or other defined connection set forth in the policy.

Typical provisions state that all claims arising out of the same "wrongful act" or "related wrongful acts" (or "interrelated wrongful acts") will be deemed a single claim made at the time the first claim was made, whether before or during the policy period. In turn, the definition of "related wrongful acts" will be broadly defined as all facts or wrongful acts connected by any fact, circumstance, transaction, etc. Insurers use these provisions to argue that a "new" claim relates back to a claim made prior to the policy period, making the new claim entirely uncovered under the current policy period. These provisions are also used by insurers to ag-

gregate multiple claims made during the policy period so that a single per claim limit applies instead of the policy's higher aggregate limit.

In procuring their D&O policies, investors and portfolio companies alike should ensure that these single or related claims provisions are drafted narrowly to avoid a situation in which coverage is precluded by operation of an overly broad related claims provision. *See, e.g., Weaver v. AXIS Surplus Ins. Co.*, No. 13cv7374, 2014 WL 5500667, at \*12 (E.D.N.Y. Oct. 30, 2014) (“Where the policy’s language refers to ‘any’ fact, circumstance, situation, event, transaction, cause or series of causally of logically connected facts, circumstances, situations, events, transactions or causes, it is ‘immaterial’ that one claim may involve additional facts or allegations because all that is required is ‘any’ common fact, circumstance, situation, event, transaction, cause or series of causally of logically connected facts, circumstances, situations, events, transactions or causes.”), *aff’d*, 639 F. App’x 764 (2d Cir. 2016). Policyholders should ensure that the focus is on how Wrongful Acts are causally or logically related, rather than similarities in any tangential or background facts. *Accord Connect Am. Holdings, LLC v. Arch Ins. Co.*, 174 F. Supp. 3d 894, 903 (E.D. Pa. 2016) (“The focus of the interrelatedness inquiry is on the acts, not on the parties or the goals.”). Insureds may either look for policies with narrow related claims provisions or may request that an existing revision be revised by endorsement so as to only apply when two claims arise out of the same wrongful acts.

## 5. Ensure That Alternative Dispute Resolution Does Not Mean Delayed Dispute Resolution

Finally, most D&O policies require alternative dispute resolution (“ADR”) in the event of a coverage dispute.

Most policies will leave the ultimate decision as to which ADR process, mediation or arbitration, up to the insured. Many of these provisions, however, include problematic limitations that result in unreasonably delayed adjudication of a coverage dispute. For example, many policies require that the underlying claim be adjudicated before the ADR process may be commenced as to any coverage dispute. Such a limitation is unreasonable particularly where an insured may be required to file a declaratory action against its insurer to receive coverage for defense costs while the underlying claim is ongoing, or where an insured must seek a determination of its right to insist on the insurer’s consent to settle. Insureds should thus make sure that their policy’s ADR provision does not contain a final adjudication requirement.

In addition, these policies often contain a cooling off period—requiring that in the event of a mediation impasse, either party may then commence suit no sooner than 90 days after the termination of the mediation. Insureds should request an endorsement that revises the 90 day requirement to a shorter time period so that they may commence a breach of contract or declaratory action seeking benefits sooner than the time permitted under the policy. Again, this is particularly important in disputes over defense costs coverage or consent to settle as the insured would otherwise be required to pay for these losses out of pocket without confirmation that coverage is due.

Investor insureds may avoid many coverage disputes and maximize insurance recovery by working with experienced coverage counsel to be proactive at policy procurement and renewal. As a result, investor directors and officers can focus on corporate growth instead of a coverage dispute, even in the midst of a major investigation or lawsuit.