This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

D&O and E&O Insurance

Hedge Fund D&O Insurance: Purpose, Structure, Pricing, Covered Claims and Allocation of Premiums Among Funds and Management Entities

Nov. 17, 2011

By Jennifer Banzaca, *Hedge Fund Law Report*

Directors and officers (D&O) liability insurance can be an expensive proposition for hedge fund managers, particularly given the growing costs of doing business. However, a number of factors make purchasing such coverage increasingly compelling for hedge fund managers. Such factors include enhanced market volatility, heightened regulatory scrutiny of fund managers, more demands for such coverage from fund investors and greater competition among insurance carriers which has resulted in moderate price reductions for D&O insurance. To assist hedge fund managers in evaluating whether to purchase D&O insurance, how much, at what cost and under what structure, this article starts by identifying nine discrete reasons why hedge fund managers may consider purchasing D&O insurance. The article then discusses: what D&O insurance is; what related categories of insurance hedge fund managers typically purchase; who is covered under a D&O policy; what types of claims are covered under a D&O policy; what types of claims are typically excluded; applicable legal standards; situations in which costs may be advanced and clawed back; the market for retentions or deductibles; "hammer" clauses; the differences among Side A, Side B and Side C coverage; and the current market for pricing of D&O insurance, including pricing of the primary layer of coverage and additional layers in the "tower." This article concludes with a discussion of how hedge fund managers are allocating the cost of premiums among management entities and funds, and the interaction between D&O policies and indemnification provisions in fund or management company documents.

Why Should Hedge Fund Managers Purchase D&O Insurance?

Hedge fund managers should consider purchasing D&O insurance for at least nine reasons.

For starters, fund managers purchase D&O insurance to minimize the likelihood of having to liquidate attractive portfolio positions or pay expenses out of pocket to defend against claims brought by third parties. (Litigation funding sources may also be available to help finance the defense of a claim, although litigation funding is more typically used to bring than to defend claims. See "In Turbulent Markets, Hedge Fund Managers Turn to Litigation Funding for Absolute, Uncorrelated Returns," Hedge Fund Law Report, Vol. 2, No. 25 (Jun. 24, 2009).)

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Second, enhanced SEC enforcement capabilities and an increase in enforcement actions brought against hedge fund managers makes it more likely that such managers will continue to receive more scrutiny from federal as well as state regulators. The SEC has recently created a specialized unit within its Enforcement Division designed to address asset management issues, and it has hired subject matter experts capable of understanding complex fund products with the intention of bringing more enforcement actions against investment advisers, including hedge fund managers. For an overview of recent SEC activity focused on the hedge fund industry, see the insider trading and due diligence sections of the Hedge Fund Law Report's Archive.

Third, in the aftermath of the 2008 financial crisis which led to the uncovering of high-profile fund frauds and the liquidity crisis, fund investors are bringing more lawsuits against funds and their related parties. For a review of current investor expectations with respect to liquidity, see "What Do Hedge Fund Investors Want in Terms of Liquidity and Transparency?," Hedge Fund Law Report, Vol. 4, No. 39 (Nov. 3, 2011).

Fourth, investors are increasingly demanding that fund managers purchase D&O insurance, including seed investors looking to protect their investments. See "Ten Issues That Hedge Fund Seed Investors Should Consider When Drafting Seed Investment Agreements," Hedge Fund Law Report, Vol. 4, No. 12 (Apr. 11, 2011). According to Louis D'Agostino, Managing Partner of insurance brokerage firm Iron Cove Partners LLC, "Investors want managers to have insurance because the bylaws of the fund and the management company stipulate that if the general partner is sued, he will be made whole by the partnership. So, if the limited partners bring an action against the GP for negligence or breach of investment objective, until it's proven that he is grossly negligent or committed fraud, he will be indemnified and made whole by the fund itself. The limited partners are bringing an action against the GP and the GP is funding his defense with their money. That's why many investors are demanding that managers have this coverage." On the flip side, some fund managers see the purchase of D&O insurance as a marketing tool by which they can attract investors to invest in their funds. See "What Should Hedge Fund Investors Be Looking for in the Course of Operational Due Diligence and How Can They Find It?," Hedge Fund Law Report, Vol. 4, No. 36 (Oct. 13, 2011).

Fifth, fund directors are increasingly demanding D&O insurance coverage before they agree to become directors of funds. See "Eight Corporate Governance Steps That Hedge Fund Managers Should Consider in Response to Concerns Expressed by Institutional Investors," Hedge Fund Law Report, Vol. 4, No. 35 (Oct. 6, 2011). Sixth, fund managers may seek D&O coverage to cover gaps where indemnification is otherwise unavailable to fund firm personnel. See "Exculpation and Indemnity Clauses in the Hedge Fund Context: A Cayman Islands Perspective (Part Two of Two)," Hedge Fund Law Report, Vol. 4, No. 1 (Jan. 7, 2011). Seventh, heightened market volatility may increase the likelihood of claims being brought against funds. Eighth, fund managers are increasingly taking active roles in relation to their fund investments, such as sitting on the boards of directors of portfolio companies and creditor committees of distressed companies, which could lead to an increased risk of liability. See "Drawbacks of Being a Lone Dissident on a Board of Directors, Starting an Activist Campaign and Targeting Retail Investors are Themes at Activist Investor Conference," Hedge Fund Law Report, Vol. 4, No. 6 (Feb. 18, 2011). Last but not least, the increasing competition among insurance carriers to provide D&O insurance has resulted in moderate decreases in the price of D&O insurance coverage.

What is D&O Insurance?

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

As a basic matter, D&O insurance generally can be structured to provide coverage for funds and fund managers as well as their respective officers, directors and employees against claims for alleged errors, omissions, negligent acts, misstatements, misrepresentations and breaches of duties brought by investors, regulators or other third parties.

D&O insurance is distinct from errors and omissions (E&O) insurance, which is generally characterized as professional liability insurance that covers claims against the fund manager entity in relation to the provision of investment management services rendered to the funds. For instance, claims of style drift or mismanagement of investments levied against the fund manager would involve E&O insurance coverage. Nonetheless, because of gray areas in coverage between D&O insurance and E&O insurance, which could result in coverage gaps if only one type of coverage is purchased, both products are typically sold together by insurance carriers.

Crime bonds or fidelity bonds are another type of coverage that has become popular among hedge funds, and such coverage is also distinct from D&O insurance. These bonds protect the manager from losses caused by an intentional wrongful or dishonest act by an employee. One example of a loss that potentially would be covered by a crime bond would involve a manager employee working in collusion with a custodian to steal client funds.

In addition to these types of insurance, fund managers also routinely purchase commercial general liability insurance, employee practices insurance, workman's compensation insurance and property and casualty insurance.

Who Is Covered by D&O Insurance?

Covered individuals and entities can include the fund manager, the general partner of a covered fund and any covered fund, as well as their respective past, present or future partners, principals, officers, directors, members, partners, trustees and employees.

Richard A. Maloy, Jr., Chairman and CEO of Maloy Risk Services Inc. noted, "The policies have morphed to cover every conceivable person or entity structure that is tied to and affiliated with a hedge fund. Policies also cover independent contractors, as long as there is indemnification between the fund manager and the independent contractor – this includes the outsourced CFOs and CCOs you see at smaller managers." On "outsourced" CCOs, see "Who Should Newly Registered Hedge Fund Managers Designate as the Chief Compliance Officer and How Much Are Chief Compliance Officers Paid?," Hedge Fund Law Report, Vol. 4, No. 7 (Feb. 25, 2011). Along similar lines, Thomas Bentz, a Partner at Holland & Knight LLP, explained that "depending on how the hedge fund manager is structured, how many people it employs and how those employees are titled, you can pick the cutoff point however you want it and tailor it to your needs."

Some managers also look for additional coverage for employees who serve on outside boards of directors because claims involving such services are generally not covered by baseline D&O coverage. As Richard Canter, Chief Operating Officer of SKCG Group, Inc., noted, "The D&O and E&O coverage may extend coverage called ODL, or outside director liability, for instances in which a manager may ask someone to sit on the board of a company in which one of the manager's funds is investing. In those cases, you want your policy to extend to cover that person on the outside board." During a recent webinar hosted by Ropes & Gray LLP entitled "Issues in Risk Management for Hedge Fund Management Companies: Insurance and Social Media," Peter Welsh, a Ropes Partner, explained that general partner liability insurance coverage policies "may provide coverage for an activist fund with representatives who take board seats

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

after investment. There may also be coverage for distressed investors whose representatives take seats on creditors' committees or equity committees. So there can be some limited coverage for service outside the fund organization."

Fund managers should ensure that their D&O insurance policies cover not only all personnel they wish to cover, but also all of the entities within the organization they intend to cover. Welsh noted, "It is very important to make sure that the 'insured organization' definition picks up the entire structure of your fund organization. Even if it's not a terribly complicated structure, you'd be surprised how many 'insured organization' definitions and policies don't pick up basic fund related entities like limited liability companies, blockers, feeders and offshore structures. Similarly, with the definition of 'insured persons' and titles like tax director and chief compliance officer, you really want to make sure those concepts are picked up implicitly or explicitly in the 'insured person' definition." Fund managers may also want to provide coverage in relation to managed accounts and single investor hedge funds. See "Single Investor Hedge Funds Offer the Benefits of Managed Accounts and Additional Tax and Other Advantages for Hedge Fund Managers and Investors," Hedge Fund Law Report, Vol. 3, No. 16 (Apr. 23, 2010). Many policies will provide for automatic coverage for new funds formed during the coverage period although a fund manager should verify this point with its carrier.

What Claims Are Typically Covered?

D&O coverage generally covers a broad range of wrongful acts or omissions, errors, misstatements, misrepresentations and negligence on the part of the insured in the ordinary conduct of its business, except for those exclusions specifically delineated in a policy and claims precluded by law. However, the definition of what constitutes an eligible "claim" or "loss" is subject to negotiation between the prospective insured and the insurance carrier. Claims can arise out of private suits brought by investors and other third parties as well as certain formal and informal investigations conducted by regulators.

Fund managers should understand what types of regulatory investigations or proceedings are required to trigger an eligible claim and carefully negotiate for coverage of informal regulatory investigations. Welsh cautioned, "The most common problem with the regulatory investigations coverage trigger is that the trigger is often defined as very Wells-like. It would require something like a formal investigative document that identifies in writing the insured as a person or entity against which the regulator intends to bring an enforcement action. This type of trigger very rarely gets tripped early in an investigation, and insurers use the limitation very regularly in limiting or denying coverage for regulatory investigations claims. It's very important to address that concept very broadly in the policy."

Fund managers should also ensure that all of their regular business activities are incorporated into the policy because a claim will not be eligible for coverage if it arises out of activities or services that are not in the ordinary course of an insured's business. Welsh suggested that fund managers carefully negotiate the definition of "professional services" or "investment activities" to cover their activities and broaden the likelihood of coverage. Welsh further explained that "depending upon the policy, this could be a very important trigger for coverage. It can also be a very clunky definition as it's defined in many of the standard policies. It's important as a purchaser of this coverage to look at that concept carefully and to make sure it picks up everything that the fund organization does in the ordinary course of its business. For example, it's not uncommon for 'professional services' definitions to speak only in terms of investing in

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
securities and therefore leave out a number of other investment strategies from the definition, so it's important to focus on that."

Finally, Welsh advised that managers should ensure that subject matter exclusions do not encompass lawsuits occasioned by financial losses which in turn were caused by events outside of the manager's reasonable control. As Welsh explained, "These types of exclusions are particularly important to focus on for sector funds such as energy funds, health care funds and consumer funds. For example, if you're an energy fund overweighted in a petroleum company that drills offshore and an oil spill occurs and the company loses a significant portion of its market cap, the fund loses money because the company lost money. If an LP suit comes out of that, the insurer should not be able to deny coverage because the moving force for that claim was a pollution event. Another example is the bodily injury exclusion. If you have invested in a company that is conducting a clinical trial and the clinical trial is shut down unexpectedly because of an injury or death involving a participant in the study, if the SEC brings a trading inquiry to investigate whether anyone knew of the problems with the trial before they were publicly disclosed, that investigation should not be excluded by the bodily injury exclusion." For more on claims in connection with clinical trials, see "Former Portfolio Manager of Hedge Fund Manager FrontPoint Partners, Joseph F. 'Chip' Skowron, Is Charged with Civil and Criminal Insider Trading Arising Out of Trading in Human Genome Sciences Stock," Hedge Fund Law Report, Vol. 4, No. 13 (Apr. 21, 2011).

What Claims Are Typically Excluded?

While a broad variety of claims are typically covered by D&O insurance, a number of claims are generally excluded from coverage, including claims related to dishonest, fraudulent or criminal conduct; willful or intentional violation of securities laws; ill-gotten gains; contractual liabilities; soft dollar disclosures; and late trading or market timing. With respect to coverage of market timing claims, see "New York Court Denies Recovery of Hedge Fund Defense Costs Under D&O Liability Policy Because Settlement Resulting in Disgorgement of Profits Was Excluded From Coverage," Hedge Fund Law Report, Vol. 2, No. 12 (Mar. 25, 2009).

Also, D&O insurance policies will often include an exclusion denying coverage for claims brought by an affiliate or related person of the prospective insured – the so-called "insured versus insured exclusion." Insurance carriers may also exclude claims from coverage if the fund manager makes false representations in its insurance application, and given the increasingly lengthy application completed by prospective insureds and the due diligence process undertaken by insurance carriers, those seeking coverage should be careful to provide accurate and complete answers in their applications. In some circumstances, D&O insurance carriers may agree to soften or eliminate these exclusions. More generally, hedge fund managers should not approach D&O insurance agreements as adhesion contracts, but rather as documents to be negotiated. As Welsh explained, "ideally, insureds will want to draft their own policy, leaving cost and market availability aside, and not rely on standard form contracts and endorsements drafted by the insurance carriers. Manuscript hedge fund policies do provide very broad coverage that is much broader than standard form policies. The quality varies depending on who's drafting the policy and who the insurer is."

While fraud is generally excluded from insurance coverage, if the policy is written correctly, the defense of an allegation of fraud will be covered until final adjudication. Canter noted, "At the end, if it's determined that you actually are guilty of what you were accused of, the insurance

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
company has the right to ask for the money back and they will. If the fraud can't be proven, then the insurance company will have defended you through the process."

A common question is whether acts or omissions involving gross negligence are covered by D&O insurance. Generally, a claim involving gross negligence is not beyond the scope of D&O coverage. However, because many funds refuse to indemnify fund managers and their employees for gross negligence, the insured may need to purchase optional coverage that covers claims based on gross negligence that are not indemnified by the fund. This option, known as Side A coverage, is discussed in more detail below.

As a general matter, D&O insurance is provided on a claims-made basis (as opposed to an occurrence basis), which means that coverage is provided for any claims made during the term, regardless of whether the alleged act or omission occurred during such term. For instance, as long as a fund manager does not know about a claim arising out of past behavior, D&O insurance can generally be structured to cover that claim if it is brought during the coverage period. Fund managers should note that D&O coverage is not provided on an occurrence basis, meaning that if an insurable event occurs during the coverage period but no claim is made during the coverage period, the D&O insurance will not cover such a claim if it is made after the end of the coverage period. As a result, fund managers winding down a fund may want to consider purchasing "tail" coverage that will cover claims made after the fund ceases operations. On other issues in connection with fund wind-downs, see "Cayman Hedge Funds, Soft Wind-Downs and Disclosure," Hedge Fund Law Report, Vol. 4, No. 7 (Feb. 25, 2011).

What Types of Costs Are Covered?

As Canter explained, "D&O and E&O insurance provide defense expense reimbursement to the adviser, the fund and the directors and officers for the defense expense they would incur if they were sued for an allegation of a wrongful act. Such policies not only cover the defense costs, but also generally cover any settlement and potential judgment."

Typically, D&O insurance policies provide an insured with the costs of investigating and defending against an eligible claim, and these funds are provided to an insured in advance of the adjudication of a claim. This is one of the most appealing features of D&O insurance as it provides front-line coverage to a fund manager defending a suit without requiring the fund manager to look to the fund for defense costs or to pay such expenses out of pocket, which are less palatable options for a fund manager. Fund governing documents typically include indemnity provisions that require indemnification of the fund manager and its personnel as well as advancement of defense costs to a fund manager, and if D&O insurance is not available to pay such costs, the fund manager may be compelled to liquidate attractive fund portfolio positions to provide cash to allow the fund to advance such defense costs.

The manager would not be required to repay such defense costs if the suit involved an insurable claim. However, as noted above, if the suit involved an uninsurable claim (such as fraud) and the manager ultimately does not prevail, the manager will likely need to repay the advanced defense costs. Although the insurer pays the defense costs, the insurer generally will not choose counsel to defend against the claim. The insurer generally will leave the decision as to choice of counsel up to the insured, subject to the insurer's right of consent, which generally cannot be unreasonably withheld.

D&O insurance policies typically cover amounts spent on settlements with private parties. However, settlements with regulators involving fines and penalties are generally excluded from

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
coverage. As D'Agostino explained, "a formal SEC investigative order is deemed a claim under the policy, so the policy will provide coverage of a formal investigation into potential violations of law. Defense and legal costs incurred responding to investigation will be covered in the claim. Fines and penalties are uninsurable by law, but the defense and legal bills can be paid."

SEC settlements are generally not covered under D&O insurance policies. Maloy, however, added the point that even if a policy would cover a settlement with the SEC, the regulator often does not allow managers to make such claims. "If you reach a settlement with the SEC – and often they are nolo contendere – basically you say you didn't do anything but agree to pay a fine. There's no adjudication against you so technically the insurance company would pay, but normally in those cases the SEC makes all those individuals who are paying those fines sign a waiver saying they will not be reimbursed by insurance. The insurance policy would pay but the SEC won't allow it."

There are, however, limits on the costs covered by D&O insurance. To begin with, D&O insurance coverage does not kick in until the insured has paid the applicable retention or deductible, and that deductible will generally apply to each claim. D&O insurance policies for hedge funds often include fairly high deductibles. D'Agostino said those costs can start at $150,000 for every million dollars of coverage and go up to $500,000 if the manager is willing to retain a larger portion of the risk. Additionally, D'Agostino noted that the reductions in premiums for taking on additional risk are fairly minimal. D'Agostino noted, "From a $250,000 to $500,000 deductible, you may only get a 6% or 7% premium credit. When you look in the grand scheme of things, the manager isn't saving much money, so he may opt to stay with the lower premium. For larger programs, it makes more sense to have the larger deductible because that 6% carries all the way up the program and could be substantive with larger coverage limits."

Additionally, in some circumstances, the amounts the insurance carrier is willing to pay in settling a claim may be limited where the policy includes a "hammer" clause. This may occur where the insurance carrier recommends settling a claim, but the insured instead opts to litigate. If the litigation results in a judgment requiring the insured to pay a greater amount than it would have paid to settle the claim, the insurer may only be willing to pay the amount that would have been required to settle the claim.

Moreover, insurers will frequently dispute whether fines and penalties fall within the definition of covered "loss" in a hedge fund manager's D&O policy. Andrew Bourne, an Associate in Dickstein Shapiro LLP's Insurance Coverage Group, noted on this point that "D&O policies almost always define covered 'Loss' as including damages, settlements and defense costs. The question of whether fines and penalties are 'Losses' under D&O policies often is disputed in coverage cases, with insured officers and directors contending that the fines or penalties are in lieu of more traditional damages. In some instances, insureds may also argue that, since the fines and penalties are insurable as a matter of law (i.e., that state law allows for corporate indemnification thereof), they also are covered under a D&O policy. Some policies explicitly provide that punitive and exemplary damages are included within the definition of 'Loss.'"

How Are D&O Policies Structured?

D&O insurance essentially has three components, Side A, Side B and Side C, not all of which must be purchased by fund managers. Side A coverage is intended to cover firm personnel that are not otherwise eligible for indemnification from the fund. Bentz noted that "the most common example of that is when the company is bankrupt or it's a derivative suit and the law prohibits indemnification." In the hedge fund context, this coverage gap often arises where a fund's

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
governing documents prohibit indemnification of firm personnel for acts involving gross negligence, and the fund manager nonetheless desires coverage for firm personnel under such circumstances. Jared Zola, a Partner in Dickstein Shapiro LLP's Insurance Coverage Group and the Deputy Practice Leader in the firm's New York office, further noted that "D&O policies typically provide 'Side A' coverage to the individual directors or officers for all 'Loss' that those individuals become legally obligated to pay arising out of a 'Wrongful Act' committed in their capacity as a director or officer. While insurers have argued that intentional conduct is not a 'Wrongful act,' courts have rejected this argument. The *PepsiCo* decision in New York is a good example. Policyholders should be aware, though, of specific 'Conduct Exclusions' that may come into play."

Side B coverage, which is the principal coverage in the hedge fund context, is intended to cover individuals and entities that are eligible for indemnification from a fund. Side C coverage provides coverage to the fund itself.

Pricing of D&O Insurance

The pricing for D&O insurance will depend in large part on the amount and type of coverage sought by the fund manager. Fund managers generally do not purchase D&O insurance with the intent of covering all of their potential liabilities. Rather, they often purchase coverage with the principal goal of covering their defense costs.

D&O insurance coverage is sold generally with a $1 million limit with additional coverage sold in $1 million limit increments. Policy limits apply both with respect to each individual claim as well as to the aggregate of all claims. Amounts advanced to pay defense costs will reduce amounts otherwise available under the D&O insurance policy.

Despite these general pricing principles, the price of D&O insurance coverage will vary depending on a variety of fund characteristics, including the fund's assets under management, investment strategy, use of leverage, quality of the service providers, portfolio construction, position concentration, liquidity, risk controls used to mitigate loss, counterparty risk, investor profile, transparency, historical fund performance and fund redemptions. Other factors may also influence pricing, including management team experience, operational risk and prior insurance claims history of the fund manager. On disclosure of performance information to third parties, see "Portability and Protection of Hedge Fund Investment Track Records," Hedge Fund Law Report, Vol. 4, No. 40 (Nov. 10, 2011).

To understand pricing, it is important to understand how the underwriters provide coverage. Coverage is often provided in layers, with each underwriter providing a different layer of coverage. Maloy explained, "All of the terms and conditions are negotiated in that first layer. After that, the fund goes out to other insurers and tells them of the policy structure and terms and conditions and gets a quote for additional coverage. Each successive layer is a percentage of the previous layer and it's usually between 70 and 80%."

As an example of how the policy is structured and priced, Canter noted that, "For smaller hedge funds, with less than $500 million in AUM, for a typical low-risk type profile, the first $5 million of coverage will typically be between $65,000 and $75,000 a year. The second layer of $5 million is typically 70% of the primary layer – it would be $45,000 to $53,000. So, for a $10 million limit, you're looking at $110,000 to $130,000 a year. For larger funds, say $1 billion to $3 billion, the first $5 million of coverage will be between $175,000 and $250,000 a year. The second $5 million layer, again, will be 70% of the primary, making it about $120,000 to $175,000 per year. The third layer

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
will be 70% of the second layer and so on." In his experience, D'Agostino said that managers will pay, on average, between $17,000 and $23,000 per $1 million of coverage. "As you buy more coverage, your price per million comes down. Also, the excess insurance carriers don't charge the same as the primary. If the primary is charging $20,000 for the first $1 million of coverage, or $100,000 for $5 million, the next $5 million of coverage might be 80% of that."

Given the high premiums for D&O insurance, there are now many carriers willing to offer fund managers such coverage. Some of the top underwriters noted by those who spoke with the Hedge Fund Law Report include American International Group, AXIS Insurance, Chubb, Hartford Financial, XL Group, Lloyds of London and Chartis.

How Are Hedge Fund Managers Allocating the Cost of Premiums Among Management Entities and Funds?

Unless the fund governing documents explicitly delineate who is responsible for paying the premiums for D&O insurance – which is unlikely – the fund manager must make a judgment as to the method for allocating such premium payments. Often, such judgments are based on the relative benefits of such coverage to the funds and the fund manager. According to Maloy, "The biggest determinant is who benefits from the insurance. That is, if only management company personnel are covered by a D&O insurance policy, would that not argue in favor of the management company paying 100% of the premiums? But there is a counterargument that even if only management company personnel are covered, that coverage enables the management company to attract the best and the brightest which benefits the fund and its investors." In addition, the availability of D&O insurance may eliminate the need for a fund manager to liquidate portfolio positions to fund defense costs, which would be of benefit to a fund.

Market Practice for Allocations

Market practice for allocations will vary, depending on what type of coverage is being considered, Side A, Side B or Side C coverage.

When discussing the main Side B coverage, Canter noted, "What we find from our clients is that hedge fund managers are allocating between 80% and 100% of the cost of the insurance to the fund, where it's allowed based on the fund documents. The reason is pretty simple: most of the funds have to indemnify the manager for any of their expenses, and therefore if there were a claim, they could look to the fund to reimburse them for the defense expense. It's really to the benefit of the fund to have these policies in the first place. The fund is getting the direct benefit of the policy. The managers that do not allocate the entire premium to the fund may believe a small percentage should be allocated to the management company because there may be some things that are covered under the insurance that the funds may not be exposed to, such as employment practice liability coverage." Cantor further noted, "The flip side to that argument for managers who want to allocate 100% of the costs to the fund is that if the fund documents say all of the administrative expenses of the manager get allocated to the fund, insurance is just another expense."

When considering Side A coverage, Maloy noted that "many managers will pay that right out of the management company and not the fund. A smaller percentage will take some of the Side A costs and allocate that to the fund – maybe 50-50. You just have to make sure your fund docs say that insurance is included in the fund expenses."

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Allocating the Cost of Premiums Among Different Funds

Once fund managers have allocated the costs of premiums among the management company and the funds as a whole, they must determine how to further allocate the costs of premiums among the various funds being managed. In instances where a single manager manages multiple funds, the determination as to how to allocate the costs of premiums is a bit more involved. Maloy noted that the default approach is to allocate the premiums among the funds pro rata based on assets under management. However, deviations from pro rata allocation can occur for various reasons. For instance, perceived heightened risks of one fund as compared with another fund may warrant the higher-risk fund paying a greater proportion of the premiums. Maloy noted, "Once you come up with that proportional amount, it has to be weighed against the perceived risk of that fund. For example, if it's a hybrid fund where there is a private equity component, that's going to be high risk and therefore should have more of the expense than just a long-short equity fund. If the fund employed an activist strategy, that would increase the risk even more." On hybrid funds, see "Hedge Fund Managers Turn to Hybrid Fund Structures to Reconcile Fund Liquidity Terms and the Duration of Assets," Hedge Fund Law Report, Vol. 2, No. 5 (Feb. 4, 2009).

Interaction Between D&O Policies and Indemnification Provisions

Covered individuals typically may receive advancement of fees or other categories of coverage from both a D&O policy and an indemnification provision in fund or management company documents. This raises two questions: where to look first, and how to make such claims. As Bentz explained, "The way an individual would look at a claims situation is that his first line of defense is the firm's bylaws or the indemnification agreement. That is going to be much broader than your typical D&O policy. Typically the indemnification provisions will say that the company will indemnify you to the fullest extent permitted by law. As an individual, that's where I'm looking first. It's only if that indemnification provision fails that an individual can then turn to the D&O insurance policy. The policy will have some significant limitations compared to the indemnification provisions – for example, it only covers actual claims. The parent company – whoever purchases the policy and is therefore the 'named entity' – is responsible for filing notices of claims, but that doesn't mean that individuals cannot do so directly. They have first party interest under the Side A coverage, so if something happens and the company doesn't provide notice, the individual can still make claims under the policy."

IMPORTANT: This article contains information protected by copyright which can only be used in accordance with the terms of your Hedge Fund Law Report subscription agreement. You must not therefore copy or forward this article, its contents, or any contents on the password-protected Hedge Fund Law Report website. (Your subscription agreement explains how you can use contents for reports and presentations.) UNAUTHORISED USE OR DISCLOSURE IS UNLAWFUL.

© 2019 Mergermarket Limited. All rights reserved.

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL