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Article

Private Equity Companies and D&O: The exit strategy – don’t count your chickens

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Emma Pereira, Product Leader – International Management Liability, Beazley

William Naylor, Partner, DAC Beachcroft, Graham Briggs, DAC Beachcroft

In the second part of our series on the investment liability lifecycle, we look at the exit strategy. Successful private equity investments and exits can hinge on financial performance in the portfolio companies. As an exit approaches, scrutiny intensifies and so the risk of and consequences from dissatisfied parties increases.

For private equity (PE) firms, there are various ways to exit portfolio businesses, whether that be via a sale, Initial Public Offering (IPO) winding up, or management buyout. Last year, the aggregate value of private equity exits globally totalled $391.44 billion.[1] Each of the exit routes for portfolio managers present a number of Directors & Officers (D&O) risks, heightening the need for risk mitigation solutions that protect against claims.

IPOs are often seen as the culmination of years of hard work for management teams, employee shareholders, and private equity backers. However, today’s

market conditions are more volatile than in previous years – Ernst & Young found that in the first quarter of 2023 global IPO volumes fell 8%, with proceeds down by 61% year on year.[2] These business milestones are complex processes, which can ultimately give rise to D&O claims.

For example, as market risks increase, there is no guarantee that investors will benefit financially from a listing. As these risks impact the price investors receive from an IPO, there is potential for D&O claims against private equity firms from investors. Investors could also initiate a lawsuit against the General Partners if they do not feel sufficient or timely action was taken to protect investors.

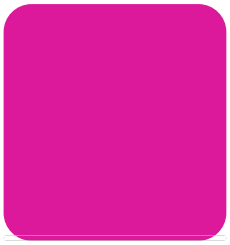
Before, during, and after Mergers & Acquisitions (M&A) deals, private equity portfolio managers are also at risk of D&O claims. The exposure of Directors to claims arising from alleged misstatements in prospectuses, and other supporting materials, is developing in England and Wales. Directors need to be particularly careful at the time of an IPO to ensure that the representations made are accurate. Disclosures made by Directors to the Market are under the spotlight from both shareholders and regulators alike. Indeed, this is evidenced by the work that the Financial Conduct Authority (FCA) is currently undertaking regarding Sustainability Disclosure Requirements in the investment management space.

These claims can often occur following the sale process, where parties allege misrepresentations were made during the exit. Dissatisfied investors in private equity PE funds who may believe the correct due diligence did not take place by the fund managers, or that they have reason to object to an acquisition for example, might wish to make a claim against the firm. Such claims can be pursued by minority shareholders by way of derivative actions or unfair prejudice petitions.

Essentially, if there are allegations of a failure to perform appropriate due diligence over deals and information shared when exiting a firm, this can lead to a costly claim. This becomes more challenging as private equity backers often sit on the boards of portfolio holdings, creating opportunities to impact decision-making and access greater information.

The upshot is that a combination of greater scrutiny and market volatility is presenting a challenging environment for PE portfolio company managers. While a number of factors are at play, private equity firms need to be alert to these risks and protect themselves from potential liability. Insurance has become an increasingly important tool in managing and mitigating a wide variety of transaction-related risks, from representations and warranties, to tax risk, management liability and D&O considerations.

As an exit approaches, the appropriate cover can ensure that PE firms' time and money are protected, in the event that a deal goes wrong. Beazley's new PE Portfolio D&O product provides cover or options to quote for all eventualities, from the first purchase of the asset to the ultimate exit strategy. Policyholders also benefit from a free legal helpline to help navigate the risks outlined above and those throughout the private equity lifecycle.



Emma Pereira

Product Leader: International Management Liability

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