Insurance For Hedge Funds

Hedge Fund managers are the epitome of perfection and therefore need no insurance. Right?

No matter how well-run your hedge firm is, you are exposed to serious liability risks given the current regulatory environment, volatile market conditions, and the public concern regarding corporate governance.

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Just wait until the next market downturn occurs to see how insulated you are.

Who sues Hedge Funds? Try: Investors, Limited Partners, Competitors, Regulatory Agencies, Companies in which the hedge fund has invested, etc.

What Are Your Liability Risks

The risks faced by a Hedge Fund include:

1. Misrepresentation – These involve claims that the fund misrepresented the investment risks, its performance or financial condition.
2. Fiduciary Breaches – If your fund acts as an administrator, investment advisor or service provider for a pension, employee benefit, group life or medical expense plan, there could be claims that there were violations of ERISA (Employee Retirement Income Security Act of 1974) or common-law fiduciary obligations.
3. Oversight Failures – This involves claims based upon the alleged failure to supervise outside service providers.
4. Negligence – Negligent claims often involve allegations of incorrect sales executions, mismanagement, inadvertent failure to follow investor instructions, etc.
5. Fidelity or Crime – This risk involves your rogue employee who steals from the "till".
6. Employment Practices – These are claims everybody has heard of - sexual harassment, wrongful termination, failure to promote and the like.

What Types of Insurance?

Hedge Funds need certain key insurance policies to protect against such risks including (among others):

1. D&O (Director & Officer) or General Partnership Insurance - to protect the decision-makers.
2. Professional Liability (E&O) Insurance – to protect the fund and the managers from professional errors.
3. Fiduciary and Trustee Insurance.
4. Crime/Fidelity Insurance.
5. Investment Advisor Insurance.
6. Employment Practices Insurance.
7. Key Man Life Insurance – in case the Fund is highly dependent upon the expertise of one or several key men or women.

How Much?

Ask your insurance broker. Insurance companies will often require a minimum of $150 million AUM (Assets Under Management) and will sell a $1 million policy at that level (with a $100K retention). We have also seen an investment fund with $10 billion AUM purchase more than $60 million in coverage. However, loss history and potential future problems are better indicators of future claims than total assets.

Defense Costs

The majority of cases that are brought against Hedge Funds and their managers are settled well before trial. As a result, the right to obtain reimbursement of your Fund's attorneys' fees is very important.

Hedge Fund policies typically place the obligation of defending the claim on the policyholder, who has to obtain the consent of the insurance company before incurring any defense costs, admitting liability or settling any claim. The insurance company is required to reimburse defense costs, but only within the limits of liability. In addition, defense costs are commonly defined to be incurred by the Insurance Company or by the

Policyholder only with the written consent of the Insurance Company. Accordingly, it is important to check your policy for such requirements and to obtain the necessary written approvals before incurring significant defense costs. Such consent should not be unreasonably withheld, even if the policy does not so state.

A corporation embroiled in high stakes litigation or subject to numerous government investigations will want to submit requests for defense costs as they come due. While various courts diverge on the issue of whether a policyholder can demand defense costs from its insurance company as the litigation is ongoing, an argument can always be made that an advancement should occur when the hedge fund insurance policy does not explicitly deny it.

Without question, insurance companies prefer to wait out the underlying litigation until it reaches its conclusion. However, refusal to advance defense costs can be unreasonably harsh on policyholders forced to bear the financial burden of defending a claim that the insurance company will eventually cover anyway. Thus, predicting when a court will enforce the advancement of defense costs is tricky. The outcome may be based on a variety of factors including (1) the basis for the coverage dispute, (2) the jurisdiction governing any legal action taken to advance defense costs on behalf of the policyholder, and (3) the language contained within the particular Hedge Fund Policy in conjunction with how the courts will interpret it.

To avoid all of this litigation, Hedge Funds should insist that the language of any defense costs provisions within the policy must be plainly worded and unequivocally require the immediate reimbursement of expenditures as they are incurred or advancement of costs before they are incurred.

The Market is Tightening

Underwriters are becoming more stringent regarding the capital they are willing to commit, the retentions they require, the funds they are willing to insure – and the breadth of coverage they are willing to sell.

- Insurance companies are limiting regulatory investigation coverage.
- Insurance companies are widening the exclusions for personal profit and wrongful acts. Under traditional policies, the exclusions would not kick in until there was a "final adjudication" of fault. The current policies use a more nebulous “in fact” standard. Stick with the old one which provided for coverage when a matter is settled (without a final adjudication and therefore is preferable to the “in fact” exclusion which allows the insurance company to deny coverage of a settlement). Settlements are very common in these types of cases making the final adjudication provision very important for you, and your interests.
- Insurance companies narrowing the severability language of their policies (which protects innocent officers from the wrongful conduct of other officers).

Insurance companies are also issuing specific additional exclusions:

- Fair market valuation
- Conflict of Interest
- Selective disclosure
- Laddering
- Market timing
- Late trading
- Front running
- Failure to maintain insurance

If the insurance companies are providing more restrictive insurance at higher prices, it tells you that the plaintiffs’ attorneys won’t be far behind.

Review your existing insurance, call a broker or other expert for assistance. The severability and defense costs provisions can be expanded through negotiation and the added exclusions can be limited. A knowledgeable buyer can beat many of these new exclusions and policy restrictions.

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