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How Managers Can Craft Protective Exculpation and Indemnification Provisions Without Violating Investors' and Regulators' Fiduciary Expectations: A Q&A with Akin Gump's Kelli Moll

The Department of Labor's new fiduciary rule, finalized earlier this year and requiring all who provide retirement investment advice to plans, plan fiduciaries and IRAs to abide by a "fiduciary" standard and put their clients' interests before profits, may have sparked a new current of investigation for the Securities and Exchange Commission. The regulator is reviewing the exculpation and indemnification clauses included in fund limited partnership agreements, management agreements and disclosure documents to determine whether private fund managers have adequately communicated to investors the legal standard of care managers owe to them and the fund; investors' rights if that standard of care is not met; and the circumstances under which the fund or investors, rather than the manager, will bear the financial burden of claims brought in connection with the advisory relationship.

Hedge Fund LCD spoke with Akin Gump partner, Kelli Moll, about private fund industry practices related to indemnification and exculpation provisions, why the SEC is focusing on these provisions, what it's looking for and how hedge fund managers can draft terms that protect themselves without incurring either investor or regulatory rebuke.

What are the purposes of exculpation and indemnification clauses?

The exculpation clause sets the standard for the conduct the manager will be held liable for in connection with the advisory relationship. You can think of it as the manager's standard of care. A typical exculpation clause will say that a manager will not be liable to a client unless the manager has engaged in fraud, willful misconduct or gross negligence. Sometimes investors in a fund or clients in a managed account relationship request additional standards, including material breach of contract and breach of fiduciary duty. An exculpation provision is standard in both private fund documentation and in managed account agreements.

Indemnification provisions generally mirror the standards set forth in exculpation provisions and typically provide that if a claim is brought against the manager in connection with its advisory relationship—either by a third party, or by the fund, or a fund investor or client—then the fund or client will indemnify the manager with the assets of the fund or managed account for losses and expenses incurred by the manager, so long as the manager is not found to have engaged in, for example, fraud, willful misconduct or gross negligence in connection with its activities.

Do these terms differ for partnerships based in Delaware versus other jurisdictions?

In the private funds industry, most partnership agreements are governed by either Delaware law or Cayman law (or some other Caribbean island jurisdiction). Exculpation and indemnification provisions are standard in partnership agreements, but how those terms are interpreted will vary depending upon which law the partnership is governed by. For example, fraud can be interpreted differently depending on the case law in the applicable jurisdiction. Gross negligence as a standard of care does not exist in the Cayman Islands (nor, for example, in BVI or Bermuda). Accordingly, a Cayman Island partnership agreement will often use gross negligence, but require that such provision be interpreted under Delaware law. If you are incorporating breach of fiduciary duty as part of your exculpation and indemnification provisions, you need to be precise as to which law you are looking to. For example, under Delaware law, breach of fiduciary duty has two elements: (i) a duty of care and (ii) a duty of loyalty. The duty of care element has been interpreted as a simple negligence standard. The duty of loyalty element would require the manager to put the interests of investors ahead of its own. New York law is very close to Delaware, but has a good faith and fair dealing element. However, under the Investment Advisers Act of 1940, as amended, fiduciary duty has been "read into" Section 206,

which is the anti-fraud provision. In looking at the Supreme Court case that described fiduciary duty under the Advisers Act—*SEC v. Capital Gains Research*—the fiduciary duty defined was one of disclosure and mitigation, where possible, of conflicts of interest. Unlike Delaware and New York law, there is no concept of a "duty of care" element to fiduciary duty.

How are these provisions different from the protections under D&O and E&O insurance?

It's really just another layer of protection. The standard provisions generally are not very different from the D&O and E&O coverage.

In what circumstances would insurance not cover an act, and instead the indemnification clause would be operative?

Insurance will have deductibles and may or may not cover former employees and directors. Indemnity provisions are often written very broadly. Managers often have discretion to choose whether to file a claim under insurance or seek indemnity from the funds, though some investors, through negotiation, may require the manager to exhaust insurance options first before seeking indemnification.

Are there any securities law requirements related to indemnification and exculpation provisions? Do investors have a private right of action under any of these relevant laws?

The SEC has stated that investment managers can use exculpation provisions only with sophisticated investors, and must include an explicit disclosure—referred to as a "non-waiver provision"—acknowledging to the investor that the investment manager continues to remain liable under federal law in certain circumstances, despite the exculpation provision.

Under the Advisers Act, a client of an adviser has a limited private right of action under Section 215, which permits a client to rescind a contract, and presumably be refunded fees it paid. Section 215 does not provide for general damages for losses caused by an investment manager. In a fund context, it is not clear whether a fund investor can exercise any direct rights under Section 215, since the fund is generally viewed as the client and not the individual investor. Accordingly, a client of an investment manager (e.g., a managed account client or a fund in a derivative suit) may bring a claim for rescission under Section 215 for violations of Section 206 by the investment manager.

With regard to ERISA plans, are there any special considerations for drafting indemnification and exculpation clauses? Is there a higher level of care or a different market for terms?

Under ERISA, there is a higher standard of care that is mandated. An investment manager would be subject to a "prudent expert" negligence standard rather than a gross negligence standard.

Why is the SEC now looking at these indemnification and exculpation clauses?

I think this is a result of some regulatory spillover from what the Department of Labor is doing in the retirement space. The DOL just issued a new rule requiring certain pension plan participants to acknowledge fiduciary responsibility in managing IRA and ERISA assets. The SEC seems to be using its inspection arm to seek to have investment managers explicitly agree to be liable for breach of fiduciary duty to their clients/funds/fund investors. Accordingly, when dealing with such requests, you will want to specify that the fiduciary duty owed is under federal law (or more explicitly under Section 206). Otherwise, a manager may be taking on fiduciary responsibilities under state/local law. You will need to negotiate carefully with OCIE so that you do not inadvertently expand your firm's liability.

What issues does the SEC have with the way these clauses are typically drafted?

Most managers are operating under the lowest standard of care, which is gross negligence. In a commingled fund context, the SEC has been pushing back a little bit and wanting to see, upon inspection, that managers understand they are still liable under the Advisers Act for breach of fiduciary duty. In particular, in an enforcement action with the SEC for breach of fiduciary duty, any loss would result in a loss of indemnification rights.

In what ways does the SEC think these clauses cause or might cause issues with regard to fiduciary duties owed by managers?

The SEC says that these clauses are deficient when they do not specifically say the manager is liable for breach of fiduciary duty. The negotiation with the SEC on drafting these provisions is to go back and explain that the manager only has a breach of fiduciary obligation under the Advisers Act.

In your experience, what are the primary concerns investors seek to address when negotiating these provisions?

Investors are often negotiating the standard of care and asking for managers to take on a fiduciary duty, or raise the gross negligence standard to simple negligence or add breach of contract as an additional claim or right that investors may have against the manager. Investors are much more successful in arguing for these greater standards of care in a managed account or a fund of one. So, it's important for managers to know what they are giving up and how it may impact them.

When a manager does seek indemnification, what are some best practices they can employ?

Many firms will require that indemnity claims be approved by the fund's board of directors and/or an advisory committee before they are processed. Firms should also have policies that outline when the firm uses insurance for a claim and when the indemnity of the fund would be employed. Internal counsel and compliance should also review claims before processing requests.