By
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Deep Cover

Insight: Insurance for limited partners of private equity funds is a product whose time has come.

To assess the viability of extending coverage to LPs, first understand the risk.

Limited partner investors in private equity funds and other "passive" institutional investors are being sued in growing numbers, a trend that can be expected to continue as courts in many jurisdictions continue to entertain such suits.

Although general partner liability insurance is by now well-established, LPs are a second, equally important player in the private equity sector. Until recently they've been more or less ignored by underwriters providing bespoke coverage to financial markets. With combined assets in the trillions, the pool of potential buyers of this coverage is vast.

To assess the viability of extending coverage to LPs, first understand the risk. Whether as a co-investor in a troubled real estate private equity fund, the recipient of a dividend recap from a distressed but not yet bankrupt portfolio company, or a preclosing public shareholder in a failed public-to-private leveraged buyout, LPs potentially face the ire, and hired guns, of disgruntled fund partners, creditors and/or bankruptcy trustees seeking to claw back or, worse, recover actual damages for alleged wrongdoing in the conduct or management of the portfolio company or its investment equivalent.

Depending on the nature of the investment and the LPs' role—frequently not nearly as passive as the "limited" connotation implies—the legal theories are a familiar mix of breach of fiduciary duty, fraudulent conveyance, and/or negligent or fraudulent misrepresentation claims already well-known to GPL insurers.

Whereas courts heretofore could predictably be counted upon to dismiss these sorts of claims against LPs based on the passive nature of their investment—hence limiting, if not eliminating entirely, the need for insurance—this safe harbor may recede if the LPs' role in the decision-making process is of a more active mien.

What if, for example, instead of ceding to the general partner the absolute right to terminate a developer/joint venture partner's management of a PE-financed real estate project, the investment vehicle gives the LP consent rights, which it exercises in favor of the put? It takes no hyperactive left brain (the half that does logic) to conclude that a suit alleging tortious interference with the PE/developer joint venture agreement and/or aiding and abetting the PE fund's alleged breach of fiduciary duty to its joint venture partner can't be far behind. Direct co-investments into a portfolio company or investments in small co-investment or special purpose funds where control or consent rights exist can also be liability inducing.

Whether residing at the fund or LP level, the core elements of coverage at a minimum would provide defense costs coverage for LPs akin to those provided in GPL covers, some form of tort/contract indemnity coverage and claw-back protection, as well as coverage for liabilities arising from public to private leveraged buyouts or similar type transactions. Such a policy could be fund- or deal-specific, could cover a PE fund's LPs for all deals during the life of the fund or only those of certain types of funds—real estate or distressed workout, for example—or be limited to certain types of claims, for instance to securities claims only.

Of the enumerated coverages, claw-back protection, while key, is also the most problematic from an indemnity standpoint and potentially raises disgorgement issues and findings of non-coverage in certain jurisdictions. Careful drafting and explicitly worded disclaimers (or assumptions) of coverage can ameliorate this uncertainty to a great extent. BR

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