



Private Equity Alert

October 2009

Weil News

- Weil Gotshal advised Blackstone Group and Lion Capital in connection with the proposed sale of Orangina Schweppes Group to Suntory Holdings
- Weil Gotshal advised American Securities in connection with its \$673 million going private acquisition of GenTek
- Weil Gotshal advised Harbinger Capital Partners in connection with its \$268 million going private acquisition of SkyTerra Communications
- Weil Gotshal advised Simmons Company (a portfolio company of THL Partners) in connection with its sale to Ares Management and Ontario Teachers Pension Plan
- Weil Gotshal advised Lee Equity Partners in connection with its acquisition of the Physicians Desk Reference business from Thomson Reuters
- Weil Gotshal advised Berkshire Partners in connection with its investment in grocery retailer Grocery Outlet Inc.
- Weil Gotshal advised GMT Communications Partners in connection with its acquisition of the Nordic operations of Reed Business Information
- Weil Gotshal advised Quantum Energy Partners in connection with the formation of a new \$2.5 billion private equity fund dedicated to the energy industry

Getting Your Portfolio Company D&O Insurance Right (The First Time Around)

By Paul A. Ferrillo (paul.ferrillo@weil.com)

It would be fair to say that many private equity sponsors don't pay a lot of attention to portfolio company D&O insurance – particularly before the company runs into problems – and leave the job of getting adequate D&O coverage to management of that company. It would also be fair to say that if sponsors took an inventory of what coverage their portfolio companies actually had, many sponsors would find wildly differing coverage among their portfolio companies with no rhyme or reason as to the differences in coverage. Sponsors also have the additional burden of coordinating their portfolio company D&O coverage with their own sponsor-level D&O coverage. Given these complexities, a sponsor may just want to throw up its hands and call its friendly insurance broker to determine what its portfolio companies need in terms of insurance coverage.

Unfortunately, the answers to what coverage its portfolio companies needs may not be that simple and deferring those decisions to an insurance broker may end in tears. “Right-sizing” and shaping portfolio company D&O insurance programs, in this litigation and economic environment, is not a task for many “generalist” insurance brokers. Why? There are lots of factors to consider, including knowledge of the firm's own sponsor-level D&O insurance coverage, knowledge of D&O coverage terms and conditions in general, knowledge of the sponsor and the private companies involved and their lenders, creditors and other constituencies (like public shareholders or bondholders) and a couple of recent Delaware Chancery Court decisions covering the area of indemnification which make this whole area rather difficult to sort out. Here, we try not to confuse (as D&O coverage is confusing enough) but to highlight various factors to consider when insuring a portfolio company correctly *the first time around* and coordinating that coverage with your sponsor-level coverage.

How Much D&O Coverage Should the Portfolio Company Buy?

Always the trickiest question to answer. And the answers are: “it depends,” “do what makes sense,” “hope for the best, but insure against downside risk of failure.” Here are some of the basic factors to consider:

- Does the company have public securities law exposure (to public shareholders or bondholders) and if so, what is the value of the company's securities held by the public?
- If the company is private, are there any other equity investors in the company and, if so, who are they?

- How much non-public debt will the company have? Who are the lenders?
- How large is the company?
- What is the size of the sponsor's investment in the company?

Each of these factors revolve around one basic question. If the portfolio company fails (and some do each year), and the directors and officers get sued, how much D&O coverage will not only adequately protect them from lawsuits that could be brought against them (including the sponsor's own designees to the board of the company), but will also insulate the sponsor's own D&O coverage, and more importantly, the fund from liability? There are no firm rules here, other than to do what makes sense. If the company involved will have a \$200 million public float going forward, having \$5 million of D&O coverage will not do the trick, especially when you factor in defense costs that will need to be paid to defend the directors and officers. If there is no public float, but aggressive lenders that might look for their "pound of flesh" in a restructuring scenario this factor must be considered as well. And then if a Chapter 11 filing is factored in, beware of hostile creditor constituencies.

Portfolio company D&O insurance should be adequate to insure the portfolio company and its directors and officers against risks related to that company. The litigation and settlement expenses of any claim against the portfolio company should not, except in extreme circumstances, require coverage by the sponsor-level D&O which is meant (traditionally) to cover potentially larger and more substantive claims against the sponsor itself, for its own conduct. This is not an area to get caught short in since the sponsor will likely be looked at "to

make up the difference" as a potential deep-pocket defendant.

Do I Need to Worry About Specific Terms and Conditions of the D&O Policy?

The unaware might assume that all D&O policies (and carriers) "are created equal" so: (1) why bother comparing and (2) go with the cheaper carrier since it really doesn't matter. Well it does.

In the current litigation and economic environment, private equity sponsors need to ensure that both their portfolio companies and they themselves have adequate D&O coverage.

As scores of directors will tell you, there is nothing worse (*nothing!*) to hear in a board meeting than "the D&O carrier has denied" coverage or "the D&O carrier has rescinded." Of course, this news was unexpected by management, but it is management often that is entrusted exclusively to "make sure" that the private company's D&O coverage is responsive to whatever sort of claim might come through the door. Directors (and sponsors) need to be vigilant in this regard, and make sure they understand fully what the portfolio company D&O policy says (and does not say), and who the primary D&O carrier is. Both matter. As to the finer points of what are the most pertinent provisions of a D&O policy to a director, we provide them below in order of importance. As to D&O carriers, we can only say, with experience, that not all D&O carriers like paying claims. Experience in handling "bad claims" is important. Experience in paying on "bad claims" is even better. Here, the

broker is not always the best source of information. The sponsor's outside securities litigators likely will have some view as to what carriers are the best (or worst) to work with. They should be consulted. In terms of both terms and conditions, and choice of carrier, this is not an area to get wrong:

- Policy must be non-cancelable and have non-rescindable Side A (non-indemnifiable loss) wording;
- Policy must contain broad-form "Insured versus Insured Exclusion" carve out so that claims brought by trustees, receivers, liquidators, creditor's committees, bondholder committees, and other bankruptcy constituencies *are fully covered* and not excluded.
- Policy must contain "Priority of Payments" clause;
- Policy should advance defense costs upon filing for bankruptcy without regard to self-insured retention (deductible);
- Conduct exclusions contained in the policy should be "fully severable" (meaning the alleged wrongful conduct of one individual cannot be attributed to the rest of the insureds under the policy); the fraud and personal profit exclusions should contain "in fact" and/or "final adjudication" language.

Which Comes First, the Portfolio Company D&O Insurance, or the Sponsor-Level D&O Coverage, in Responding to Claims Against the Directors?

In years past, this question was not very difficult to answer. In the event of a lawsuit commenced against the portfolio company directors and officers, the portfolio company D&O insurance would provide the first line of defense (or primary) D&O coverage

for the lawsuit. In the event the portfolio company D&O insurance was exhausted by defense costs or an adverse judgment or settlement, the sponsor-level D&O insurance would then provide coverage “excess” of the portfolio D&O insurance for those designees of the sponsor sitting on the board of the portfolio company (most often under the “outside director” coverage (or ODL coverage) in the sponsor-level D&O policy).

But as nothing is ever for certain in the land of D&O insurance, things may have suddenly changed. Two recent Delaware Chancery Court cases, *Levy v. HLI Operating Co. Inc.*, 924 A. 2d 210 (Del. Ch. 2007), and *Sodano v. American Stock Exchange*, 2008 WL 2738583 (Del. Ch. July 15, 2008), have noted that given the sometimes very broad advancement and indemnification provisions of various fund partnership agreements (many of which generally require “mandatory” advancement of expenses and indemnification of sponsor designees to portfolio company boards), questions can arise in the context of a litigation or settlement as to which entity (the portfolio company or the sponsor) is the primary indemnitor, and which is the secondary indemnitor. In some instances, where there is no express agreement to the contrary, courts have noted that the portfolio company and the sponsor might *both* owe indemnity obligations to a director sitting on the board of a portfolio company and thus would

“share” responsibility for indemnification obligations in some respect. The recent decision of the Delaware Chancery Court in *Stockman v. Heartland*, 2009 WL 2096213 (July 14, 2009), reaffirmed, among other things, that advancement and indemnification provisions of partnership agreements that require mandatory advancement of expenses and indemnification of defense costs, judgment and settlements will generally be enforced as written under the guiding principles of Delaware law which promote service on corporate boards, and the need to protect them from unjustified suits and expenses associated with litigation commenced against them.

But how do these Delaware law principles affect D&O coverage that might be provided under both the portfolio company D&O insurance, and the sponsor-level D&O insurance for a particular litigation that could impact both coverages? Well, could the portfolio company D&O carrier claim that the sponsor-level D&O carrier “share” in settlement and litigation expenses for a director of the portfolio company for a large claim based upon overlapping indemnification obligations? Maybe, but this would not be a result that anyone intended, and flies in the face of how sponsor-level D&O coverage is intended to work (i.e., coverage is excess of the portfolio company D&O insurance). But in the absence of clear wording in the sponsor-level D&O policy, any ambiguities could be

potentially exploited. Here we suggest that the sponsor-level D&O policy contain specific wording in its “Other Insurance Clause” which clearly states that with respect to a portfolio company claim against a representative of a sponsor sitting on the board, the portfolio company D&O insurance is “primary” and the sponsor-level D&O insurance is “excess.” Similar clarifying language should be used in the portfolio company D&O policy. In addition, sponsors may also want to consider entering into separate letter agreements with their portfolio companies confirming that their portfolio companies are the primary indemnitors for advancement, indemnification and D&O insurance purposes.

Conclusion

Getting portfolio company D&O insurance right is not intuitive and is not a job to leave solely to company management or even your insurance broker. Getting the right coverage and the right insurance carrier is important in terms of protecting the sponsor and its fund investors. In evaluating what coverage is appropriate, sponsors will need to consider the specifics of their own sponsor-level D&O coverage. In this litigation and economic environment, sponsors need to ensure that both their portfolio companies and they themselves are adequately covered in the event of a significant claim.

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