

Financial & Transactional Services Bulletin



Equity Risk Partners — Financial & Transactional Services

The Financial & Transactional Services team of Equity Risk Partners (FinTran) provides periodic updates on recent developments impacting the D&O, E&O, and Transactional Liability insurance products that we specialize in providing to private equity firms and their portfolio companies, hedge funds, and other clients.

SEC and Regulatory Investigations on the Rise – Important D&O Coverage Considerations for Private Equity Firms and Hedge Funds

Federal and state regulators are increasingly active in investigations of the activities of private equity and hedge funds. It seems that every week a new hedge fund investigation hits the press. In recent weeks, newly announced investigations have implicated North Carolina-based SJK Investment Management (alleging that CEO Stanley Kowalewski used client funds for personal use), Level Global Investors LP and Diamondback Capital Management LLC (in connection with an insider trading probe), as well as several other ongoing investigations.

In addition, the SEC's newly formed Asset Management Unit is charged with increasing its focus on the private equity industry. Under the Dodd-Frank financial reform act, private equity funds with assets of \$150 million or more are required to register with the SEC. As if this was not enough, the whistleblower provisions of the Dodd-Frank Act provide for payment of a substantial bounty to individuals who provide "original information" to the SEC leading to fines in excess of \$1 million. The so-called "whistleblowers" are eligible to receive a minimum of 10 percent and a maximum of 30 percent of any fine levied by the SEC, providing added incentive for individuals to "go public" with concerns about corporate conduct.

This environment is likely to lead to more frequent investigations of private equity firms and hedge funds, and their respective directors, officers and employees. Moreover, these investigations can impact not only those firms and individuals that are the primary "targets" of the investigations, but other firms that traded with or had other business connections or involvement with the "target" firms. Legal fees for responding to these investigations easily can reach seven figures.

With this landscape, it is important to review your D&O policy to determine what protections exist for investigations involving the firm and its directors, officers and employees. The scope of coverage for investigations can vary significantly from one D&O policy to the next.

Inside This Issue

- 1 SEC and Regulatory Investigations on the Rise – Important D&O Coverage Considerations for Private Equity Firms & Hedge Funds
- 2 Representations & Warranties Insurance – Strategic Applications on Buy & Sell Side of Transactions
- 3 Cyber Liability: An Increasing Issue for All Businesses
- 5 Meet the Equity Risk Partners FinTran Team

Equity Risk Partners seeks to address these issues as well as obtain many other coverage enhancements for its clients. We encourage you to contact our team with any questions.

At Equity Risk Partners, we negotiate enhancements from the “shelf” product offered by insurers. These enhancements often include provisions to broaden the coverage available for regulatory investigations.

For example, it is very important to seek to include a definition of “Claim” that encompasses regulatory proceedings and investigations. However, there are often wide variations on the scope of regulatory and investigation coverage provided by such an enhancement. Some provisions include formal investigations initiated by an order or service of a subpoena. However, SEC investigations and other regulatory investigations may begin as an “informal” request for information without a formal order or service of a subpoena.

In some cases, the definition of “Claim” may be broadened to encompass a wider range of investigations against the entity or individual insureds. However, this coverage can be difficult to negotiate depending on the nature of the entity. Accordingly, it is important to carefully review with your broker the D&O policy’s definition of “Claim” and seek to negotiate as broad of coverage for investigations as possible.

In addition, careful attention should be directed to the Insured vs. Insured exclusion. Insurers often will offer carve-backs to the Insured vs. Insured exclusion, but the scope of the carve-backs can vary significantly. For example, with respect to whistleblower actions, some carve-back language only references Sarbanes-Oxley whistleblower actions, which means that the exclusion would still apply to other whistleblower actions such as those under the Dodd-Frank Act.

In summary, SEC and other regulatory investigations are an increasing risk that should be addressed in connection with D&O insurance. While the scope of coverage available will vary to some extent based on the risk profile of the insured firm, it is important to consider that the investigatory landscape that private equity and hedge firms face has changed significantly in the last year.

Representations & Warranties Insurance – Strategic Applications on Buy- and Sell-Side of Transactions

Representations & Warranties Insurance (R&W Insurance) was an actively used product in 2010 on several fronts. The year was marked by the entrance of new capital in the transactional insurance market, which included Beazley, Allied World Assurance Company, Houston Casualty Company and Ironshore, along with the continued presence of long-term players Ambridge Partners, Concord Specialty and Chartis Insurance.

Pricing was extremely competitive, creating a favorable environment for utilization of R&W Insurance, with rates commonly in the 2 to 3 percent range of limit purchased.

We saw an increased strategic use of R&W Insurance by private equity firms on the buy-side – incorporating R&W Insurance into a bid strategy by offering to limit the seller's indemnification obligations at an escrow amount and supplementing indemnification protection with a buy-side R&W Insurance Policy. In addition to favorable rates, coverage terms have improved with limited exclusions and an "actual knowledge" of breach standard being negotiated with respect to the exclusion for items discovered in pre-closing due diligence.

In addition, as many private equity funds near the end of fund life, sell-side applications of R&W Insurance are increasingly considered to foster a clean exit from a portfolio investment. Again, more favorable coverage terms are obtainable in the current market, allowing the insurance to more closely track the indemnification obligation in the underlying acquisition agreement and minimize gaps in protection. A fund wind-down policy can also be crafted to wrap up all trailing indemnification obligations for a liquidating fund into a single policy to allow for distribution to limited investors without risk of clawbacks in the event of an indemnification claim from a portfolio exit transaction. These policies also provide an element of umbrella executive liability protection for the fund.

Cyber Liability: An Increasing Issue for All Businesses

Cyber liability continued to be an expanding area of exposure in 2010, with continued increase in the incidence of cyber crime, data privacy breaches and other internet liability such as online defamation, libel and violation of trademark and copyright laws.

Many insurers now offer cyber liability insurance products. However, as with many emerging insurance products, one size does not fit all and it is important to carefully review the offerings and determine the type of cyber insurance appropriate for each business.

Cyber risks may be addressed in connection with enhancements to existing Property & Casualty insurance policies, D&O or E&O insurance policies, or as a stand-alone insurance policy. For organizations that have a higher risk of data privacy breaches or cyber liability exposures, a stand-alone policy should be considered as the most comprehensive coverage, and separate dedicated limits can be obtained in this manner. This would include businesses in the healthcare, education, financial services, hospitality, and retail sectors.

Equity Risk Partners is a leader in negotiating placement of transactional insurance products, and we would be glad to respond to any questions you may have regarding particular situations where R&W Insurance may be utilized to facilitate a transaction.

However, it is important to recognize that all businesses are exposed to cyber risks.

Experts have commented that small- to medium-sized businesses are being targeted by cyber criminals as easier targets due to the probability that less safeguards are in place. For example, cyber criminals have engaged in large scale schemes to obtain online bank account and log-in details through infiltration of malware or Trojan horse viruses on employee computers, and effect transfers of large sums through fraudulent payroll or other payments from the business account.

By the time the missing funds are discovered, the money usually has left the country and may be impossible to track down and recover. While banks are legally responsible for fraudulent activity on individual accounts, banks may disclaim responsibility for such losses on business accounts and assert that the losses are not the bank's responsibility since the transfers were effected with proper log-in credentials, and responsibility for safeguarding such credentials lies with the customer. The losses associated with this type of activity can be devastating and are not likely to be covered under many traditional insurance policies.

Losses may also result from data breaches, which occur when personally identifiable information is compromised. This may involve customer or employee information, and can be triggered by a lost or stolen laptop containing personally identifiable information, inadvertently throwing sensitive data into the trash, by an employee participating in a scheme to steal sensitive data, or by a third-party hacking into a company's system. Whatever the cause, the consequences may be very costly.

At last count, 46 states currently require businesses to notify affected individuals when their data has been lost or stolen. In addition, credit monitoring often must be provided to breach victims to help mitigate potential damages. In addition, forensic computer experts may need to be retained to investigate the incident and its cause.

One study has estimated the average cost of an incident at \$202 per each record compromised. (Ponemon Institute Fourth Annual U.S. Cost of Data Breach Study, Benchmark Study of Companies). For a retailer with 15 sales a day, this would amount to over \$1 million for a year of customer records compromised.

The Identity Theft Resource Center (ITRC) reports that there were 662 identified data breaches in the United States in 2010 - over a 30 percent increase from 2009, which exposed a total of 16,167,542 records. The incidents encompassed a wide range of businesses.

Nearly every business today has a website. Even if no business transactions are conducted online, exposure exists for material published on the website. Third-parties may assert that such content violates intellectual property rights or other legal rights.

Cyber exposures present an issue that every business should evaluate in connection with their insurance program. Existing insurance policies should be carefully reviewed to determine what protections are currently included, and the particular risks faced by the business evaluated to determine if additional insurance is appropriate. Equity Risk Partners welcomes the opportunity to work with you in addressing this important area of exposure.

Meet the Equity Risk Partners FinTran Team



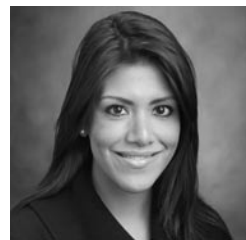
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