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INVESTORS AND INVESTING

Are Investment Managers Indemnified for Inter-Party Disputes?

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During the 2008 financial crisis, many private funds were wound up due to significant liquidity constraints faced by the industry. The liquidity constraints and the subsequent losses experienced by many hedge and other private funds led to multitudes of inter-party disputes surrounding issues such as improper valuation, investment strategy drift, the suspension of redemptions, or mechanisms put in place to payout redemptions in kind, caused by investors seeking to withdraw a significant amount of capital from a fund with limited liquidity. Disputes also arose based on poor performance, disruption of the investment manager's ability to continue business operations, regulatory enforcement investigations and actions brought by the SEC, the DOJ or other government agencies against investment managers alleging insider trading or other violations of law. These situations have highlighted that, in addition to claims brought by third parties against the fund and the investment manager, disputes between the funds and the investment manager can occur and should be considered and addressed upon drafting the indemnification clauses in governing documents.

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Indemnification provisions are a way for one party to allocate the costs and other losses it is legally responsible for to another party. The typical elements of an indemnification provision include: (1) an obligation or right to assume and control the defense and settlement of covered third-party claims; (2) definitions of certain terms that determine threshold matters and that can restrict or broaden the scope of the indemnification; (3) carve-outs from the indemnification which generally include negligence, recklessness, and willful misconduct; (4) advancement of legal expenses (including attorney's fees); (5) the indemnitee's obligation to notify the indemnifying party of third-party claims and the procedural mechanisms used to enforce the indemnity; (6) an indemnification cap; (7) assignment of indemnification obligations; and (8) the duration of the indemnity.

Notably, indemnification clauses, including those contained in private fund and separately managed account documents, generally do not expressly contemplate indemnification for costs associated with the defense of inter-party actions or proceedings. Depending upon which side of the issue one is on (and this is often more problematic from the investment manager's standpoint, who would generally be the one seeking indemnification from the funds related to an action brought by the funds), this could be problematic because the general rule is that each party is required to pay its own attorney's fees unless recovery from the losing party is "authorized by agreement between the parties, statute or court rule." *See, e.g., U.S. Underwriters*

Inc. Co. v. City Club Hotel, LLC, 789 N.Y.S.2d 470, 473 (2004), *Hooper Assocs. Ltd. v. AGS Computers, Inc.*, 549 N.Y.S.2d 365, 366 (1989). The rationale behind this rule is that it ''provides freer and more equal access to the courts and promotes democratic and libertarian principles.'' *U.S. Fidelity and Guar. Co. v Braspetro Oil Services Co.*, 369 F.3d 34, 74 (2d Cir. 2004) (internal quotes omitted). While parties are free to override the general rule, there is a strong presumption in New York and Delaware against inferring that parties to an agreement intended for indemnification to extend to inter-party disputes where such indemnification is not expressly authorized.

This article briefly examines New York and Delaware case law relating to indemnification provisions in the context of inter-party disputes and identifies red flags and strategies to help facilitate the effective drafting and negotiation of indemnification provisions for funds, individual investors, and investment managers. In light of the risks highlighted in this article, it is important for practitioners to be proactive about considering whether to include inter-party disputes within the scope of the indemnification in private fund documents (including limited partnership agreements and investment management agreements) and other documentation relating to separately managed accounts.

I. Indemnification Concerns for Private Funds and Separately Managed Accounts

Private Funds

It is foreseeable for an individual investor in the fund to sue the investment manager and/or the fund. Generally, these investor suits would be covered by the indemnification clause because these individual investors would be deemed third parties. If, however, there is a side letter in place between the funds and the investment manager, on the one hand, and an individual investor, on the other hand, the indemnification that is more generally applicable to the fund could potentially be restricted in scope with respect to the individual investor. Thus, it is imperative for legal practitioners in the private fund industry to treat indemnification clauses as more than mere perfunctory provisions.

Separately Managed Accounts

In the context of separately managed accounts, the investment manager is most likely dealing with a third party. The provisions contained in an investment management agreement between a sophisticated investor and an investment manager are subject to a greater level of negotiation and, as such, differ from those contained in private fund documents. However, it is still important for investors and the investment manager to exercise caution when drafting indemnification provisions because the same issues applicable to individual side letter arrangements between the fund and an investor in a private fund are applicable to separately managed accounts.

II. New York and Delaware Case Law on Inter-party Indemnification

For funds domiciled in the United States, the primary documents addressing governing laws are the investment management agreement, limited partnership agreement and subscription agreement. These are typically governed by either New York or Delaware law. Thus, it is necessary to consider both New York and Delaware case law relating to indemnification provisions in the context of inter-party claims and consider how the lessons can be applied in an investment management context.

New York Case Law

The New York Court of Appeals established in *Hooper Associates, Ltd. v. AGS Computers, Inc.* the principle that a claim for the recovery of attorney's fees by one contracting party against the other is allowed only where an indemnification clause makes it ''unmistakably clear'' that indemnification was intended to apply to inter-party disputes. 549 N.Y.S.2d 365, 366 (1989).

In *Hooper*, the plaintiff, Hooper Associates, agreed to purchase computer equipment and related services from the defendant, AGS Computers. A dispute arose and Hooper sued AGS for breach of contract, breach of warranty and fraud, and won. Hooper then pursued a claim against AGS to recover the attorney's fees incurred in the underlying suit. The Court of Appeals held that the contract's indemnification clause did not apply to inter-party disputes because the parties did not use specific language addressing inter-party disputes. *Id.* at 367. The Court cautioned that courts must ensure that a party has unequivocally assumed an obligation to indemnify the opposing party because such practice is contrary to the general rule ''that parties are responsible for their own attorneys' fees.'' *Id.* Thus, the Court held that an indemnification clause must make it ''unmistakably clear from the language'' and the surrounding circumstances that the parties had agreed to indemnification for inter-party disputes. *Id.* The Court of Appeals additionally noted that the types of claims specifically referenced in the underlying contract were those typically seen in third-party actions, which supported the Court's conclusion that it could not be inferred that inter-party disputes would be covered in the indemnification. *Id.* Furthermore, the Court of Appeals found that a separate clause in the contract providing that Hooper would promptly notify AGS of any claim to which indemnity would apply and for which AGS could potentially assume a defense further signaled that the parties did not intend for the indemnification clause to extend to disputes between the contracting parties themselves. *Id.* In order to ensure that none of the provisions in the agreement were without force, the *Hooper* Court interpreted the indemnification provision as unmistakably relating only to third-party claims. *Id.*

Since *Hooper* was decided, New York courts have continued to apply the ''unmistakably clear'' test, signaling a general unwillingness to ''rewrite the contracts and impose something that the parties did not intend.'' *Adesso Café Bar & Grill, Inc. v. Burton*, 74 A.D.3d 1253 (N.Y. App. Div. 2d 2010); *see also Bridgestone/Firestone, Inc. v. Recovery Credit Servs., Inc.*, 98 F.3d 13 (2d Cir. 1996); *Gotham Partners, L.P. v. High River L.P.*, 22 Misc. 3d 1121(A), 880 N.Y.S.2d 873, 2009 WL 323386 (N.Y. Co. Jan. 21, 2009). In order to satisfy the ''unmistakably clear'' test, it is important to ask if it is foreseeable, from the language of the indemnification clause and the surrounding provisions, that the indemnifying party's actions or omissions would result in a third-party action. If third-party disputes were foreseen by the parties and there is no unequivocal reference to inter-party claims, a New York court is likely to conclude that the indemnity does not satisfy the *Hooper* test and that the indemnification clause is limited to third-party claims only.

Despite frequent findings that the exacting *Hooper* standard has not been met, some New York courts have found certain contracts to satisfy the ''unmistakably clear'' standard. For example, in *Pfizer, Inv. v. Stryker Corp.*, the United States District Court for the Southern District of New York found that it was ''clearly implied from the language and purpose of the entire agreement and the surrounding facts and circumstances'' that the indemnification covered claims between the contracting parties. 348 F. Supp. 2d 131, 146 (S.D.N.Y. 2004). The *Pfizer* Court held that the inclusion of indemnification for breach of warranty or representation in the underlying Purchase Agreement suggested the indemnification clause covered both inter-party claims and third-party claims. In reaching its conclusion, the Court noted that ''it is difficult to imagine a third-party action as a result of the indemnifying party's misrepresentation.'' *Id.* (citing *Promuto v. Waste Mgmt., Inc.*, 44 F. Supp. 2d 628, 652 (S.D.N.Y. 1999)). The *Pfizer* Court also concluded that the structure of the Purchase Agreement evidenced the parties' intent to indemnify costs associated with inter-party disputes. Because there was a provision setting forth a general mechanism for enforcing claims in addition to a specific provision for when a party was seeking indemnification for third-party claims, the court read the general provision as covering both inter-party and third-party disputes, because reading it to the contrary would render the specific provision regarding third-party claims ''surplusage.'' *Id.* Based on the language and structure of the Purchase Agreement and the surrounding facts and circumstances, the *Pfizer* Court held that the plaintiff was entitled to indemnification for costs associated with the inter-party dispute. *Id.*

Separately Managed Accounts – A Case Snapshot

A recent case out of the Southern District of New York highlights the need for a closer look at the indemnification provisions in the context of separately managed accounts. In *Gramercy Advisors, LLC v. Coe*, the United States District Court for the Southern District of New York was faced with a dispute over whether an investment management agreement between investors and the investment adviser covered inter-party disputes. No. 13-CV-9069 (VEC), 2014 WL 4197370 (S.D.N.Y. Aug. 25, 2014). The investors argued that the Investment Management Agreement provided for indemnification only for third-party proceedings because the indemnification provision did not unmistakably apply to inter-party suits and certain language contained in the indemnification provision (such as ''fines and penalties'') anticipated third-party claims. *Id.* at *5. The Court disagreed with the investors and held the fact that the parties had anticipated the possibility of third-party claims was not dispositive as to whether the parties also contemplated inter-party actions. *Id.* Moreover, the Court held that the parties intended plaintiffs not to be liable for its own costs in an inter-party dispute was evident when the agreement was examined in whole. *Id.* The investment management agreement contained two provisions stating that plaintiffs could not be liable to defendants and that defendants would cover the plaintiffs' costs associated with defending against ''any claim or alleged claim, of any nature whatsoever.'' *Id.* According to the Court, the only reasonable reading of these provisions was that the parties intended to indemnify one another in the context of inter-party suits. *Id.*

Private Funds – A Case Snapshot

The indemnification provisions in investment management agreements between private funds and investment managers are typically put to the test when the relationship between the investment manager and the fund itself turns acrimonious, especially when the fund has incurred losses as a result of the investment manager's actions. In *In re Refco Securities Litigation*, representatives of certain hedge funds that were in the process of being liquidated brought an action against the hedge fund manager and individual officers, claiming they wrongfully diverted monies held in protected customer-segregated accounts to unprotected unsegregated accounts for misappropriation. 890 F. Supp. 2d 332 (S.D.N.Y. 2012). The defendants asserted a counterclaim for indemnity pursuant to the applicable service agreements between the hedge funds and the investment manager for the fees incurred in connection with defending the inter-party suit. In deciding whether the indemnification clause covered the inter-party dispute, the Court noted that New York courts look at ''the language and purpose of the entire agreement and the surrounding facts and circumstances'' when applying *Hooper*'s ''unmistakably clear'' test. *Id.* at 341.

The indemnification provision at issue provided for a mutual indemnification in that the administrator would provide indemnification to the hedge funds and the hedge funds would provide indemnification to the administrator as set forth in the Service Agreement. *Id.* at 339. However, the mutual indemnification contained in the Service Agreement was not an identical 'mirror' mutual indemnification. *Id.* The notable differences were: (a) the express inclusion of attorney's fees in one indemnification clause and not the other; and (b) that one of the indemnification clauses related to losses suffered in relation to claims arising out of breaches of the service agreement; while the other covered losses resulting, more generally, from the failure to perform the indemnifying party's obligations under the service agreement. *Id.* Because of the varied drafting of the provisions, the Court held that the parties understood how to provide for indemnification when intended, and, because no such recovery was specified for the administrator, declined to extend indemnity to cover inter-party disputes. Further, the Court noted that while New York courts have generally determined that both third-party and inter-party disputes were covered by agreements containing both broad and narrow indemnity clauses, the indemnification clause favoring the administrator in this situation applied more directly to third-party claims and thus, would not cover inter-party disputes. *Id.* at 347. Ultimately, the Court concluded that the parties did not, with unmistakable clarity, indicate an intent to indemnify the administrator for its attorney's fees or other litigation expenses incurred in a suit between the contracting parties themselves. *Id.* at 350.

As the discussions above demonstrate, using the *Hooper* test as a guide, New York courts have navigated the issues relating to indemnification for inter-party disputes by (1) analyzing the specific language in the contracts and looking at the provisions as a whole, rather than reading any one specific provision in isolation; and (2) considering the surrounding circumstances to devise a more accurate picture of the intent of the parties at the time the agreement was drafted. To avoid ambiguity, one must ensure that clear and concise language addressing the issue is present in the relevant documents – whether expressly including or excluding it.

Delaware Law

Although the case law addressing indemnification for inter-party claims is not as fully developed in Delaware as it is in New York, courts have taken a position similar to that of New York courts when applying Delaware law. In Delaware, for an indemnification provision to be enforceable as to inter-party disputes, the intent of the contracting parties must be ''clear and unequivocal'' on the face of the indemnity provision. *See, e.g.*, *Fina v. ARCO*, 200 F.3d 266, 269 (5th Cir. 2000) (applying Delaware law) (noting that Delaware courts ''have consistently refused to enforce indemnity provisions that use broad, catch-all language but fail to make a specific reference to claims arising from the indemnitee's own negligence'').

In *DRR, L.L.C. v. Sears, Roebuck & Co.*, Sears sold Delaware real estate to DRR. 949 F. Supp. 1132 (D. Del. 1996). During redevelopment of the property, DRR discovered underground storage tanks containing oil and oil compound requiring Sears to expend significant resources to remediate the environmental hazard. This prompted Sears to assert that it was entitled to reasonable attorney's fees pursuant to the indemnification provision contained in the purchase and sales contract. In particular, the purchase and sales contract provided that DRR was responsible for ''all reasonably attorney's fees incurred by Sears in connection with the environmental condition and/or environmental liabilities associated with the Premises.'' *Id.* at 1142. The United States District Court for the District of Delaware held that the indemnity clause was the type of clause commonly found in real estate sales contracts and was only intended to cover third-party claims. *Id.* at 1143. Moreover, there was additional selection of counsel language in the contract, which indicated that the indemnification applied only to third-party actions. *Id.* The Court noted that Delaware law ''disfavors'' indemnity clauses and uses the ''clear and unequivocal'' test when assessing whether indemnification clauses extends to inter-party suits and ''if a contrary intent can reasonably entertained, the Court will rule against indemnification.'' *Id.* (citing *Paoli v. Dave Hall, Inc.*, 462 A.2d 1094, 1098 (Del. Super. Ct. 1983)).

Like the New York Courts, Delaware Courts have been reluctant to extend indemnification provisions to cover inter-party disputes. Based on this general policy, players in the funds industry must exercise the same caution in drafting indemnification clauses governed by either New York or Delaware law, containing a ''clear and unequivocal'' indemnity provision which would extend to inter-party suits if the contracting parties desire such an extended indemnification.

III. Practical Tips

Based on the New York and Delaware case law discussed above, it is important to keep the following points in mind when drafting an indemnification clause and to consider whether explicit language covering inter-party disputes that may arise between funds and investment managers is appropriate:

1. Clear, unequivocal, express contractual language referring to inter-party claims is the most effective way of providing indemnification for inter-party litigation. Broad indemnification provisions without specific references to inter-party claims have been placed under the microscope by the New York and Delaware courts, and they frequently fail to meet *Hooper*'s ''unmistakably clear'' test in New York as well as Delaware's ''clear and unequivocal'' test.

2. If there is no express contractual language, a court will look to the surrounding circumstances at the time that the agreement was entered into. A threshold question would be whether disputes between third parties were foreseeable at the time of contract. If so, it is more difficult to argue for indemnification for inter-party disputes.

3. In the absence of explicit language, courts will look at other provisions in the operative agreement to ascertain whether inconsistencies exist between the provisions. For example, if one indemnification clause is broader than another (i.e., includes inter-party disputes) this might be interpreted to mean that both third-party claims and inter-party disputes were contemplated at the time the agreement was drafted.

4. Lastly, courts will examine whether there is a provision for indemnity for breach of warranty and/or representation. Such a provision may be construed as evidencing the parties' intent to extend the indemnification to inter-party claims.

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