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Three Ways To Ensure That Your Hedge Fund Insurance Coverage Will Be There When You Need It

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IN 2008, THE S&P 500 DROPPED 41% and the Dow 36%. Market losses and Madoff's schemes reverberated throughout the hedge fund industry, which experienced a net outflow of investor capital. The Wall Street Journal called 2008 the worst year for hedge funds since 1990.

While things are better today, serious liability risks remain given the current regulatory environment, volatile market conditions, and the public concern regarding corporate governance. Risks include claims for misrepresentation, breach of a fiduciary duty, oversight failures, negligence, and even outright fraud.

Hedge funds should carry both Director's and Officer's Liability Insurance (D&O) and Errors and Omissions Insurance (E&O). The former protects directors and officers from liability, while the latter protects the fund and its managers from professional errors.

Below, we spotlight three of the most pressing concerns for hedge funds when seeking liability coverage.

1. Coverage for Governmental Investigations

Government investigations into a company's alleged failure to disclose certain information, improper lending practices, or accounting irregularities are covered under many D&O and E&O policies. Such policies typically include "investigations by a governmental entity into possible violation of law" in the definition of a "Claim." In addition, the policies normally cover "defense costs" incurred from responding to a government or regulatory inquiry. The definition of "loss" will also typically include coverage for settlements and judgments arising from the underlying claim. However, insurance companies often argue that an informal document request by the SEC, as compared to a formal investigation with the exercise of subpoena power, will *not* be considered a "Claim" as defined by their D&O and E&O policies.

One current policy form, which arguably fails to provide adequate coverage, defines an "Investigation Claim" to mean a civil, criminal, formal administrative or formal regulatory investigation of an Insured Person in case of an investigation by the SEC or similar state or foreig n government authority, *after the receipt of a formal investigative order by such Insured Person.*

By contrast, courts have found coverage for informal document requests by the SEC under policy language defining a "Securities Claim" as "a formal or informal administrative or regulatory proceeding or inquiry commenced by the filing of a notice of charges, formal or informal investigative order or similar document…."

The protection afforded by coverage for informal regulatory investigations is exceedingly valuable to any hedge fund. Negotiating and working with the SEC when investigations are informal is critical to an early and less public resolution of any changes. It can also be expensive. While the associated defense costs may be significant, the facts developed in responding to such an investigation are commonly used to convince the SEC that formal charges are not called for. Accordingly, coverage for defense costs at the informal stage will not only reduce the direct costs, but will also be critical in heading off a formal investigation and perhaps even significant fines.

While obtaining coverage for informal investigations is challenging, policy language varies and is negotiable. Hedge fund partners or managers in charge of procuring insurance coverage should therefore consult their brokers to make sure they have the broadest possible coverage for both formal and informal investigations.

2. Coverage for Allegations of Fraud

Most D&O and E&O policies exclude claims based upon fraud or dishonesty. There are two types of fraud and dishonesty exclusions: those that require a final

adjudication showing fraud or dishonesty and those that do not — e.g. those that exclude any claims where there is a fraud or dishonesty "in fact." The former version of the exclusion is preferable in that it prevents the exclusion from being used as a coverage defense unless and until there is a final adjudication of active and deliberate dishonesty that is material to the claim. Such language allows for coverage when there is a settlement that contains the normal caveats whereby the accused "neither admits nor denies" the wrongdoing. Coverage for such settlements is insurance gold that should not be forfeited in advance with "in fact" language.

Even policies that require formal adjudication in the exclusion can provide a hair trigger for coverage denial. A policy currently available to hedge funds, for example, excludes coverage for "any payments for Loss in connection with any claim made against an Insured arising out of or resulting… from any criminal or fraudulent act, error or omission….if any judgment, final adjudication, alternative dispute resolution proceeding, or any admission of the Insured if evidenced in written form, establishes that such criminal or fraudulent act… was committed."

Be aware that anything that can be construed as an admission of wrongdoing or responsibility in settlements with government agencies may lead to attempted D&O coverage denials for all related litigation.

3. Payment of Defense Costs

Defense costs often exceed the cost of settlements with litigants or government regulators, and are immediately incurred. Thus coverage for defense costs is a critical part of any risk management program for hedge funds.

Hedge fund policies, however, may place the initial obligation of defending the claim on the policyholder — and the policyholder will generally need to obtain the consent of the insurance company before incurring any defense costs, admitting liability, or settling any claim. The insurance company is generally required to reimburse defense costs but such reimbursement is generally subject to the limits of liability.

Obtaining such coverage requires policyholders to work with their insurance companies and to obtain the necessary written approvals while moving forward with a defense. Insurance companies cannot unreasonably withhold consent, but they will use any opportunity to argue that they did not have the chance to give consent prior to the incurrence of costs as a means to avoid payment.

For example, some current policies contain language whereby the policyholder "shall not admit or assume any liability, enter into any settlement agreement, stipulate to any judgment, or incur any Defense Costs without the prior consent of the Insurer. Only those settlements, stipulated judgments and Defense Costs which have been consented to by the Insurer shall be recoverable as Loss under the terms of this Policy."

Policyholders may be entitled to the advancement of defense costs, and should always seek the advancement of defense costs in the absence of policy language preventing it. To avoid litigation on this front, hedge funds should insist on defense costs provisions that unequivocally require the immediate reimbursement of expenditures as they are incurred or advancement of costs before they are incurred.

Conclusion

D&O and E&O policy language changes constantly. Hedge fund managers can "increase" coverage for their funds in the same way they beat the market: by maintaining a knowledge edge. In this arena, knowledge comes from understanding the options and recognizing what policy language can make the difference between having coverage and the alternative - paying significant fees and indemnity assessments. Understanding the issues outlined above, and making sure that a hedge fund is properly protected, will help hedge against the risks associated with expensive litigation.

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