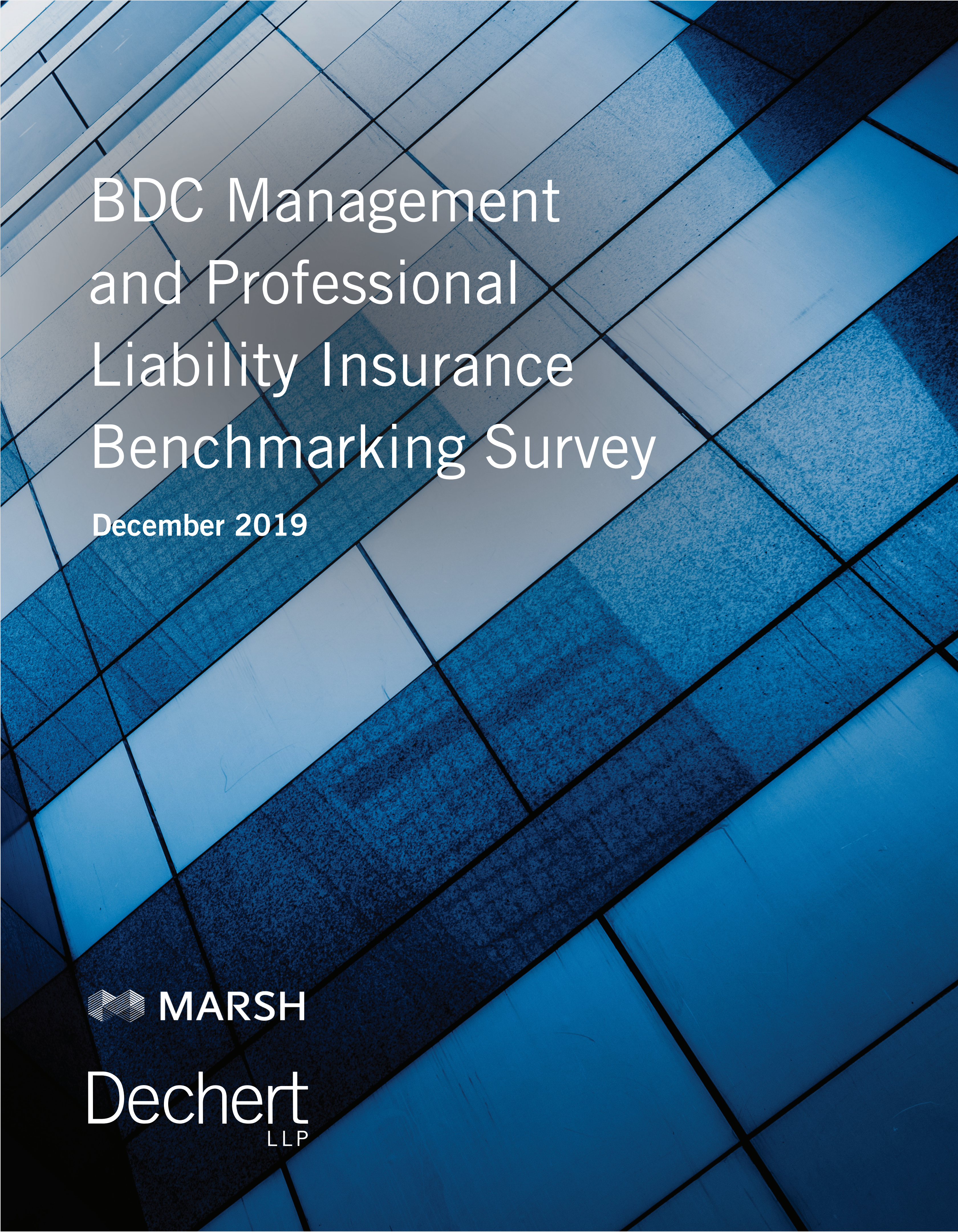

BDC Management and Professional Liability Insurance Benchmarking Survey

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MARSH

Dechert LLP

Dechert and Marsh recently conducted a benchmarking survey regarding management and professional liability insurance practices in the business development company (BDC) industry. The survey was developed based on requests for benchmarking information from clients regarding BDC directors and officers (D&O) liability insurance, with results intended to provide industry participants with information that may be useful in reviewing their current insurance programs as compared to the industry as a whole. The survey was distributed in early 2019 to general counsels, chief financial officers, chief accounting officers and other senior executives of both internally and externally managed BDCs.

This report includes results of the survey provided by 26 BDCs and culled from other industry sources, as well as frequently asked questions regarding common insurance risk management practices.

Frequently Asked Questions About D&O Insurance

What is D&O insurance? What is E&O insurance?

D&O insurance is liability coverage for the directors and officers of a BDC or a BDC itself. Generally speaking, D&O insurance provides reimbursement for losses (including settlements or judgments) and the advancement of defense costs in the event of a covered claim.

D&O insurance generally covers directors who are "duly elected" by stockholders and officers who are "duly appointed" by a BDC's board of directors. Importantly, it usually does not cover non-officer employees.

Errors and omissions (E&O) insurance, also known as professional liability insurance, covers a firm or fund in its performance of, or failure to perform, a professional service. Nearly all BDC management liability policies contain a component of E&O coverage.

What are the three layers of D&O insurance coverage?

D&O insurance typically comprises three core, separate agreements:

- **Side A coverage,** also known as personal asset protection, provides insurance protection for individual directors and officers for defense costs and any settlement or judgment that is not indemnified by the BDC (i.e., where the BDC legally is not permitted or unable to indemnify them — for example, due to insolvency).

- **Side B coverage,** or balance sheet protection, reimburses (usually subject to a retention, which is more commonly referred to as a deductible) the BDC for its indemnification of a director or officer.

- **Side C coverage** (which also is typically subject to a retention) protects the BDC from claims made against the BDC itself. In the context of a public company, Side C coverage is often limited to securities claims in which the BDC itself is targeted together with its directors and officers.

Specifically in respect to BDCs, Side C coverage is often extended to provide full professional liability coverage for claims based upon, or arising out of, BDCs' and their employees' and/or managers' alleged failure to perform professional services and claims relating to lender liability and portfolio oversight matters. Examples of claims related to this type of broader professional liability coverage include claims against the BDC for "undercapitalizing a portfolio company" (i.e., "corporate veil" issues), and failure to provide proper advice and influence over a portfolio company.

What other coverages should be included in a BDC's management liability policy?

E&O coverage for a BDC's acts performed in connection with providing professional services can be incredibly valuable to a BDC. Many BDCs consider purchasing a combined D&O/E&O policy — sometimes called a general partnership liability policy — instead of a simple D&O policy.

The D&O/E&O policy that BDCs purchase should contain outside directorship liability (ODL) coverage for directors, officers, and employees in their capacity as directors to outside entities or portfolio companies. A BDC's policy should extend to any individual sitting on the board of, or serving as a board observer to, a portfolio company. This coverage should sit excess of any insurance procured at the portfolio company level, and any indemnification that may be available from the portfolio company.

What steps should independent directors take to ensure that their BDCs have the right coverage?

Independent directors and/or their counsel should become actively involved, early in the D&O insurance renewal process, to make sure they understand the gives and takes of any proposed D&O insurance policy. This proactive engagement should include discussions with the BDC's D&O insurance broker regarding coverage terms and conditions and the claims-paying reputation of each insurer being considered.

What should BDCs be focused on in connection with the renewal of D&O insurance policies?

The market for management and professional liability has become significantly more challenging for some buyers in 2019. Rates have rapidly increased across all industries, with financial institutions seeing large rate increases.

It is perhaps more imperative now than ever before to differentiate your BDC from the overall financial sector, since BDCs have historically had more favorable loss experience than the more general alternative investment space.

Additionally, when approaching the underwriter community, it is important for you and your broker to focus insurers on the highly regulated nature and overall positive performance of BDCs.

Given the challenging D&O insurance environment, it is recommended that BDCs and their brokers start the insurance renewal process as early as possible.

What trends in the BDC industry have impacted or may impact the BDC D&O insurance market?

Unfortunately, in any industry or sector, there will be one or two occurrences that will cause underwriters to take a more skeptical view of the industry as a whole. A BDC's ability to utilize more leverage will cause some concern. Continued pushes by activist shareholders, proxy fights and M&A activity are additional drivers of insurer apprehension.

Recent SEC enforcement actions in the investment management industry may also catch the attention of insurers even though the fines and settlement amounts in such actions have been manageable to date.

What are shared limits and why is it important that directors and officers of BDCs understand their potential implications?

Shared limits refer to the limits of liability coverage available to the group of insureds under a D&O insurance policy (i.e., the BDC and its directors and officers and potentially the investment adviser and other parties, collectively). Many D&O insurance policies provide that all insureds — independent directors, interested directors, officers, the BDC and the investment adviser — share policy limits. For example, if a D&O insurance policy has a shared limit of US$10 million for all covered insureds, then the shared limit would decrease for each claim submitted under the policy. Because D&O insurance policies cover losses resulting from settlements, judgments and defense costs, the BDC's legal expenses in connection with a covered matter can deplete available insurance.

Moreover, due to the intertwined nature of D&O claims and claims involving the failure of a BDC or the advisor to perform a professional service, D&O and E&O limits are most often shared.

How can officers and directors manage the shared limits risk discussed above?

Nearly all BDCs will purchase some form of "dedicated" Side A coverage, meaning coverage for the insured persons (which would provide coverage if they do not receive indemnification from any source) that cannot be eroded by the entity or indemnifiable loss.

Additionally, some independent directors of BDCs may wish to procure independent director liability (IDL) insurance that provides coverage solely for their benefit. This coverage may provide Side A coverage only or Side A and Side B coverage. The cost of IDL insurance is generally less than standard D&O insurance, as independent directors are involved in litigation less frequently than insured entities or affiliated insured persons.

Another approach that some insured parties that share limits may take is to enter into sharing agreements outside of the insurance policy. Under an insurance sharing agreement, the insured parties enter into a contractual arrangement with the purpose of ensuring that the insured parties would in all events have some amount of coverage under the insurance policy available to them during the entire policy year. This agreement holds even if the existence and size of claims against other insured parties might — without the benefit of the agreement — otherwise drain available insurance coverage under the policy. Insurance carriers and brokers generally are not involved in insurance sharing agreements.

Do most D&O insurance policies include coverage for investigatory expenses incurred prior to bringing formal charges against insured individuals?

Historically, D&O insurance policies have excluded coverage for investigatory expenses incurred prior to bringing formal charges against an insured individual. However, some D&O insurance policies include coverage for investigatory expenses. Given the significant costs that can be incurred in the early stages of regulatory/criminal investigations, BDCs should consider whether it makes sense to obtain coverage for investigatory expenses.

What are the rules of the road with respect to providing notice to D&O insurance carriers regarding potential claims to be made under D&O insurance policies?

D&O insurance policies are "claims-made" policies, meaning that they provide coverage only for claims that are made against an insured during the policy period (not necessarily when the alleged acts took place) and for which the insurer has been provided notice during the policy period. These notices must be specific as to the actions and individuals involved, even if there is not a current claim against them. The notice of claim is extremely important given that coverage can be lost due to inadequate or late notice.

What is D&O tail insurance and when would a BDC typically need to obtain it?

As discussed above, D&O insurance policies are "claims-made" policies, meaning that they provide coverage only for claims that are made against an insured during the policy period. So, for example, if a set of actions took place in 2018 but a party brings a claim related to those actions in 2019, it is the D&O insurance policy that is in place in 2019 (and not in 2018) that would cover the related claims.

D&O tail insurance covers what would otherwise be a gap in coverage for directors and officers after the sale of a BDC, whether by merger or otherwise. The gap exists because the D&O insurance policy of the acquiring BDC will typically not cover claims on behalf of the selling BDC's directors and officers for claims that arise post-closing that relate to pre-closing matters.

When a D&O tail insurance policy is purchased, the insurer for the selling BDC agrees to hold open the D&O insurance policy for a specified period of time past the policy's normal expiration date; based on our experience, this period is almost always six years. In other words, if a claim arises within six years after a BDC is sold, the selling BDC's directors and officers will be covered under the selling BDC's D&O insurance policy which was in existence immediately prior to the sale transaction.

How does E&O insurance differ from D&O insurance?

The main difference between E&O and D&O insurance is the type of claims covered. D&O insurance focuses on management decisions, while E&O insurance is concerned with the products and services that the BDC offers. For example, the failure to make a loan to a prospective portfolio company could become an E&O claim, while management's decision to merge its own BDC with another is most likely a D&O claim.

What trends are impacting the D&O and E&O insurance markets?

After years of generally favorable conditions for buyers, the D&O and E&O marketplace has rapidly shifted over the last calendar year. Securities class action litigation is at an all-time high, merger objection and bankruptcy litigation are rampant, and years of declining insurance rates have led insurers to rethink their approach to underwriting. Recent court decisions, such as the U.S. Supreme Court's decision in *Cyan Inc. vs Beaver County Employees Retirement Fund* (which held that state courts can continue to hear certain securities class actions brought under federal law, disappointing public companies that wanted such claims to only be brought before federal judges) have only compounded the market challenges. Coupled with severe losses relating to recent hurricanes and wildfire events, insurers are seeking rate increases to turn profitable. As a result, BDCs should expect the cost of these insurance products to continue to trend upward.

Survey Results and Key Takeaways

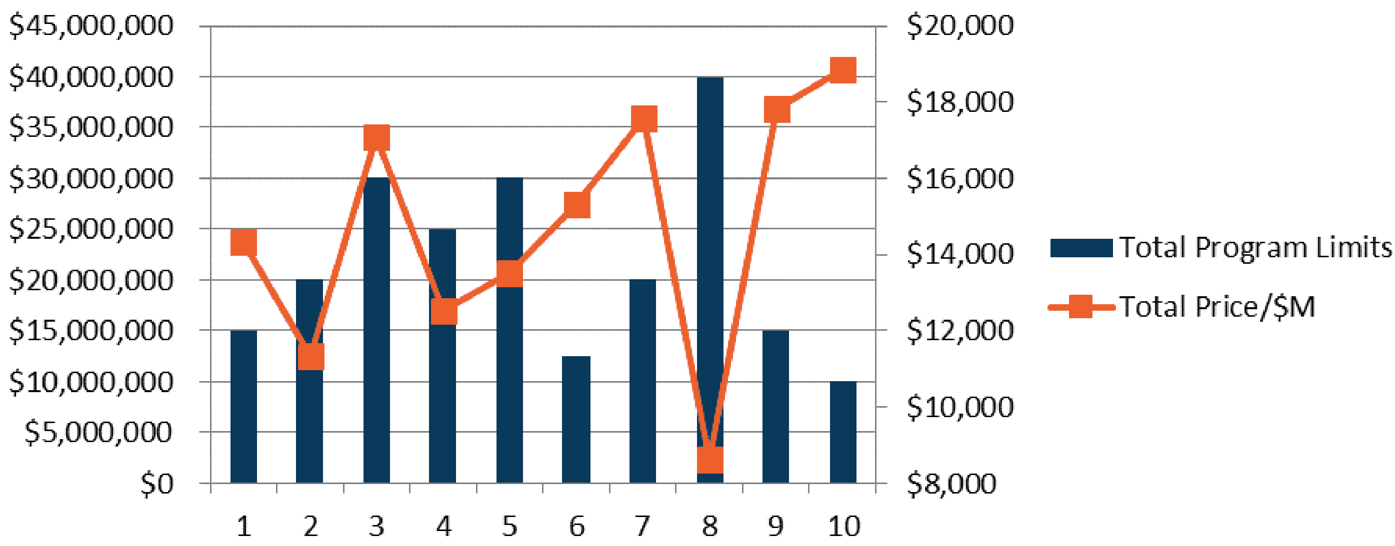
As seen in the table below, the largest writers of D&O and E&O for BDCs are AXA XL and Sompo. Nearly all BDCs purchase some level of Side A dedicated coverage, at a minimum limit of US$5 million. Of the respondents to the survey, the rate per million was significantly higher for those insureds that have had any claims history, significantly skewing the data. When those insureds are removed, the average primary rate/million dollars is just over US$20,000. This compares to US$26,000/million when those insureds with a claims history are included.

We also see from the data that most BDCs maintain US$250,000-$500,000 retentions (deductible), with the larger BDCs retaining the first US$1 million of loss. As the insurance market continues to become less buyer-friendly, we would expect insurers to increase retentions as a first step to improving their profitability.

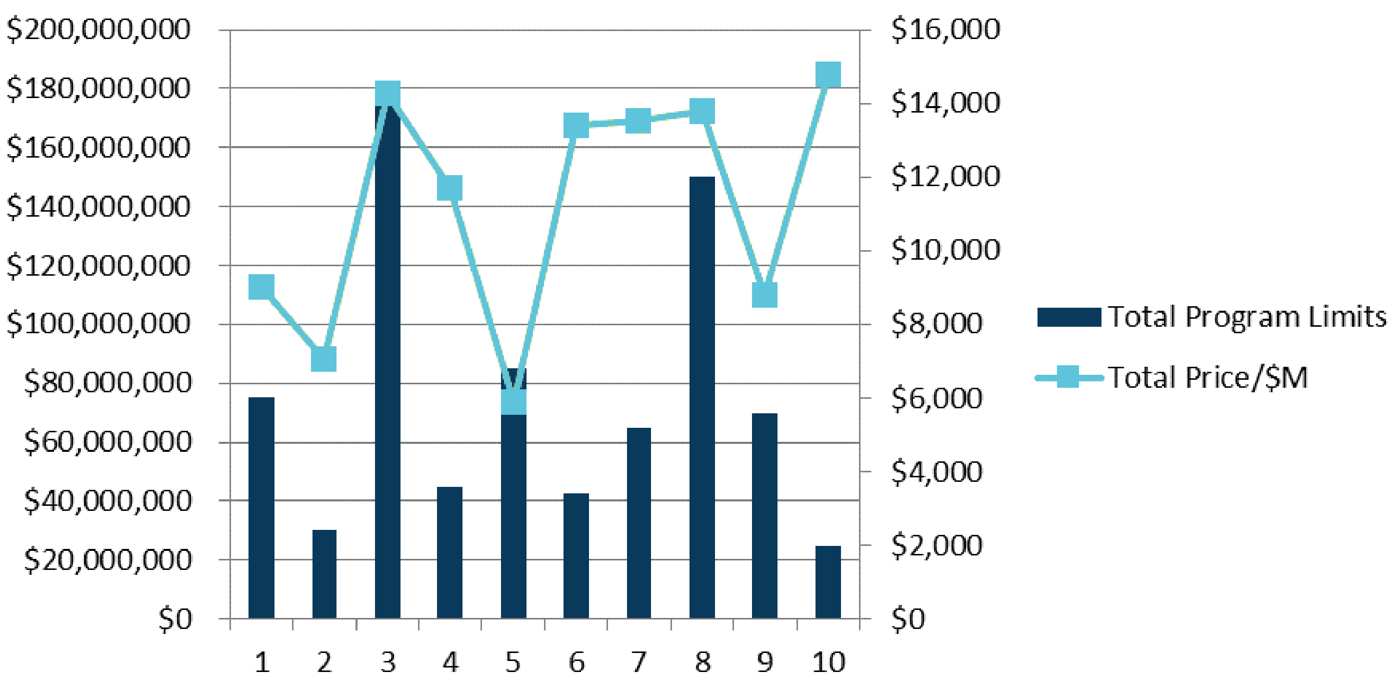
NAV Range	Lead Insurer	Primary Retention	Total Program Limits	Total Price/$M	Primary Limit	Primary/$M	Side A Limit (Included Total)
$100M-$250M	Travelers	$150,000	$15,000,000	$14,333	$10,000,000	$16,834	$0
	CNA	$500,000	$20,000,000	$11,353	$5,000,000	$12,282	$5,000,000
	XL	$1,000,000	$30,000,000	$17,067	$10,000,000	$27,000	$10,000,000
	Travelers	$250,000	$25,000,000	$12,520	$10,000,000	$17,500	$5,000,000
	XL	$350,000	$30,000,000	$13,533	$5,000,000	$56,200	$5,000,000
$250M-$350M	Sompo	$250,000	$12,500,000	$15,320	$5,000,000	$21,000	$5,000,000
	Sompo	$250,000	$20,000,000	$17,585	$5,000,000	$31,500	$5,000,000
	Sompo	$500,000	$40,000,000	$3,625	$5,000,000	$22,000	$10,000,000
$350M-$800M	AIG	$250,000	$15,000,000	$17,819	$10,000,000	$20,387	$0
	XL	$500,000	$10,000,000	$18,871	$10,000,000	$18,871	$0
$800M-$1.1B	CNA	$1,000,000	$75,000,000	$9,024	$10,000,000	$19,500	$25,000,000
	Axis	$250,000	$30,000,000	$7,039	$5,000,000	$13,699	$5,000,000
	AIG	$3,000,000	$175,000,000	$14,286	$10,000,000	$50,000	$50,000,000
	XL	$500,000	$45,000,000	$11,711	$10,000,000	$22,500	$15,000,000
$1.1B+	Lloyds	$500,000	$85,000,000	$5,869	$20,000,000	$8,500	$25,000,000
	Sompo	$500,000	$42,000,000	$13,412	$5,000,000	$37,000	$12,500,000
	CNA	$1,000,000	$65,000,000	$13,506	$10,000,000	$26,500	$15,000,000
	XL	$2,000,000	$150,000,000	$13,766	$10,000,000	$50,000	$40,000,000
Unavailable	Hartford	$1,000,000	$70,000,000	$8,800	$10,000,000	$20,000	$10,000,000
	Chubb	$250,000	$25,000,000	$14,785	$5,000,000	$29,725	$5,000,000
Median		$500,000	$30,000,000	$13,520	$10,000,000	$21,500	$7,500,000
Average		$700,000	$49,000,000	$12,961	$8,500,000	$26,050	$12,375,000
1st Quartile		$250,000	$20,000,000	$10,771	$5,000,000	$18,529	$5,000,000
3rd Quartile		$1,000,000	$66,250,000	$14,919	$10,000,000	$30,169	$15,000,000

The charts below provide additional detail regarding the total program limits and total pricing (per US$1 million in coverage) for BDCs with less than US$800 million in net assets and those with more than US$800 million in net assets.

BDC Limits and Pricing, NAV < US$800M



BDC Limits and Pricing, NAV > US$800M



What insurance risk management policies other than D&O and E&O insurance are typically used by BDCs?

All BDCs are required to carry an "Investment Company Bond," which may also be called a fidelity, '40 Act or Rule 17g-1 bond, per the related provision in the Investment Company Act of 1940. Your insurance broker should be well versed in not only the limits that your BDC is required to carry, but also several key aspects of the policy that must conform to the '40 Act, such as a nil retention for the fidelity insuring agreement and that the insurer will notify the SEC of cancellation of the bond.

One of the hottest topics in corporate insurance is cyber liability coverage. Many BDCs, other '40 Act funds and alternative asset managers/funds have elected not to purchase such coverage as they often do not directly hold personally identifiable information (PII), such as social security numbers, addresses, bank accounts, and HIPAA-related information. However, as litigation and losses continue to mount in cyber-related matters, and more firms are dragged into such litigation peripherally, it is more prudent than ever to discuss this coverage with your broker and have them perform a "gap analysis" for all of your insurance coverages.

As noted above, IDL coverage is another form of insurance that some independent directors have procured in order to ensure that the independent directors maintain some level of insurance coverage in the event that there are shared limits under the D&O insurance policy.

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About Dechert LLP

Dechert is a leading global law firm with 26 offices around the world. Our multidisciplinary permanent capital team is actively engaged in advising asset managers in all aspects of their capital strategies. We have particularly deep experience in BDCs, having worked with this structure since it was first authorized by law in 1980. Today, we have one of the leading BDC practices in the nation, representing more than 40 BDCs on a variety of formation, transactional and regulatory matters. We also act for 41 of the top 50 global private debt firms as identified by *Private Debt Investor* in 2018. Dechert's lawyers possess a detailed understanding of the most current trends and developments, the latest regulatory hurdles, up-to-the-minute market terms and an insider's perspective when it comes to regulatory compliance. We are committed to turning our experience and expertise into value for our clients.

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