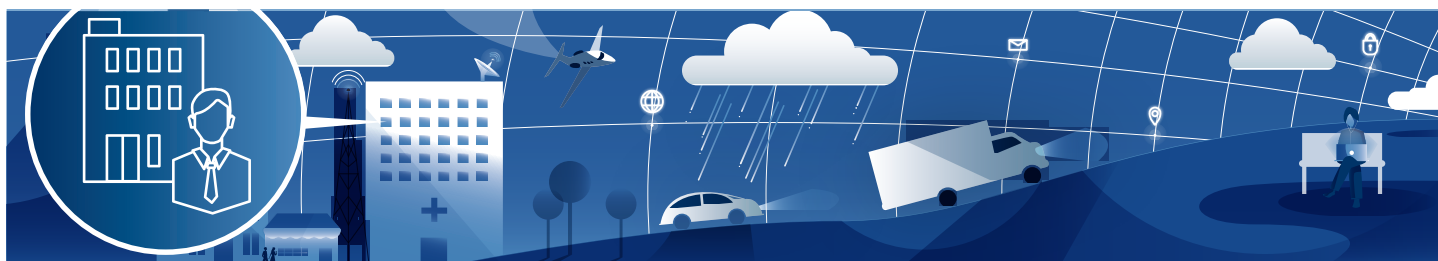


# DIRECT INVESTING AND DIRECTORS & OFFICERS COVERAGE: *A PRIVATE RISK MANAGEMENT PERSPECTIVE*

Author: Amy DeForeest | Contributor: Matt Felman



## WHO IS AT RISK?

Successful individuals face a host of exposures in their daily lives, many of which can be addressed by transferring them to an insurance company. We often think of these exposures as coming from the most obvious causes of loss, such as fire or water damage to tangible property, liability cases stemming from automobile accidents that potentially result in inflated monetary payouts to injured parties, and employment practices-related lawsuits initiated by domestic staff, etc. These exposures are clearly covered under various personal lines policies.

Some activities and professions, however, can increase the exposure of successful individuals and compromise their personal assets, both tangible and investable. For our family office clients, the pursuit of direct investments in real estate and the operation of businesses and board membership, especially for directors and officers, can raise public profiles. At the same time, it also unwittingly puts personal assets at risk. The policies available to protect these families and individuals have been developing over the past couple of decades and are not as “cookie-cutter” as many personal lines policies – they cross over into commercial and financial lines and can be tailored to fit the risk.

## DIRECT INVESTING: THE APPEAL AND INCREASED ACTIVITY FOR FAMILY OFFICES

Over the last 10 years, advisors and organizations working with family offices have noticed an increasing move toward direct investing by their clients. Clients see direct investing as a way to add more diversity to their portfolios, exert greater control over their investments and engage in an investment strategy that supports their goals of succession planning and ongoing wealth creation for generations to come. According to FOX (Family Office Exchange) and its 2017 research numbers, more than half of its families (57%) are actively engaged in direct investing.

Many families are drawn to direct investing in operating businesses because they’ve built their wealth in this way and can bring considerable experience and legacies of success to running profitable firms, even if these operations are outside of their specific industry expertise. The experience of investing time, energy, and resources can re-connect them to their entrepreneurial beginnings and create opportunities to bring in the skills of next-generation family members.

There is also a rise in co-investing with other families. They like investing with other people they trust and aligning shared values. This can help create long-term strategies in place of having a short-term focus on multiple liquidity events.

## THE RISK OF DIRECT INVESTMENT: AN INSURANCE PERSPECTIVE

When families are involved in operating businesses, there is a range of risks of which they need to be aware. Having a reliable team in place can help ensure that these risks are kept to a minimum. In an article published in Financial Advisor in 2017, Scott Kegler identified the top four insurance-related risks as follows:

- Investing in operating businesses without adequate insurance
- Investing in operating businesses with significant outstanding liabilities associated with insurance programs
- Investing in operating businesses without an understanding of the costs, risks, and compliance status of employee benefits
- Investing in real estate projects that are not adequately insured to protect the equity partners

In its 2018 Global Investment Survey, FOX found that “From a staffing perspective, one fifth (20%) of family offices report that they have a sophisticated internal private equity team in place. More than two-thirds (68%) are actively or periodically looking at deals with a small or limited team.” In addition to their internal team, families recognize that it is not just about deal flow but also about protecting the valuation of the business in which they want to invest and, perhaps most importantly, protecting the existing assets of the family office. With an experienced insurance advisory team in place, families can ensure their financial exposure is limited. The team should be able to move comfortably in both the personal and commercial space and work in conjunction with its outside team of advisors, including investment bankers, attorneys, etc. The team should also remain relatively static to understand the existing exposures within the family’s current program, the family dynamics, individual members involved in both the decision-making and execution of deal flow, the family’s risk tolerance, and its appetite for additional liabilities.



**For private equity, venture capital, family office investment groups, and other like-minded investors, a number of steps should be taken to protect the investment and balance sheet of individuals or executives. This begins with ensuring there is a sound risk management program for both the investors and the companies in which they are invested. Unlike traditional business, executives within investment firms, as well as family office direct investment groups, face a unique exposure as they are officers within their own investment firm, trusted by limited partners to grow wealth at an expedited rate, are sitting on multiple boards within their portfolio, are involved in business associations, speaking on panels or writing white papers, and face a higher risk of corporate litigation by the inherent nature of the M&A business.**

## **INSIDE A GENERAL PARTNER (GP) FUND LIABILITY POLICY**

Family office groups, whether operating with committed funds or otherwise, should have a General Partner (GP) Fund Liability policy that includes the following:

- Directors & Officers (D&O) Liability
- Outside Directorship Liability (ODL)
- Professional Liability (Errors & Omissions/E&O)
- Employment Practices Liability Insurance (EPLI)

As previously noted, these contracts are not “off the shelf,” and investment firms should work with a broker who understands the nuances of each product and has experience in placing them.

## **D&O INSURANCE**

Each portfolio company of an investment firm should have its own unique D&O policy specific in its limits, retention, and structure to address its goals. This policy should be tailored to fit that of a company with a financial sponsor. It should include full antitrust coverage, enhanced Side-A provisions, investor defense coverage, liberalization clauses, and no outside capacity exclusion, among other features. Please note these are examples of coverage features, and other enhancements should be considered upon your broker’s recommendation. While each portfolio company should have a dedicated policy, there are strategies that investment firms can utilize to maximize purchasing power. Management Liability consolidation programs among investment firms, especially private equity firms, will not only benefit from premium breaks but also familiarity of coverage terms, benchmarking for limit adequacy, speed of underwriting, pre-negotiated tail, and finally, as we are seeing now with an ever-hardening market, less volatility to market changes.

## **ODL & E&O INSURANCE**

There are two components to the GP Fund Liability policy that make it unique to investment firms: one is the ODL; the other is the inclusion of E&O. E&O is common to most businesses that provide professional advice or consultation; however, it’s included as a part of the D&O here. This is done intentionally to avoid the blurred trigger between what is an E&O and D&O exposure. In placing them together, we’re covering an entity and their executives while also extending

coverage for capitalization, formation, solicitation, operation, management, administration, marketing, and other professional services that investment executives perform on a day-to-day basis to maximize a return.

The ODL is a key component of any well-negotiated family office policy. This factor often can be misunderstood, but it's the most critical component of the policy. The "Insuring Clause" extends coverage to an "Insured Person" who occupies a board seat or executive position on a portfolio company. Coverage applies on a double-excess basis, meaning the policy will respond over and above any valid and collectible insurance at the portfolio company level, as well as any indemnification provided by the portfolio company. Once both options are exhausted, the ODL "Insuring Clause" is triggered to cover the "Insured Person" who occupies a board seat or executive position at the portfolio company. Without the ODL function on a double-excess basis, investment firm executives put their business and maybe even personal assets at risk and are left without insurance to continue to defend litigation on their own.

The final coverage component is EPLI and, while not the focus of this article, it is an integral part of any GP Fund Liability policy, as well as general Management Liability policies. The policies cover employment-related claims, most notably discrimination, sexual harassment, wrongful termination, retaliation, and disability disputes.

## **THE CASE FOR CYBER LIABILITY & CRIME INSURANCE**

Investment firms should also consider Cyber Liability and Crime insurance as a backstop to protect their transactions and operation against ransomware attacks, social engineering, fund-transfer fraud, computer fraud, and a host of other related attacks. While Cyber and Crime insurance are most commonly written as separate policies, they have common coverage parts. At times, when there is a cyber loss, we see both policies respond, as crime is primarily considered the "act" or "loss" while cyber is the "fall-out" or "investigation" of the loss. Negligence or oversight by investment firms that results in the compromise or loss of personally identifiable information, financial information, or funds can trigger D&O or E&O claims against the entity and executives for failure to protect this information or monies. Be sure to review these contracts with your insurance company and broker as Crime insurance is most often thought of as first-party

coverage. However, should a limited partnership lose its capital call due to a breach within the system, it will want its money back, and you will want to stay in the partnership's good graces. With an insufficient Crime policy, you could be footing that bill.

## **DIRECTORS & OFFICERS AND BOARD MEMBERSHIP: WHERE IS THE EXPOSURE?**

For family offices, members often sit on the boards of the operating business they are investing in, resulting in a for-profit board exposure. Additionally, for many professionals and their spouses, board membership is an opportunity to give back to their communities and enhance their public profile for career advancement by seeking out opportunities in the non-profit sector. Suppose these individuals are insured by one of the high net worth insurers. In that case, they often have an automatic liability coverage extension for volunteer and non-profit board activities, provided they are not a director or officer. With not-for-profit boards, the directors and officers should be protected by a D&O policy secured by the organization for which they serve. While many non-profits purchase these policies, the coverage is often inadequate, as many operate with lean budgets and purchase basic policies or policies with low limits. The coverage is also written on an aggregate basis, with directors and officers all sharing the limit. For example, a \$1 million D&O policy designed to cover ten directors and officers will only provide \$100,000 to each officer in the event of a lawsuit, not \$1 million.

With for-profit boards, depending upon the nature of the board and the company's revenue, the D&O policy may also fall short. We see this quite a bit with startups, which can greatly impact private equity and venture capital investors' exposure.

A large for-profit D&O policy can also be pierced. For example, look at the settlement of Sam Zell and former executives of the Tribune Company. The \$200 million settlement amount significantly exceeded the company's D&O limits and will be paid for by the various individual defendants. The takeaway here is that even large, corporate, D&O policies can be pierced. (RT ProExec Insights Volume XIV Issue 3 Summer 2019).

## HOW CAN WE HELP?

AHT is well-positioned to address the risks involved in direct investing. Our parent company, BRP, is owned by a family office engaging in this activity with much success and recently had a controlled IPO. Our team of professionals manages the existing insurance programs for all these businesses, as well as personal insurance for the family office.

We want to be sure that none of our clients is put in a position to have to liquidate assets and, thus, at the very least, would like them to have a conversation with us about their exposures and how we can protect them. When discussing the risks and coverages available, it's essential to have a basic understanding of how these policies are structured (see the "ABCs of D&O").

For our clients who serve as directors or officers for non-profits, we can provide coverage in \$1 million increments if a company dedicated to serving the needs of the affluent provides their personal insurance coverage. These companies (Chubb, AIG Private Client, PURE, and Cincinnati) offer an endorsement to their existing Excess Liability policy for a small additional annual premium.

For our clients who are directors or officers of for-profit boards, we can offer Portable Individual D&O (PIDO), an excellent option for some of our private equity and venture capital clients. The PIDO policy is based on terms and conditions similar to what clients expect to find in broad-form Side A D&O policies. These policies are modified to allow an individual or group to purchase the program independent of the entity whose board they serve. Additionally, the policy is not tied to one entity – the coverage will follow the individual(s) to any other boards of directors on which they might sit.

## BENEFITS OF A PIDO INCLUDE:

- Individual protection of personal assets regardless of the number of boards on which the person sits
- If purchasing as an individual, the program is fully dedicated to that individual
- The policy is no longer tied to the entity
- Program is structured to sit in excess of any other insurance or indemnification
- Policy form contains coverage for extradition and certain fines and penalties
- Limited reporting duties over the course of the policy term
- Limits up to \$5 million

The most complex piece of this relates to the direct investing activities of family office clients. These clients would be well served to work with an experienced broker who understands the risks inherent in these activities and can bridge the gap between personal and commercial coverages mentioned above:

- General Partner Fund Liability: Directors and Officers Liability, Outside Directorship Liability, Professional Liability (E&O), Employment Practices Liability Insurance (EPLI)
- Cyber Liability
- Crime Insurance

## THE ABC'S OF D&O

“D&O insurance is a financial backstop used to provide protection to the directors and officers when indemnification by the corporation is not available.”  
*David Lewison, Financial Services National Practice Leader, AmWIns.*

### D&O Insurance Coverage Parts:

#### SIDE A

Directly protects the directors and officers of a company when the organization is unable to indemnify those leaders for acts on behalf of the corporation.

#### SIDE B

Reimburses the corporation when it IS able to indemnify the directors and officers for their activities (essentially protecting the balance sheet of a corporation).

#### SIDE C

Solely protects the corporation for the wrongful acts attributed to the organization and not the directors and offices.



## WHAT IS THE TAKEAWAY?

A private risk advisor's role is to provide a comprehensive personal insurance program that considers the many potential risks clients face. This must go beyond the standard exposures addressed by basic, "main-street" policies. We must be diligent in genuinely understanding the liabilities and providing solid counsel to clients. Only by taking a deep dive into uncovering the risks and backing that up with a solid understanding of how to provide proper coverage can we truly protect our clients.

Regarding direct investing, having a team experienced in evaluating and understanding current insurance policies' benefits and limitations is crucial. Families should interview their advisors and potential advisors to ensure a level of trust and understanding, so they feel fully supported in their endeavors.

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