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# Professional Indemnity & Directors and Officers Insurance: the fallout from Madoff and the financial crisis



Gavin Davies  
Managing Partner

The PI and D&O Insurance market has been hit by a perfect storm. The first wave came in the form of the global financial crisis, and the unraveling of structured investment products containing sub-prime and toxic assets. The second wave took the form of Bernard Madoff.

## The impact of the storm

The global financial crisis has hit insurers both directly and indirectly, says Paul Richards at risk management and insurance intermediary Willis. "A number of insurance companies themselves have had direct exposure to sub-prime and toxic asset investments that have depleted their balance sheet, at a time when their investment portfolios have already been reduced by the steep drop in equities," he explains.

On top of this, there have been a number of direct claims against insurers underwriting a wide range of financial institutions, including some major UK banks.

"In total, the market estimate for PI and D&O losses for sub-prime and the credit crunch is approximately US\$10 billion," Richards says.

It was against this challenging backdrop that the Madoff scandal took centre stage – bringing with it insurance-related claims of around US\$2 billion and total losses of US\$65 billion.

"There is a fear that there will be a further wave of litigation as things work down to investor level, and they seek to work out where they could recoup some of their losses," Richards warns.

## The reaction from insurers

PI and D&O insurance providers are responding to these challenges by toughening up their underwriting and due diligence procedures. "When capital was freely available and insurers made money from their investment portfolio, they concentrated less on underwriting profit. Now this focus has changed quickly," Richards explains.

As a result, Private Equity and Property Fund Managers can expect insurers to be a lot more discerning about who they insure; the premiums they charge; and the coverage terms they provide. Indeed, "some insurers are seeking 20 to 30% uplifts on premiums compared to last year, due to increased claims activity and reinsurance premiums," says Mike Lobb at insurance brokerage Howden Group. "Your broker must be able to differentiate you from the pack or you will have to wear these increased premiums or unacceptable changes to the policy language," he adds.

## How should Private Equity and Property Fund Managers respond?

As a result of these trends, Fund Managers should devote more time than ever to their insurance application process, brokers say. The first step is to start thinking about the insurance renewal earlier than before, and to engage in a closer dialogue with both the broker and the insurers themselves. "We normally start our renewal conversations with clients 90 days from the renewal date. With financial institution clients, we now tend to start these conversations 120 days from the renewal date," Richards says.

Indeed, Colin West at insurance brokerage Windsor Partners believes that the relationship between broker and client should be an ongoing process. "It's the brokers' job not just to get the best deal for clients during the renewal process, but look after clients throughout the policy year as well," he says.

It is now more important than ever for Fund Managers to be as transparent as possible with their potential insurers meeting directly if possible. "Any client that meets the Underwriter tends to get a better deal, because the Underwriter will gain a better understanding of how the business is run and can bounce questions off the client rather than just reading from a proposal form," says West.

"Taking the time to read the small print is also more important than ever," says Lobb. "Directors need to understand what they've bought – making sure that the language of the product they are buying provides the cover that they require. Directors should push their brokers to answer questions on the real issues that they potentially face," he says.

Meanwhile, insurers are now trying to exclude Madoff and credit crunch related issues from future cover. As a result, Fund Managers approaching their insurance renewal should look carefully at their exposures in these areas. "If you haven't reported to insurers any claims or circumstances that may arise out of Madoff, sub-prime or toxic exposures, you may find that cover for those matters is excluded going forward," Richards says.

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## The Carbon Reduction Commitment (CRC): implications for Private Equity and Property Funds



Ian Kelly  
Partner & COO (Europe)

Private Equity and Property Funds will be responsible for compliance with a new UK carbon trading scheme within their portfolios. Failure to meet requirements could ultimately result in a prison sentence.

### What is the CRC?

The Carbon Reduction Commitment is a mandatory UK government scheme designed to reduce carbon emissions and promote energy efficiency among organisations across both the private and public sectors.

Like the existing European Emissions Trading Scheme (ETS), the CRC is based on a 'cap and trade' model, with the long-term goal of creating a market for a finite number of carbon emissions credits.

All organisations will be obliged to participate in the scheme if they have one or more half-hourly electricity meters in the UK and those that use more than 6,000 megawatt-hours (MWh) will have to purchase emissions allowance.

6,000 MWh is equivalent to the consumption of 1,000 family households!

The timetable is as follows:

**In September 2009**, the Environment Agency – will contact all UK billing addresses with settled half hourly meters providing them with Qualification Packs. All organisations will need to collate information on their total half hourly electricity consumption for 2008 together with a list of their half hourly meters, assisted by their electricity supplier, to assess whether they qualify for the scheme.

**The first compliance year (April 2010 – March 2011)** is a 'Footprint' Year. The first six months of the Footprint Year is also the registration period. Organisations who qualify must register or make an information disclosure by 30 September 2010. A monetary fine will be imposed on organisations who fail to do so by the deadline.

**April 2011:** Purchase emissions allowances for both the previous and the following 12 months. Allowances will cost £12 per tonne of carbon dioxide emitted. The BVCA estimates that a company using 6,000MWh of electricity will need to buy just under £40,000 – worth of allowances per year.

**July 2011:** Report carbon emissions and surrender one allowance for every tonne of CO<sub>2</sub> emitted.

**October 2011:** Proceeds from the purchase of emissions allowances will be redistributed to organisations participating in the CRC.

**Every April from 2012 onwards,** organisations will be obliged to purchase further emissions allowances to cover their predicted emissions for the following year.

The price of allowances will be fixed at £12 for the first three years of the scheme. The government then plans to cap the number of allowances sold, and allow the market to determine their price.

As part of the scheme, the UK Government will publish a league table showing organisations' relative performance in terms of management of energy and emissions levels. Companies improving in these areas will be rewarded with bonus payments when the proceeds from allowances are redistributed. Those with rising emissions or declining energy efficiency performance will face a penalty.

Civil penalties for failure to comply with the scheme include the following:

- £5,000, plus £500 per day, for failure to register for the CRC.
- £5,000, plus 5p per tonne of CO<sub>2</sub> per working day, for failure to provide an annual report.
- £40 per tonne of CO<sub>2</sub> for incorrect reporting.

Organisations will face criminal penalties for offences including:

- Intentionally obstructing the regulator.
- Failure to comply with an enforcement notice.
- Knowingly or recklessly making a false or misleading statement.

The maximum penalty for such offences will range from a three-month prison sentence to two years' imprisonment.

### Why does the CRC matter to Private Equity and Property Managers?

The CRC treats all members of an organisational 'group' as a single participant in the emissions trading scheme. This group could manifest itself as a corporate conglomerate, a partnership or even a joint venture, comprising a 'parent undertaking' and 'subsidiary undertakings'. A parent undertaking is defined as a person holding majority voting rights; a holder of the right to appoint a majority of board members; or the holder of the right to exercise a 'dominant influence' over a subsidiary undertaking.

Crucially, under the terms of the CRC, a Limited Partnership/Fund is likely to be defined as the parent undertaking to portfolio companies. This means that Private Equity and Property firms may be responsible for meeting all of the CRC obligations of their portfolio companies, the emissions of which would be treated as part of an aggregate group.

As the BVCA has pointed out, this raises a number of questions for Managers:

- To what extent will GPs as well as LPs be faced with new obligations under the CRC?
- How should the costs associated with complying with the CRC be distributed among portfolio companies?
- How should, and indeed how can, an LP enforce compliance with the CRC among the boards of various

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## LP Defaults



James Watts  
Head of Onshore Client Services

Augentius has seen few issues with LPs. But what else is happening in the market?

### Is the risk of LP defaults really rising?

Over the past decade, GPs have had few reasons to be concerned about LP defaults. "Before October last year, I could count the number of LP defaults on the fingers on one hand: there was literally one," says Jason Glover, Partner at Clifford Chance.

Even during recent turbulent months, LP defaults may have appeared to remain relatively rare occurrences. But this may change over the medium term. "A number of LPs are significantly cash constrained at the moment. However, because there are relatively few drawdowns taking place, I don't think that the extent of the problem has materialised yet," Glover explains.

Duncan Woollard, Partner at SJ Berwin, adds that there are already clear signs that LP default risk levels are on the rise. "Around half the funds I have worked on in the last few years have concerns with defaults or likely defaults," he says.

### What types of investors are most likely to default?

Woollard believes that GPs should focus most attention on potential defaults among Fund of Funds, especially those that have followed a particularly aggressive investment strategy or relied on leverage.

Some Fund of Funds are 'strategically defaulting' – defaulting in funds to which they have the least exposure, or those that they feel are the least likely to deliver strong returns.

"High net worth individuals experiencing financial difficulties as a result of the credit crisis and Lehman-style institutional collapses are other potential sources of defaults," Woollard adds.

### How should GPs mitigate default risks?

Woollard advises GPs to talk to their investors to establish whether they have issues with meeting drawdown calls. If they have, GPs can discuss potential ways of dealing with the issue, such as bridge financing, for example.

Drawing down early is another potential default avoidance tactic. "The more you draw down and invest, the less attractive strategic defaults become," explains Woollard. However, he admits that this is easier said than done. "Because of the effects on IRRs, not many GPs want to draw down 10% and have it sitting in cash, even though that might well be all you need to move you sufficiently down the list of funds worth defaulting on."

"GPs could also try to assist the defaulter with a secondary transfer," says Glover.

What if such default avoidance measures prove unworkable? "If potential secondary acquirers are not available, the only remaining option may be to begin legal proceedings for breach of contract," says Woollard, who admits that this is not an easy route:

"The last thing you want to do as a GP is get involved in litigation with LPs. But in this market, where the potential acquirers of secondary interests are moving quite slowly, and where there is unlikely to be an appetite from the GP to take over the commitment of a defaulting investor, you are almost forced into a situation where legal proceedings are the only meaningful way of dissuading an investor from defaulting."

Indeed, there have already been a number of examples of such proceedings in the US. "I suspect that it won't be too long before we see some in the UK," Woollard predicts.

At this point, it is very important for GPs to take legal advice to ensure that they are in

compliance with all relevant documentation and legal protocols, Glover says: "Once you have reached a particular point in the default procedures, your discretion as a GP ends, and you are obliged to take certain actions." Failure to do so could leave the GP itself exposed to accusations of breach of contract or a failure to meet its fiduciary obligations. "The biggest danger for a GP is failure to comply with the LP agreement," Glover explains.

### Mitigating default risk in the long term

"LPs conduct a huge amount of due diligence on GPs before they commit but there has often been very little commercial due diligence conducted by the GPs on the LPs they bring into the Fund," explained Woollard.

Why has this been the case? "It has always been the assumption of GPs and Placement Agents that if an LP signs the subscriptions agreement, they will be able to pay," says Woollard. "Going forward, some of the smaller, less well-known investors will have to undergo a lot of scrutiny before they are allowed into Funds."

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portfolio companies, each of which have their own discrete shareholder, management and reporting structures?

Organisations including the BVCA and the CBI are discussing these and other concerns with the UK Department for Energy and Climate Change. In particular, the BVCA is putting forward the view that Private Equity and other groups should have the freedom to choose whether to comply with the CRC at a group level, or to permit portfolio companies to comply with the scheme individually.

A full user guide can be obtained from: [www.defra.gov.uk/environment/climate-change/uk/business/crc/comply.htm](http://www.defra.gov.uk/environment/climate-change/uk/business/crc/comply.htm)



# TECHNICAL

## Augentius Update

Many businesses have suffered during the recent months as a result of the economic climate. Fortunately, Augentius is not one of them.

There is no doubt about it, new Fund launches have slowed and indeed we saw little activity of this nature between November and March. The fund raising climate has started to change in recent months and we have started to see a number of Funds successfully raise capital and launch, particularly within our Property/Real Estate team. On a global basis there are currently 1,600 new funds looking for US\$600 billion in investor commitments. Investors are appearing to be cautious with their cash!

What has definitely happened during the last few months is that CFO's have started to review and consider their own Fund Administration arrangements. With Managers/GP's having to survive, in many cases, on management fees alone, internal processes and reviews have been the norm. A number of groups are seriously considering outsourcing their administrative arrangements to save costs and create efficiencies. Others have reviewed their current outsourced arrangements especially where quality of service was an issue. Augentius has been successful in securing a number of substantial new relationships previously administered by large US banks and others. As a result of these reviews, there is an increasing flow of business from other administrators to Augentius.

Our business continues to flourish. We are proud of the fact that we have not had to make any redundancies during the period. Indeed we have never stopped recruiting to service our clients. Some of our competitors have not been so

fortunate and have, unfortunately, had to release staff. To accommodate our continued growth, we have secured significant additional long-term floor space at Two London Bridge – and so our views over the river and the City have been secured for the long term.

Our New York office, set up in the Autumn of 2008, is also experiencing unprecedented growth and, as the US emerges from recession, we see significant opportunities to expand the business in America.

### Augentius facts and figures

- Current staffing – 112 globally
- Turnover – currently up 25% on last year
- Debt – in the seven and half years since our inception we have never utilised any of our banking facilities

Both the Draft EU Directive and proposed SEC regulation are new challenges that our industry will have to face over the coming weeks and months and we are closely monitoring these proposed changes. In addition the industry continues to change in many other ways – additional requirements from LPs, the changing use of different domiciles and locations and new accounting initiatives etc. As the industry changes so we will structure and change our business to meet those needs.

We are very proud of the continued success of Augentius and the high quality reputation that the business has within the industry. We will continue to grow and develop our business to remain at the forefront, whilst at the same time maintaining the highest quality service to our clients and their investors.

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“It is also important that Fund Managers take care over the wording of their declarations to insurers relating to their awareness of exposure to Madoff and related issues,” says West. “Close cooperation with brokers in this area is crucial.”

### What other questions will insurers be asking?

Private Equity Fund Managers should expect more questions about the type and number of their US investors and how they invest in their Fund, and the assets they have in the US. They should also expect more queries about debt covenants on portfolio companies. In addition, they should prepare for more due diligence on the type and valuation of their portfolio companies; the type of outside directorship positions being held; and the cover portfolio companies have for D&O Insurance themselves.

Meanwhile, Property Fund Managers should work with their brokers to provide insurers with as much detail as possible about the nature of their operations, and their outsourced activities. “Some insurers will approach these Funds from a commercial property valuation and management perspective, as opposed to a financial asset management perspective,” explains Richard. Ensuring that insurers genuinely understand the nature of your operations and Property Fund is therefore crucial for getting appropriate cover.

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