



No matter how well run your hedge firm is, you are exposed to serious liability risks given the volatile market conditions at present, shareholder concerns regarding corporate governance, and due diligence current FSA/SEC regulatory pressures.

Institutional Investment is increasingly becoming more scrutinised, investors demand for rigorous due diligence process when selecting directors of a fund and/ or a fund manager, and a documented risk strategy throughout all aspects of the fund/manager's business is growing. Investors require the directors of the fund and the manager to have assessed their risk and sought to mitigate these through means of insurance, offering memorandum, and contractual agreements.

In a world of increased litigation who is likely to sue hedge funds? Investors/ shareholders for a start, then there's Limited Partners, Competitors, Regulatory Agencies, Companies in which the hedge fund has invested, Employees.

Persons who act as directors are now held to be personally liable for their actions and decisions should they breach any of the many duties owed to them in relation to their management or fund, thus putting their own assets at risk if tested in the courts.

What are your key liability considerations and how can they be remedied?

Most risks faced by directors of hedge/funds are now common law fiduciary obligations.

These include:

- Fiduciary Breaches (acting in good faith)
- Companies Act (over 200 offences)
- Insolvency Act ("Wrongful Trading")
- Health & Safety at Work Act
- Data Protection Act
- Consumer protection legislation
- Company Directors Disqualification Act
- Financial Services Act
- Company Securities (Insider Dealing) Act
- EC Directives and Regulations
- Racial & Sexual Discrimination legislation
- Misrepresentation (this may profess that the fund misrepresented the investment risks, performance or financial condition, or reasonable care and diligence.
- Oversight Failures failure to supervise either internally or with external service providers
- Care of duty not acting within the remit of the authority given to them.



Taking into account the exposures highlighted, the following circumstances can quite often give rise to claims or legal proceedings:

- Sale of assets / divestments
- Acquisitions/investments
- Poor performance
- Share issues / Change of share ownership
- Expansion plans or rationalisation
- Liquidation
- Failure to supervise
- Adverse publicity
- Dishonesty of fellow directors
- Safety and emergency regulations

Liability of Directors & Officers

The costs involved to defend directors are substantial, as are penalties that can be personally incurred.

While a company is legally permitted to cover the personal liability costs resulting from activities performed on behalf of the company, this ability - called indemnification - may not apply to every situation. In some cases, the financial burden of the liability is the sole responsibility of the director or officer or other insured.

One remedy is the purchase of Directors' and Officers' insurance.

The primary purpose of D&O insurance is to fill these gaps, protecting the personal assets of the individual director or officer.

D&O offers directors and officers the protection they need from personal liability and financial loss arising out of wrongful acts committed or allegedly committed as corporate officers and directors by transferring this risk to the insurance market.

Even in cases where indemnification is available, most policies contain a second feature, corporate reimbursement, which will advance on behalf of the company, or repay expenses or losses incurred by directors and officers.

D&O covers have gradually broadened over the years but a combination of rising claims numbers, a doubling of average settlement cost per claim, and increased shareholder activism has radically changed that market.

Fraudulent behavior by directors is being alleged in many cases today. Most insurers agree to pay defence costs for directors up until they are found guilty of fraud. When a director is found to be fraudulent, insurers look to recover defence costs already paid out.



Professional Indemnity Insurance

All Professionals including fund managers are legally liable for their actions and if they fail to deliver a high level of service to their clients they could be sued for compensatory damages. They also have a duty of care in the provision of their professional and financial services to third parties where they take a fee for side services. There is an increasingly litigious environment and it is important to reduce risk and keep premiums as low as possible. Although Professional Indemnity (PI) is compulsory for many professionals in the UK (lawyers, surveyors, etc) there are no requirements to carry such cover if you are a fund manager.

No two firms are alike and do not assume that what is suitable for one manager is suitable for another. What most fund managers need to identify are potential exposures in their everyday working lives.

These include:

- Breach of Contracts or offering memorandums
- Under performance claims from shareholders or investors
- Wrong NAV calculations
- Fidelity of Employees
- Lack of due diligence on investments or funds (Madoff)
- Fat Finger or trade execution
- Failure to transact trades on time
- Counterparty failure to supervise

PI protects the fund manager and its staff against claims brought by third parties for compensatory damages for actual or alleged wrongful acts. A claim can be brought against you alleging negligence or for a breach of statutory duty or other civil liability, for example. PI insurance protects an organisations' reputation and assets against claims and potential legal liabilities arising from its professional performance. The legal costs and expenses incurred in an investigation and in the defence of claims are also protected. PI cover is only needed for fund managers, as they carry the exposure. Professional Indemnity insurance is an essential part of the risk management element, and is considered an asset when Investors are performing due diligences on the managers.

Grosvenor Brokers is a well-established independent specialist insurance broker operating both internationally and at Lloyds of London.

For more information on the types of coverage's mentioned please contact Shaun Butler on +44 (0) 20 7337 6802 or Colin Fraser +44 (0) 20 7337 6811