PE Private Equity

Claim Scenarios

"Bad Actor" Exclusions, Triggers and Attribution

Most policies contain "conduct" exclusions for dishonesty, fraud, illegal profit or advantage. Such exclusions appear in all policies, but vary widely. The conduct exclusions are implicated in virtually every D&O claim, as most every suit alleges that the defendant director or officer acted in self interest or without full disclosure. To preserve their right to deny claims based on these conduct exclusions, insurers issue "reservation of rights" letters allowing them to defend the claim without being bound to the outcome, and also providing an escape if new facts surrounding the director or officer's conduct are uncovered in the discovery phase. It is important to determine if the "trigger" for enforcing the exclusion is a "final adjudication" (which would be preferred, as it requires a finding of misconduct), or a "finding of fact" or "admission of fact" (which is too ambiguous and open to interpretation). It is also critical to confirm the circumstances under which the conduct of one director or officer can be imputed to the portfolio company or other directors or officers. For example, many policies impute the conduct of a senior officer to the company coverage, but may uphold the personal coverage.

Securities Law Claims and Issues

It is important to consider whether the D&O coverage under a policy extends to investor claims for violation of applicable securities laws, which can apply to private placements and public offerings. While private equity funds invest in private placements of equity or debt, it is possible (and will often be claimed by portfolio company founders or other investors) that the offering violating the filing or anti-fraud requirements of the Securities Act of 1933 or applicable state laws. Such claims may be uninsurable as a matter of public policy, so it is critical to understand how securities law violations, claims or damages are defined or addressed by the D&O policy. Thus, whether a claim for coverage can be denied as a securities claim or as counter to public policy, will depend on the language of the policy and also the law. For this reason, notwithstanding how director or officer-favorable a policy may be, it is critical that experienced legal counsel manage any litigation, including any settlement or drafting of any settlement agreements or orders, with this potential exclusion in mind. "Side C" coverage within a policy covers securities claims.

"Insured Plaintiff" Problem in Closely Held Companies

Every policy should be reviewed to determine the existence and breadth of any "insured versus insured" exclusion. In many portfolio companies, it is possible that a plaintiff shareholder (e.g., a company founder who continues to hold equity and a company office, and who sues the board) may also be an insured (i.e., as an officer). Surprisingly, a claim brought by a current insured, or even a former officer or director who continues to be insured, can be excluded under many policies. However, this exclusion can be negotiated so as to apply only to claims by the company under Side B coverage, or at least to limit the exclusion to certain types of shareholder claims.

Portfolio management

Insured enters into an agreement with a pension fund. After several years of double-digit returns, the account performs significantly below the benchmark. The trustee of the pension fund sues the company and the portfolio manager for making numerous investments in companies that were allegedly unsuitable investments, along with breach of fiduciary duty and mismanagement.

Funds withdrawal

A client of your Insured makes a request to liquidate his account effective immediately. One week later the client calls to check on the status of the liquidation and the client representative finds no record of the request. During that week the market value of the account dropped by 20 percent. The client sues, alleging the company was negligent and, as a result, the client was unable to close on a real estate property due to insufficient funds.