Industry Insights

Private Equity Portfolio Companies and D&O: Why the first two stages of the lifecycle are critical

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As private equity (PE) firms navigate the lifecycle, they are also juggling a number of potential Directors and Officers (D&O) risks associated with each stage. From formation to disposal, appropriate risk management is essential for PE firms to protect themselves from any potential exposures.

PORTFOLIO ACQUISITION

When a PE firm considers purchasing a portfolio company, one of the things it considers is its financial health, then decides whether to move forward with investment. the D&O risks for the PE firm and the portfolio company are myriad. They are faced with numerous boardroom risks, such as the potential for mismanagement or errors in the due diligence process.

Importantly, PE firms can be blamed for any mistakes made in the assessment of a portfolio's financial health or any unanticipated or undisclosed risks. The underlying risks can change on short notice, and so the stakes are high.

There is also the potential for insider trading: this risk is especially relevant in the first or pre-investment phase, when firms are gathering and processing confidential information about a prospective portfolio. Without vigilance, private equity firms could be found liable for any insider trading activities conducted by their board members or employees.

To properly manage these D&O risks, PE firms must ensure they have the appropriate insurance coverage in place. This means finding a policy that will provide comprehensive protection from both known and unknown risks throughout the entire lifecycle of a portfolio.

PORTFOLIO MANAGEMENT

Once a PE firm has acquired a portfolio, they take on the management of all aspects of that portfolio – including restructuring, selling and refinancing. During this time, PE firms need to be on alert for any risks that may arise in order to protect the interests of their investors.

Boardroom risks can be especially prevalent during this phase, due to the large number of stakeholders involved. Directors and officers could be sued for mismanagement or breach of duty by other board members, creditors, shareholders, or even regulators.

Recent data suggests that the average length of time for a regulatory investigation by the Financial Conduct Authority (FCA) in 2021 was 25 months. If any investigation leads to formal enforcement action then proceedings can last many years. It is therefore important that directors have provisions in place to mitigate against the costs exposure of an FCA investigation.

There is also the risk of shareholder class action suits resulting from management decisions made on behalf of the firm. Such actions are on the rise in the UK due to the development of the S90A Financial Services and Markets Act 2000 regime and the maturing litigation funding market.

Directors will also need to consider employment rights when implementing any restructure at any level. This includes ensuring that they comply with relevant legislation relating to redundancies or the redeployment of workers within the business. Companies and their directors can face employment claims where correct process has not been followed.

PE firms and their directors require specialist D&O cover to include D&O risk mitigation solutions and having the right coverage in place is of particular importance during the first two stages of a portfolio lifecycle. With the right policy in place, PE firms can protect themselves from potential liabilities and ensure their investments remain secure.

UK Beazley policyholders benefit from a free legal helpline to help navigate the risks outlined above (and any others) throughout the private equity lifecycle.

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1 FCA operating service metrics 2021/22 | FCA