A Search for the Deepest Pocket: 
Chief Compliance Officers – Are Your Indemnification Agreements Protecting You? 
By: Tamara Snowdon, Esq. and John Kerns – March 2014

In a litigious environment, where regulators swear to be “bold and unrelenting” in their oversight of hedge funds, investors sustaining losses often look to sue those with the deepest pockets. Investors will name managers, advisors, auditors, directors and officers as well as chief compliance officers (CCOs) of these funds in order to cast the widest net for potential recovery in their complaints. At the onset of such litigation, the importance of directors and officers insurance (D&O) and indemnification provisions between entities and their directors and officers, becomes paramount in determining whose pocket is deepest.

Investor claims often stem from successful regulatory proceedings. In a recent Securities and Exchange Commission (SEC) decision, Bernd E. Young, the chief compliance officer of Allen Stanford, was ordered to disgorge almost $600,000 plus prejudgment interest for his role in a Ponzi-scheme perpetrated at his firm. Other individuals implicated in the scheme were ordered to disgorge an additional $4.25M. Along with the SEC’s recent decision against Ted Urban, this case indicates that the potential scope of a CCO’s liability is expanding. Despite the dismissal of the Urban case, legal and compliance officers are now exposed to direct liability as legal advisors and, potentially, as business advisors in their role as supervisors.

The benefits of indemnification and D&O insurance protect the hedge fund and its directors and officers from having to advance defense costs to battle frivolous litigation which keeps fund money where it belongs – in the trading pool. In the absence of D&O insurance, directors and officers must rely on their indemnification rights, provided via the articles of operation or through contracts, to determine whether their personal assets are exposed.

Complex litigation often forces hedge funds to name their own advisors for breaches of fiduciary duties, creating potential public relations nightmares when that same fund indemnifies those directors with investor funds.

Conduct Exclusions:

Indemnification agreements come in many varieties and, depending on how much protection a fund is looking to provide, may either permit or require indemnification. Even those requiring indemnification will have limitations for the directors and officers fraudulent, willfully deceitful or grossly negligent misconduct. Most indemnification agreements and D&O policies will exclude fraud and gross negligence on the grounds of public policy. The key to narrowing these provisions is to ensure that the determination of fraud and applicability of this exclusion take place only after there is a final and non-appealable determination in the underlying action. Formulating the language in such a manner allows for immediate advancement of defense costs by either the fund or the policy, but imposes a clawback in the event of a fraud determination.

Complex Fund Structures:

Complex fund structures have further complicated indemnification, especially where directors and officers are appointed to the boards of both the advisor and fund or other affiliates. Oftentimes, having indemnification rights in a role as the director of the advisor does not equate to the same indemnification rights in another role throughout the fund structure. Indemnification agreements and D&O policies must avoid circularity of indemnification obligations, leaving the directors and officers with no safe haven. Directors & Officers policies often mitigate the possibility of this occurring by allowing the hedge fund to sue and indemnify the
advisor even if both entities have overlapping directors. This is because there is a legal requirement to sue advisors that have breached their fiduciary duties to the investors of the fund.

Insolvency:

An area of deep concern for directors and officers of any hedge fund is the potential for insolvency which would leave them with no source of indemnity - even if such were required. A Side A policy, which insures only the individuals (no entity coverage) from dollar one (no self-insured retention) for non-indemnifiable losses, would alleviate this concern. Side A policies have fewer exclusions than typically found in a standard D&O contract and, therefore, provide broader coverage even in the event of a bankruptcy. Moreover, a Side A policy cannot be claimed as an asset of the trustee’s estate in a bankruptcy proceeding and continues to be in force despite changes in status. Such a policy can even be bought excess of a traditional D&O program, usually purchased with a Difference-In-Conditions (DIC) feature to drop down when the underlying D&O policy is more restrictive. Because Side A policies are solely for individuals, they cannot be depleted by claims brought against the hedge fund, insuring that the limits of liability purchased truly protect the individuals. They can even be tailored to cover just the CCOs and GCs.

Chief compliance officers and the general counsel of hedge funds must face the possibility that they might be exposing their personal assets in their role as advisors, compliance personnel and as attorneys for their funds and affiliates. Given the complexity of the compliance environment, and ever evolving definitions of “supervisor,” CCOs and GCs must take special care to ensure they are indemnified or insured regardless of which roles their acting in. Insuring against these direct and indirect risks presents a great opportunity to transfer defense costs, ultimately one of the largest portions of any investigation or litigation, to an insurance vehicle such as a D&O, Side A or E&O policy.

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