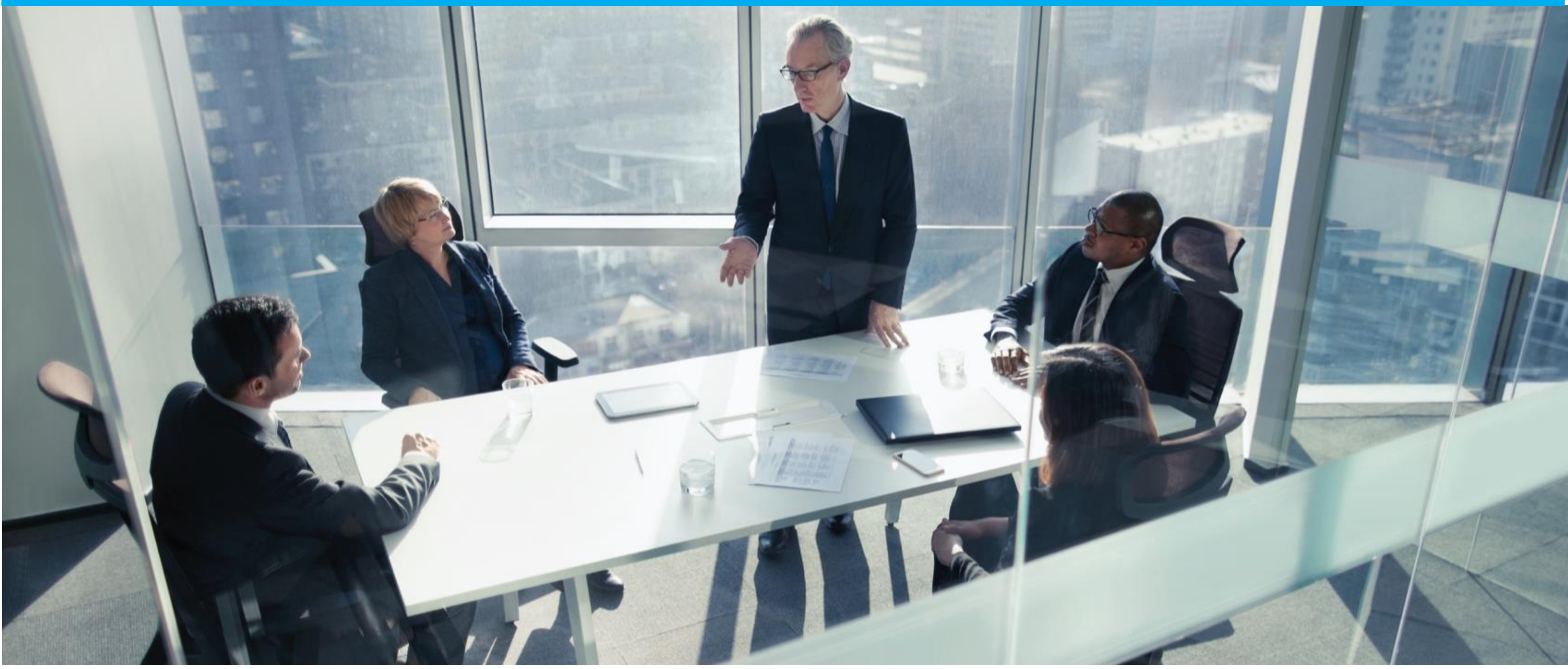
HUB INTERNATIONAL FINANCIAL INSTITUTIONS PRACTICE

D&O Insurance Programs

Holistic Strategies to Protect your Portfolio Companies



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Introduction

Many private equity firms have realized the value of actively managing the directors' and officers' liability insurance programs of their different portfolio companies. Portfolio company D&O insurance is the first line of defense for outside directors, but also can protect the balance sheet of investments.

There are various reasons why proper D&O insurance coverage may not be in place at the portfolio company level:

- CFO did not purchase adequate coverage;
- Coverage was canceled by the carrier;
- Coverage was not adequately negotiated by the insurance broker or PE firm.

Uncovered losses create a drag on company performance and require additional resources to manage and resolve.

Taking a deliberate approach to portfolio company D&O insurance enables PE firms to employ buying leverage to minimize costs and achieve broader coverage. Doing so helps ensure that the proper coverage is in place, with adequate coverage limits and optimal terms and conditions.

Understanding Different Program Structures

1. **One Master D&O Insurance Policy Covering All Portfolio Companies**

Securing a single D&O insurance policy to cover all portfolio holding companies may allow a manager to achieve economies of scale on the cost of insurance and provide consistent coverage across all the companies in a portfolio.

A master policy offers one aggregate coverage limit for the overall program as well as individual coverage limits for each portfolio company depending on its individual risk profile — size of company, industry sector and financial strength. The aggregate level should be high enough to cover the total annual coverage for the firm's covered portfolio companies, yet low enough to achieve a meaningful premium discount on the entire program.

Unlike other program structures where each portfolio company has its own dedicated policy and premium, most fund managers will want to allocate the overall cost of the D&O insurance program to each portfolio company. This can be a laborious process and require ongoing discussions with portfolio company CFOs about whether their allocations are fair, and whether or not a single portfolio company has driven up the total cost of the program due to a higher risk profile or prior insurance claims. Additionally, CFOs often try to find alternative, cheaper coverage outside of the master program which leads to additional conversations regarding the structure, premium allocations and overall benefits of the master program.

Another consideration of a master program is the addition or exit of companies within the portfolio. Each time a new portfolio company is added to the program, the insurance company assigns an additional premium to the master program. The sale of a portfolio company creates more challenges as a return premium needs to be determined and a six-year run off needs to be created.

Master programs have become rarer due to the complexity of managing the programs and their potential pitfalls.

2. One Insurance Company, Separate Policies for Each Portfolio Company

Using one insurance company to provide separate policies for each company within the portfolio is very common. The fund manager should engage in a competitive bidding process with several insurance providers, and then award the contract to the broker or carrier who offers the best combination of underwriting flexibility to match the firm's industry target focus, coverage needs and pricing.

The advantage of this approach is that the firm can gain buying power by working with one insurance company. Each portfolio company gets its own dedicated policy and coverage limit, eliminating premium allocation discussions. Coverage is consistent across the entire portfolio, with the use of one insurance policy often supplemented by an amendatory coverage endorsement negotiated for all portfolio companies.

This structure also eliminates the complexity of reevaluating premiums as the manager buys and sells portfolio companies, given each company has its own dedicated policy. However, with several individual policies requiring annual renewal applications, managers should try to negotiate a streamlined renewal process — including but not limited to streamlined applications and automatic renewals where possible.

One of the potential limitations of this program structure is that by having "all of your eggs in one basket," one portfolio company with repeated insurance claims can cause stress on the entire program and all other parties involved.

Also, depending on the underwriting appetite and financial condition of new or existing portfolio companies, a program insurer may not agree to provide the most competitive coverage and pricing compared to what could be achieved in the open market. This can cause an erosion of the relationship with the insurer and the associated program benefits over time if portfolio companies leave or refuse to join the program over this issue.

Careful consideration of the insurer's experience and long-term commitment to the private equity market is critical to avoiding insurer turnover every few years.

3. Individual Policies with A Panel of Two or Three Different Insurers and an Amendatory Coverage Endorsement

Another option is to partner with three insurers chosen to best match the diversity of the portfolio companies. The three insurers would agree to a minimum, consistent standard of coverage through an amendatory coverage endorsement. During the initial program set up and subsequently every three years, the fund manager could create a competitive bidding process to better ensure it is receiving the most competitive market pricing.

Engaging with two or three fully vetted insurers to bid on each of the portfolio companies alleviates some of the concern that individual portfolio companies may not be getting the best possible coverage and pricing from a single program insurer.

This model does not put as much stress on the insurance companies as a single insurer model. Depending on the portfolio, it may be difficult to find one insurer who is willing to provide coverage across all the portfolio companies. However, it is a lot easier to find a fit among two or three panel insurers.

The other advantages of this program structure include:

- Insurers are kept honest. They have to bid for each new portfolio company and may lose a company at renewal if their terms are no longer competitive.
- Spread of risk. If one insurer becomes difficult, there remains one or two other preferred insurers underwriting the program.

- One portfolio company cannot jeopardize the entire program for the companies with one or several claims. Premium allocation is unnecessary as each portfolio company is individually rated.
- Clean exits, as run-off calculations are easy.

There are a few potential concerns related to this program structure. First, this structure involves multiple individual policy renewals. Second, there can be the perception that a manager is not getting the same volume pricing discount it may receive by placing all of its portfolio companies with one insurer. Lastly, the policy wordings may be slightly different across three different providers versus working with one.

Other Coverage to Consider Including in These Programs

Excess D&O

Deciding on how much D&O insurance coverage to buy for any or all of your firm's portfolio companies is not straightforward. While coverage limit benchmarking based on size of firm, nature of operations and jurisdiction can help guide decisions, it is not a perfect solution. Many private equity firms choose to "top up" coverage over their individual portfolio companies, which may have different coverage limits with a single excess liability policy. Buying this kind of coverage across all portfolio companies can take some of the guesswork out of whether enough coverage was purchased for any one particular portfolio company. And, because it is subject to an annual aggregate potential payout limit, it is often less expensive than simply buying more coverage for each portfolio company in the portfolio.

Side A DIC (Difference in Conditions) Coverage

We also see more private equity firms purchasing this coverage on a blanket basis for their portfolio of companies. In the past it was more commonly purchased by large publicly traded companies.

This coverage is different than excess D&O coverage in that it only protects the directors and officers — not the corporate entity — and is only triggered when indemnification and no other insurance is available.

Tips and Tools to Manage These Programs More Efficiently

1. **Interview potential insurance program providers.** Creating these programs can take time and it can be disruptive if you have to change insurers. Make sure your insurance company providers are committed to the private equity market and understand how you do business. It is also important to understand each insurers' approach to underwriting and claims handling, selection of defense counsel, etc.

2. **Negotiate An Amendatory Program Coverage Endorsement for Your Firm.** It is not uncommon to find up to 20 coverage endorsements added to a D&O insurance contract. Negotiating all of the available and appropriate insurance contract endorsements requires time and skill by an experienced insurance broker. Placing portfolio company D&O insurance policies with different brokers and different insurers guarantees you will not get consistent — and likely not best in class — coverage.

   By negotiating an omnibus suite of endorsements for each portfolio company D&O policy, you can ensure consistent, above average coverage for all of your portfolio companies.

3. **Establish a streamlined policy renewal process with your insurers.** This can include having one or two common policy renewal dates to having a streamlined renewal application or

automatic renewals, as long as no material changes have taken place with each portfolio company.

4. **Have a meeting with your portfolio company CFOs** to explain how you plan to manage their respective D&O insurance policies.
5. **Have one insurance broker manage both your firm's general partnership liability and your portfolio company D&O insurance program.** It's the best way to ensure coverage is properly placed between the two insurance programs.

Set Your Firm Up for Success

D&O insurance portfolio programs require some thoughtful design before executing. Spending some time discussing your priorities, risk tolerance and goals with your insurance broker upfront improves your odds of running a smooth and profitable risk management program.

Strategic support that puts you in control.

When you partner with HUB International, you're at the center of a vast network of experts who will help you reach your goals. We can help you minimize losses, protect your reputation and plan confidently for the future.

For more information on how to manage your insurance costs, reduce your risk and take care of your portfolio companies, contact us.

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