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A Fund Managers' Guide to Maximizing D&O and E&O Insurance Coverage

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As the economic impact of COVID-19 continues to reverberate across all global industries, there is an increased risk of claims being asserted against private fund managers, their funds and portfolio companies, as well as key individuals, both in their capacity as members of fund management and/or as members of a portfolio company's board. At the same time, however, the insurance market has become much more challenging for fund managers to successfully navigate. The global pandemic has adversely affected insurance companies, which also are facing economic pressures—their behavior has changed accordingly. On the underwriting side, insurers have become more careful as to the risks and terms they will accept. In this regard, many fund managers have experienced difficult insurance renewal negotiations and significant premium increases. On the claims side, insurers have become more aggressive in handling and challenging claims. This has led to frustrating claim denials for fund managers, which, if uncontested, can result in substantial losses that must be satisfied by the insured entities and/or individuals.

In light of the foregoing, now, more than ever, it is imperative that fund managers take active steps to ensure they are protecting themselves, their funds, any portfolio companies and their personnel against the extensive risk of claims they face through strong directors and officers (D&O) and errors and omissions (E&O) insurance coverage.

This article summarizes certain best practices for fund managers—particularly in the current economic climate—for negotiating and obtaining strong insurance protection and maximizing recovery when claims arise. Although this article focuses on D&O/E&O coverage—which fund managers typically purchase as part of the same policy—the same general best practice principles apply to other types of insurance as well.

Negotiating D&O/E&O Insurance Coverage

Any discussion of best practices for negotiating insurance policies starts with a simple, but often overlooked, premise: insurance policies *can* and *should* be negotiated. Many fund managers do not seek to negotiate their insurance policies based on common misconceptions about insurance coverage, and the process for obtaining such coverage.

Misconception	Reality
Policies are not negotiable.	The policies that fund managers purchase are *highly* negotiable. If a fund manager purchases an insurer's standard policy without any negotiation, the policy likely will be substandard.
All policies are essentially the same.	There is tremendous variation in quality among policies issued by different insurers, and even among policies issued by the same insurer (depending on how well-negotiated the policies are).
I have a broker and, therefore, there is no need for legal review and negotiation of policy language.	It can be a tremendous mistake to assume that a broker has negotiated the best coverage possible. Further, even the best brokers (and there are some great ones in the fund space) benefit from collaborating with counsel in the review and negotiation process.
Policy language is not that important; the business relationship with the insurer matters more.	Having strong policy language is *the most important factor* in getting a claim paid. Fund managers should not rely on how or whether the insurer values the business relationship. This is particularly true in the current economic environment, in which insurers are under tremendous financial pressure and are experiencing significant turnover in personnel.

Best practices for negotiating policies are relatively straightforward. If legal review and negotiation has not recently (or ever) taken place, a fund manager would be well-advised to conduct a comprehensive policy review with its insurance counsel and broker, including any policies of funds and portfolio companies. This will enable the fund manager, insurance counsel and broker to collectively design a strategy to explore additional insurance options, identify weaknesses and gaps in coverage and negotiate the strongest policies possible. Certain key coverage deficiencies, which fund managers can enhance significantly through negotiation, include:

- Coverage for Government Investigations. This is one of the most critical risks fund managers face. While the scope of coverage available for government

investigations has improved significantly in the marketplace over the past few years, many fund managers do not have the broadest coverage in this area. Some policies even exclude certain types of regulatory investigations. Insurers' base forms, and even certain endorsements, often are insufficient, as language should be negotiated to ensure that coverage is triggered at the early stages of an investigation and irrespective of whether the investigation is "formal" or not.

- Overly Broad Exclusions. A typical policy includes a number of coverage exclusions. The most common exclusions include: conduct exclusions (*e.*, excluding claims for fraud, crime and improper profits); the insured versus insured exclusion (*i.e.*, excluding claims by one insured party against another insured party); and the contractual liability exclusion (*i.e.*, excluding claims for contractual liability). There are also "hidden" exclusions in most policies, such as not covering any loss that is "uninsurable." While all exclusions can never be completely removed, it often is possible to significantly reduce their potential applicability, for example, by negotiating exceptions to the exclusions. Seemingly minor changes to the language of an exclusion can mean the difference between a claim being covered or denied.
- Lack of Coordination between the Manager/Funds' and Portfolio Companies' Policies. When a fund manager appoints an individual to the board of a portfolio company, and that individual is sued in that capacity, the expectation is that the individual will first be covered under the portfolio company's policy. If both sets of policies are not negotiated and coordinated, however, a multitude of issues can arise. For instance, if the policies do not specify which applies in the first instance, both sets of insurers may deny coverage to the individual and argue that the other insurer is responsible for covering the claim. There can also be confusion as to who has the right to select the individual's counsel. These issues can be avoided if identified and addressed at the outset, rather than waiting until a claim arises. It also is important to ensure that the policies are coordinated with the funds' and portfolio companies' indemnification obligations, as set forth in their respective governing documents, to ensure that there is a clear priority as to the respective individuals' sources of recovery.
- Onerous Provisions Governing the Claim Process. One of the unfortunate realities of insurance claim disputes is that the policyholder often spends as much time fighting with the insurer about whether the policyholder has done something to forfeit coverage as it does fighting about whether the claim should be covered in the first place. Insurers often rely on stringent provisions regarding notice, consent and cooperation obligations to deny coverage. Additionally, significant disputes often arise regarding the fee rates that the insurer will pay for the defense of a claim, and the information that the policyholder must provide regarding the claim. The severity of these disputes, which occasionally are inevitable, can be

significantly reduced by negotiating the relevant policy provisions at the outset. There are numerous ways that the notice, consent and cooperation provisions can be enhanced to make them less onerous and make it more difficult for the insurer to deny coverage based on such provisions.

Importantly, even after a fund manager has made an effort to negotiate strong coverage at the outset, the manager should stay vigilant in ensuring that the policies continue to provide adequate protection going forward. Insurance policies and coverage should not remain stagnant—instead, they should evolve year-over-year. Best practice is to implement an annual review process that involves your broker, in-house financial officers and insurance counsel. Working together, this group can seek to ensure that policies remain strong in the face of changes in the broader insurance market, the fund manager's business and global financial markets and economies.

Once strong coverage is in place, it is not necessary to return to square one for each subsequent renewal. It is important, however, to review the policies in advance of each renewal, as coverage enhancements rejected one year can become market standard the next year. Similarly, risk profiles change—a risk that was once of little concern to a policyholder can take on paramount importance based on changes in business strategy or broader changes in the global financial markets or economies. For example, in 2019, few fund managers worried about the potential impact that an outbreak of an infectious disease or significant public health concern could have on their portfolio companies; however, now, every insurance policy should be reviewed in light of the impact of COVID-19.

Maximizing Coverage for Claims and Potential Claims

As noted above, coverage disputes can result from self-inflicted wounds. That is, the insurer denies coverage not because (or solely because) the claim is excluded on substantive grounds, but, instead, because the policyholder:

- failed to provide timely notice of the claim;
- did not cooperate with the insurer; and/or
- failed to obtain the insurer's consent before incurring defense costs or settling the matter.

In such instances, the policyholder risks losing out on coverage as a result of its failure to have followed the policy's procedural requirements regarding management of the claim. In certain instances, policyholders fail to even submit a potentially covered claim, thus losing out on any chance to recover their losses. As with failures to negotiate policies, failures to seek coverage promptly—or at all–is often based on common misconceptions about what the fund manager's policy actually covers and the procedural requirements for claims and potential claims.

Misconception	Reality
A "Claim" means a "Lawsuit." If we haven't been sued yet, there is no coverage.	While a lawsuit certainly constitutes a "Claim" that should be reported, policies usually define a "Claim" in much broader terms. For example, most policies define a "Claim" to include a written demand for monetary or non-monetary relief. Thus, a demand letter accusing the fund manager or covered person of wrongdoing and requesting money or other relief is a "Claim" under most policies.
If the SEC is just requesting documents, and hasn't yet issued a Wells Notice, there is no "Claim" yet.	In a well-negotiated policy, a "Claim" will include an SEC investigation from its early stages, and irrespective of whether the investigation is "formal," including service of a document request accompanied by Form 1661 or 1662.
We think a "Claim" may be made at some point in the future, but, since we haven't been sued yet, there is no need to provide notice to the insurer.	Policies provide the option to give the insurer a "notice of circumstances" of events that could reasonably be expected, in the future, to give rise to a "Claim." Providing such a notice of circumstances seeks to ensure coverage for future "Claims" that arise from the previously-noticed events under the current policy, which may be strategically desirable. Further, well-negotiated policies also will include "look-back" coverage, which affords coverage for costs incurred *after* providing a notice of circumstances, but *before* a "Claim" arises, if a "Claim" later arises from the aforementioned events.

Fund managers should have processes in place to ensure that all claims are reported promptly, and that proper consideration is given to whether circumstances exist that should be reported as a notice of circumstances. Certain key best practices in this regard include:

- Assigning responsibility for ensuring that claims and potential claims are brought to the attention of counsel and the broker to assess and discuss whether notice should be provided to the insurer(s).
- All written demands—not just filed complaints or Wells Notices—should be evaluated for potential submission as a claim or notice of circumstances.
- Any contact from the SEC's Division of Enforcement or other regulatory body or staff should be evaluated and discussed for potential submission as a claim or notice of circumstances.
- Any events that cause concern or suggest that a claim will or even may be made should be evaluated and discussed for potential submission as a notice of circumstances.
- After a claim or notice of circumstances is submitted, a fund manager should continue coordinating closely with its broker and counsel during the claim process to minimize the risks of the insurer denying or attempting to restrict coverage.

The insurance market likely will continue to be challenging for the foreseeable future. Adopting the best practices discussed in this article can help ensure that you have strong protection against potential claims and help maximize potential recovery if and when claims occur.

Proskauer's Insurance Recovery and Counseling Group has extensive experience working with fund managers to negotiate insurance policies, seek coverage under such policies and assist in coverage disputes with insurers. Please do not hesitate to contact us if you have any questions.

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