It's a bit of a Liability

Advice on the problems associated with inadequate insurance protection for fund structures.

In the current environment of economic uncertainty, the "compensation culture" mentality, and in recent times actions of fraud and embezzlement, quite simply, there has never been a more important time to ensure that a fund structure has adequate insurance protection for the numerous risks it may face.

The actions of directors are increasingly under scrutiny, not only by investors / shareholders, but also by a wider audience - including regulators, government bodies and industry commentators. Talk within the local legal sector is that litigation within the fund industry is set to explode with disgruntled investors and a host of other potential claimants all clambering to seek recompense for what they deem mis-management of the fund, and / or negligence on the part of the manager, advisor or general partner.

A decision may be made to procure insurance protection – some because they believe in its benefits, some as a "prudent act", some because the regulatory Codes insists on it. Nevertheless, we still see numerous instances where, for whatever reason, insurance cover has not been arranged. In these litigious times, is this something that you are comfortable with?

Let us look at individual, specific examples – all actual illustrations of cases we have experienced here in Jersey - where the insurance protection should be reviewed or considered:-

1. No insurance cover in place

It is hard to believe that, in the current climate, fund structures still operate without any insurance protection – but many examples of this do exist.

With strict corporate governance principles and rules in place, it is difficult to believe how a board can approve the operation of the entity without identifying the risks faced and subsequently looking to mitigate or transfer such risks. With the ever increasing litigious society in which we live can a failure to purchase insurance cover be deemed acceptable practice? Are the directors aware that their personal liability is unlimited? What calibre of non-executive director would accept an appointment these days without receiving assurance and evidence of adequate insurance protection having been arranged?

2. Relying on your employer's policy

The standard professional indemnity insurance ("PII") for an offshore based service provider will include an "Outside" Directorships Liability extension ("ODL"), i.e.; Directors' and Officers' insurance (D&O) cover for the positions that employees of the service provider will hold as directors of client companies.

It is common practice (although often not ideal) for the service provider to rely on their ODL cover where they will provide all of the directorships for that client company. We often find however that this cover is also relied upon where a "split" or "mixed" board exists, where, for example, the promoter or principal behind the investment structure assumes a board position. In such circumstances the service provider will benefit from their ODL insurance, but the other directors are often left without any D&O protection. In the absence of other, more specific insurance, the service provider's ODL cover may inadvertently be called upon for an act by another (non-employee) party – even if the service provider's employees feel they were not responsible.

Further complications arise when more than one service provider may supply directors for an entity (common in the investment fund world) where, for example the law firm and fund administration business may each provide one, perhaps 2, directors, and other parties associated with the structure provide the remaining board members. In such circumstances each party may decide that they do not need to buy specific PI and / or D&O insurance for the fund structure believing they can rely on the "umbrella" ODL cover provided by their respective employer's policy.

This scenario can lead to potential problems should allegations be made of the board members as confusion may arise as to which employers' policy the claim should be directed to. Notwithstanding the fact that there will be at least 2, possibly 3 or more insurance providers each with a different policy wording, different limits of indemnity, different deductibles, different exclusions, etc. In such circumstances which policy should provide the cover? There is the threat that none will provide indemnity. Also, many policy wordings contain an "Other Insurance" clause which state that in the event there is any other potential coverage available such other insurance will take precedent over the policy in question. You could therefore sit between two insurers arguing that each other's policy should provide the required indemnity.

Moreover, should it be felt that the cause of a claim was as a result of a "wrongful act" or decision taken by one individual (for example the property expert on a real estate fund), the other board members may feel that they can escape liability in so far as such the decision was made by that individual and as a result the claim should be directed towards his employer's policy. What would happen if, for example, the action was directed at all directors and not purely the property expert? Furthermore it is likely that any such a decision would have been ratified by the remainder of the board and as such other board members could be held equally responsible for endorsing and approving such a decision.

Finally, the service provider(s) should ensure that they are entirely comfortable in exposing their own insurance programme by "tucking away" a potentially large D&O exposure within. Should a claim materialise, then it will sit on their company claims record for many years – and, as such, their insurers will increase the PII premium to compensate for the loss they've paid for for the fund. A stand-alone D&O policy would not endanger the provider's programme as the claim would be "ring-fenced" and would die with the policy when it lapses.

3. **Fund investment delayed**

   We have seen a number of examples where a fund was postponed or sidelined for various reasons – e.g.; failing to raise the expected commitment, or property funds delaying draw-down of the committed investment as a result of the depressed property market. In such circumstances, what insurance cover should be considered?

   Whilst the manager / GP / fund may not have undertaken any investment activity or decisions, the parties will have carried out a certain amount of work, for example, compiling the PPM or prospectus, researching markets, entered into contracts for services, secure subscriptions, etc. As such, they could be challenged for acts of negligence or "wrongful acts" for their work to date. Professional indemnity and D&O policies are written on a "claims made" basis – which provides cover for claims made against the entity during the period of insurance (assuming such cover is in place). If the decision to affect the insurance cover is also delayed no protection is in place for allegations of negligence or for incorrect decisions made.

4. **Deficient insurance cover**

   Many existing policy wordings are deeply flawed and contain irrelevant or unwelcome clauses. Careful analysis of the existing or proposed insurance should be made, and questions asked of your insurance providers to fully explain the features and, more importantly, the exclusions and endorsements attaching to your policy cover.

Insurance Protection to be considered

The structure and inter-relationship of investment managers, advisors and funds can inject great complexity into potential claims scenarios. The different managerial and professional duties owed by directors/officers to shareholders, investors, employees and third parties can result in a myriad of different actions – all perhaps emanating from the same event.

A professional service provider owes a duty of care – for which Professional Indemnity insurance can provide protection. Investment management and advice is clearly the provision of a professional service, but a general partner would also provide management services, for which "errors and omissions" may arise. Directors' & Officers' indemnity affords protection to directors for allegations of "wrongful acts" – risks faced by board members of a fund, GP, manager and advisor.

In addition fidelity exposures may also need consideration – i.e.; employee dishonesty or theft of assets from the funds structures.

In summary, a review of all risk exposures should be carried out and solutions discussed by the board. On-going advice and dialogue is key as circumstances do change. Each director and Officer should be fully aware of the insurance protection provided and ideally should be provided with guidelines describing the policy's operation and how to comply with its terms and conditions.