WOODRUFF SAWYER

Guide to Insuring Fund Liability Risks for Venture Capital and Private Equity Firms

Key Considerations in Today's Litigation and Regulatory Environment, 2024 Edition

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Introduction

Understanding the Core Elements of Fund-Level Coverage is Critical to Mitigating Losses

Woodruff Sawyer has been a leader in the fund-level General Partnership Liability space since the inception of the insurance product over 30 years ago. In today's business and regulatory environment, the venture capital, private equity, and broader financial institutions sector would not be able to conduct business without a comprehensive insurance program that protects the general partners or directors and officers of these firms from allegations of negligence and/or wrongdoing that leads to a loss.

While the regulatory environment is constantly changing, it is always a good exercise to understand the basic, core coverage modules that are critical to not only mitigating losses that could negatively affect the fund internal rate of return (IRR), but also impact the personal assets of the general partners of the funds or management companies themselves.

Given our expertise in this space, Woodruff Sawyer's Venture Capital and Private Equity Practice has created this *Guide to Insuring Fund Liability Risks for Venture Capital and Private Equity Firms* to help both clients and others understand the basic coverage modules within a GPL program. This guide is by no means a comprehensive list, as coverage needs can change depending on the risk profile of each individual firm.

Coverage also can vary significantly depending on the broker and insurer partners chosen to transfer the general partnership liability risk. For this reason, we always recommend working with an experienced broker. In most cases, an experienced broker will have negotiated manuscript coverage forms or specific amendatory endorsements that enhance coverage above and beyond the "basic" or "core" coverages. The best brokers

will also have their coverage forms vetted and reviewed by outside counsel.
In addition to detailing each coverage module, this guide includes sample claims scenarios where coverage could apply under each module. Woodruff Sawyer has been tracking GPL claims for over 30 years, and our database of claims scenarios is extensive. One of the key areas to consider when choosing a broker partner in the GPL space is historical claims experience. After working on over 2,000 claims for financial institutions and asset managers, we have built a claims management platform that helps clients close claims with greater certainty, faster outcomes, and greater efficiencies.

The second part of this *Guide* delves into new rules put forth by the SEC. In this section, Woodruff Sawyer's in-house regulatory and securities litigation experts provide feedback on what's been happening recently in this space and potential ramifications on the corresponding insurance coverage.

General Partnership Liability: Key Coverages and Claim Scenarios

Background of GPL Coverage and What It is Today

General Partnership Liability Insurance (GPL) is a longstanding insurance product tailored for executives acting in a different fiduciary capacity than a traditional corporation or LLC, such as on behalf of a general partner or limited partnership. Traditionally structured private or public D&O policies often exclude or limit coverage available to partnership entities, so a tailored solution was needed in the form of either a partnership endorsement to an existing D&O policy or a dedicated blended D&O/ General Partnership Liability policy. While the language is a bit more nuanced for partnership exposures, the exposures and types of claims covered were fairly uniform in the context of what a D&O insurance policy covers.

Over the last quarter century, the meaning of a GPL policy has evolved to be synonymous with a blended D&O/E&O/Fund Liability coverage suitable for asset management firms with private fund structures, usually with a GP/LP type structure. Therefore, we now have the "GPL" monicker.

GPL policies structured for these entities and structures are intentionally broadened to provide comprehensive coverage for everyday business management activities, such as oversight of limited partnerships, portfolio company investment, and overall investment management. In the following pages, we dive into specific elements of GPL policy structure and why it is imperative for venture capital and private equity firms to not only purchase a GPL policy, but to ensure they work with an insurance expert who understands the unique exposures of the firm.

Element 1: Side A Non-Indemnifiable Coverage

This coverage responds to claims involving your investment professionals for loss arising from their activities when indemnification from the firm or fund is not available. This is first-dollar coverage, meaning that it responds with no retention (deductible) applied. Triggers typically involve situations where the venture capital or private equity entity is either insolvent or legally unable to indemnify the individual.

Claim Example:

Shareholder derivative action filed against former executive officers and directors of a publicly traded PE firm. Action arose from defendants' obtaining, approving, or acquiescing to the backdating of stock option grants in violation of their fiduciary duties.

A myriad of allegations were brought, including but not limited to:

- Alleged violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5, breach of fiduciary duty
- Unjust enrichment
- Gross mismanagement
- Constructive fraud

Element 2: Side B Indemnifiable Coverage

This coverage responds to claims involving your investment professionals for loss arising from their activities when indemnification from the firm or fund is available. In these situations, the insurance will pay after the retention is satisfied, often starting in the six-figure range. This insuring agreement would typically kick in if an insured individual at the firm is named in a suit for alleged wrongdoing and is intended to reimburse the organization for defense and potential damages.

Claim Example:

A general partner of a venture capital firm was sued by his prior firm two-and-a-half years after he left to start a new firm. The suit alleged misappropriation of proprietary information and poaching of investors. The claim alleged that the former partner sought to liquidate his holding in the company (which was performing very poorly at the time) which then countersued with these allegations. The insurance company payout was $1.5 million to cover his current firm's expenses for defense and damage.

Element 3: Side C Entity Liability Coverage

This coverage responds to claims made against an insured entity or funds. Like indemnifiable loss for individuals, the base policy retention does apply, and insurance will pay after the retention is satisfied. This agreement would likely respond to typical everyday business claims or if a fund or management entity is named in conjunction with an insured individual.

Claim Example:

A claim was brought against a venture capital firm arising from public disparagement of another financial institution. Insurance paid out approximately $1 million in defense costs.

Element 4: Private Investment Activities and Errors & Omissions Coverage

Often referred to as E&O coverage, this is arguably the most important language you'll find in a GPL policy. The nuanced and specific language is intended to cover all aspects of the everyday private investment activities and services provided by a venture capital or private equity firm, including but not limited to:

- Solicitation of outside investor funds into a fund
- Formation of said fund, investment (or failure to invest) into a portfolio company
- Services provided to a portfolio company
- Management of LP funds
- Extension of or failure to extend or grant a lease, loan or extension of credit
- Selection and oversight of outside service providers

Like Elements 2 and 3, a retention does apply to this coverage grant.

Claims Examples:

A firm was engaged in a bidding process to purchase a potential portfolio company. During the due diligence process, the firm uncovered that the target company was struggling more financially than they had initially anticipated. As such, the offer was revised/reduced. The owner of the target company sued the firm for diminishing the value of the portfolio company. Allegations of breach of fiduciary duty and tortious interference were brought, and over $5 million was spent in defense costs alone, with the remainder of the firm's $10 million insurance limit having paid out as part of a settlement.

A claim is brought against a venture capital firm in relation to product liability claims against a sold portfolio company. The claim is an attempt to recoup the venture capital firm's earlier financial gain from the portfolio company sale, for the benefit of product liability claimants. The claim is open and insurance has paid out more than $2 million in defense costs alone.

Element 5: Outside Directorship Liability Coverage

Another key and often triggered part of the GPL policy is the Outside Directorship Liability (ODL) Coverage extension. ODL coverage protects firm individuals who are serving on the boards of portfolio companies. The coverage typically responds in a "double excess" capacity, meaning it will sit in excess of any other insurance (D&O) and indemnification available to the underlying portfolio company. A common scenario where the insurance would pay at this level would be a situation where the portfolio company is insolvent, and all underlying D&O insurance has been exhausted.

Claims Examples:

A private equity firm invested in a portfolio company that had an underfunded MEP Defined Contribution (DC) plan. Ultimately the private equity firm couldn't turn the company around and put it into bankruptcy, preserving a small portion of their debt investment but none of their equity. Courts have pierced the corporate veil and ruled that the private equity firm itself is financially responsible for the unfunded portion of the DC plan. The matter is ongoing and associated costs could climb to tens of millions of dollars.

A portfolio company was performing very poorly and began layoffs to control costs. They dropped their D&O coverage to control costs as well. Several EPL claims came in against the portfolio company and each of its board members, including some private equity firm representatives on the board. The portfolio company subsequently filed for bankruptcy. There was no underlying coverage and no assets to indemnify at the portfolio company level, so ODL on the private equity firm's policy kicked in to defend insured board members. The result was a seven-figure claim in defense/settlement with no retention applied.

Element 6: Additional Coverage Considerations:

Employment Practices Liability

Coverage is typically bolted on with limits shared with the GPL insurance and is intended to cover claims alleging wrongful employment practices (sexual harassment, discrimination, wrongful termination) by the management company or its directors, officers, and employees. Coverage typically extends to both first-party claims (claims brought by employees) and third-party claims (portfolio company employees or business invitees of the organization).

Claim Example:
A venture capital firm experiences a $1 million EPL loss from a sexual harassment claim.

ERISA Fiduciary Liability

Coverage may also be added to the GPL policy to address claims involving the creation, administration, operation, or termination of an employee benefits plan sponsored by the management company. Under the Employee Retirement Income Security Act (ERISA), fiduciaries may be held personally liable for breaches of their fiduciary duty. Typically, any ERISA 3(38) services provided by an insured to a third-party client would be addressed under the E&O portion of the GPL policy.

Financial Institution (Fidelity) Bond

This bond protects against loss resulting from employee dishonesty, burglary, robbery, forgery, and computer fraud/funds transfer fraud. More recently, coverage has extended to certain exposures involving “voluntary parting” resulting from social engineering or phishing attacks. This protection would apply both to the firm’s own capital and customer/client funds.

Claim Example:
In this funds transfer/social engineering incident, a hacker provided false wiring information to a venture capital firm looking to distribute funds to limited partners following a liquidity event. The money was inadvertently distributed to the incorrect bank account, resulting in a loss of over $1 million.

Cyber Liability

Coverage for third-party costs related to defense and damages from a network security/privacy breach. It also provides for first-party costs to notify customers, credit monitoring services, forensic expenses, and costs to restore data. Coverage typically extends to cyber extortion and network interruption/loss of income.

Claim Example:
Cyber criminals hack into a venture capital firm's system and hold it "hostage" unless the general partner pays the criminal $2.5 million. This is a classic example of a ransomware attack.

SEC Risk Update

State of the Regulatory Environment

With the passage of sweeping new rules for investment advisers, 2023 represented an escalation in the government's regulatory campaign against private fund managers. The picture is complicated this election year. We may wake up in a brave new regulatory world in January 2025—or just more of the same. And while industry challenges to the SEC's Private Fund Adviser Rules may yield fruit by mid-2024, managers facing continued legal uncertainty and evolving investor expectations will need to chart a reasoned course forward.

With good housekeeping, legal and compliance teams can mitigate regulatory risk. An expertly crafted insurance program—tailored to your business and risk profile—will help dampen the blow if you do find yourself facing a government investigation.

Private Fund Adviser Rules

With the adoption of the Private Fund Adviser Rules in 2023, the SEC changed the rules for venture, private equity, and hedge fund managers. As discussed in more detail in our article from earlier this year, the new rules impose a variety of meaningful new obligations on registered investment advisers (RIAs) and exempt reporting advisers (ERAs) alike. Significant provisions address preferential treatment of investors and target "restricted activities." Restrictions on charging investigative defense costs to funds underscore the importance of maintaining appropriate insurance coverage.

Industry groups have mounted a legal challenge to the rules. The lawsuit is on an expedited track in the Fifth Circuit Court of Appeals (the same court that recently put a temporary stop to the SEC's new climate rules). At oral arguments in February, observers saw strong signs the panel might strike down the rules—at least in part. The SEC will likely appeal an adverse decision, attenuating the uncertainty. Even in the event of a technical (and perhaps temporary) reprieve, some managers may find that aspects of the rules have already become table stakes for many investors.

Proposed BSA/AML Rules

In February 2024, the Treasury Department's Financial Crimes Enforcement Network (FinCEN) proposed to subject RIAs and ERAs to the Bank Secrecy Act's (BSA) AML program and SAR filing requirements. Our recent article addresses the new rules and their implications in detail.

BSA/AML compliance is a tricky and high-risk area for investment advisers serving numerous investors, frequent transactions, and other risk factors who do not already maintain a strong voluntary program or rely on a compliant affiliate program. While reliance on outside service providers is permitted by the proposed rules, fund managers may be held liable for vendor mistakes.

If FinCEN adopts the rules, expect the SEC to use its delegated examination authority to closely scrutinize investment adviser AML programs (as it already does for broker-dealers) and refer problematic cases to the Division of Enforcement.

Proposed Cybersecurity Rules

With the SolarWinds case and new disclosure rules, 2023 was a big year for the SEC's cybersecurity ambitions. In the asset management space, the SEC's proposals to amend Reg S-P and to mandate new cybersecurity risk management programs and disclosures received less attention. However, if they are adopted as expected in spring 2024, the impact would be significant.

Taken together, the SEC's new rules will create a grab bag of new cybersecurity-related obligations for RIAs, including:

- Adoption and implementation of written cybersecurity policies and procedures reasonably designed to address cybersecurity risks
- Adoption and implementation of written policies and procedures for incident response programs to address unauthorized access to or use of customer information
- Mandated reporting of significant cybersecurity incidents to the SEC
- Mandated customer notification for incidents involving sensitive customer information
- Documentation and recordkeeping requirements

Unlike the Private Fund Adviser Rules, there seems to be general consensus that these cybersecurity-related rulemaking activities are reasonable. RIAs should prepare accordingly. Check out our recent article for a discussion of recent Reg S-P and Reg S-ID enforcement activity.

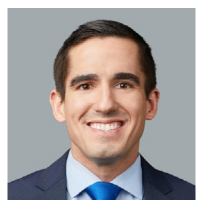
Through the various rules discussed above, the SEC is opening up several new avenues to police the activities of private fund managers. It is challenging to defend against an aggressive SEC exam or enforcement investigation from a reactive posture. Managers who can proactively and effectively prepare robust policies, procedures, and controls in emerging risk areas will be best positioned to minimize the expense and distraction of future government scrutiny.

For More Information, Contact:

Luke Parsons
Partner/Senior Vice President,
National Private Equity &
Venture Capital Practice Leader
lparsons@woodruffsawyer.com
302.245.2122

Brian O'Regan
Vice President, Private Equity &
Venture Capital Group
boregan@woodruffsawyer.com
415.402.6559

Walker Newell, Esq.
Vice President,
Management Liability
wnewell@woodruffsawyer.com
617.658.7109



Patrick Cagney
Vice President,
Account Executive, Financial
Institutions
pcagney@woodruffsawyer.com
415.402.6680

Colin Lindsey
Senior Claims Consultant
clindsey@woodruffsawyer.com
415.399.6359

Dan Ahern
Account Executive
dahern@woodruffsawyer.com
415.402.6558

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For More Information

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