



[Alternative Asset Managers And D&O Insurance...To Hedge Or Not To Hedge?](#)

Jun 2 2011 | 3:22pm ET

By Scott Davidoff, William Gallagher Associates -- Do hedge funds need directors and officers (D&O) liability insurance? That's a tough question to answer. Let's start with another question...

Do most hedge fund managers understand the reasons for purchasing D&O insurance? No.

While a D&O policy will pay for defense costs, judgments and settlements rendered against a fund and its directors, officers, general partners, and investment advisors for a wrongful act, the way a manager should think about coverage is in respect to defense costs only. A D&O policy is not intended to provide catastrophic coverage and should not be viewed as such.

In order for a manager to make the right call on whether or not to buy D&O insurance (which also incorporates errors and omissions coverage), a hedge fund manager needs to understand both the tangible and intangible cost factors such as: how much money will it cost me to defend a regulatory claim? An investor claim? An employee claim? Can I or do I want to self-insure or pass along the costs to investors? And in the event of a claim, how will that hurt investor returns, my reputation, and my capital raising efforts? After determining a course of action, your insurance broker should be able to guide you in obtaining appropriate limits.

Is there a regulatory requirement in the new Dodd-Frank Law to obtain D&O insurance? No.

However, Dodd-Frank has upped the ante on exposure to hedge fund managers, so that the potential for increased claims is more evident now than ever. Mary Schapiro, chairperson of the SEC, has been tasked with weeding out corporate malfeasance and has set her sights on hedge funds. In addition to the creation of an Asset Management Unit that will focus on hedge funds, newly-empowered SEC auditors have subpoena capability, obviating the need for lengthy committee reviews, which creates an effective weapon in the SEC's arsenal.

While a D&O policy will not provide coverage for general SEC sweeps, a well-worded policy can provide formal and informal investigation coverage. It is anticipated that once Dodd-Frank takes effect on July 21, the sub-billion dollar SEC registered hedge funds will be targeted initially for surprise examinations by auditors.

Do investors require D&O insurance? Some do.

Savvy institutional investors understand that going “bare” is troubling since in the event of a claim, a manager is permitted (as per the Private Performance Memorandum) to liquidate fund positions in order to provide for a manager’s defense, which can be devastating to fund returns. Further, more institutional investors are asking the D&O question of managers, while others are mandating D&O coverage prior to an allocation as investors like the comfort of a backstop should a manager not live up to expectations.

Do independent directors require D&O insurance? Again, some do.

Obtaining the best independent directors to sit on a fund’s board to guide growth is vital. An independent director will usually require either a formal contract to provide protection against a claim or in lieu of a contract, require a D&O policy for said protection.

Is this a good time to buy D&O insurance? Yes.

D&O insurance premium rates that should have increased after the economic debacle of 2008 have paradoxically plummeted by 25% or more. Why? Contributing factors such as a lack of claims resulting from Madoff, Bear Stearns and the sub-prime fiasco, coupled with the once rich premiums, which enticed insurance carriers to jump into the market, have since pushed down rates drastically.

So, back to my original question...

Do hedge funds need Directors and Officers liability insurance? You already know the answer.

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