STANDARDS BOARD FOR ALTERNATIVE INVESTMENTS

Indemnification Wording in Fund Governing Documents

SBAI Toolbox

1. Introduction

The Governing Documents[1] of most alternative investment funds include indemnification clauses. These clauses are important to investors as they highlight the circumstances or events where the fund may be required to reimburse the asset manager for losses related to the management of the fund.

How these clauses are drafted can have implications for investors, as the use of different standards of care (discussed later in this document) has significant impact on the types of loss events that asset managers can claim against the fund's indemnity.

The wording used within indemnification clauses is not standardised and can vary from manager to manager and jurisdiction to jurisdiction. There are very few cases in which indemnification has been triggered, partially due to insurance coverage (discussed further later), however, asset managers and investors should still be aware of the spectrum of indemnification provisions out there and how they could potentially impact all parties.

This Toolbox memo is an informational tool for investors and asset managers to aid with the understanding of the scope of wording and highlights areas that investors should consider in their due diligence processes. It will look at the topic from the following angles[2]:

1. Indemnification as a sub-set of Liability
2. Spectrum of Wording in Governing Documents
3. Regulatory Views on Indemnification Wording
4. Potential Issues and Considerations

2. What is Indemnification Wording?

Indemnification wording highlights the circumstances or events where the fund may be required to reimburse the asset manager for losses related to the asset management of the fund. These provisions typically include carve-outs where the manager is not entitled to reimbursement, for example, in the case of "wilful misconduct", "negligence" or "gross negligence" referred to in this memo as "bad acts".[3]

In a commingled fund, the indemnification language will typically be based on form language drafted by the law firm representing the manager. The language will likely have been in place since the launch of the fund and in some cases may have been negotiated with either a seed investor or a large initial investor. Typically, there is limited scope to re-negotiate this language after the fund launch (due to the legal costs charged to the fund for updating constitutional documents). Investors may choose to clarify vague

[1] Governing Documents includes include private placement memoranda, subscription documents, limited partnership agreements, articles of association and other related documents, as applicable.
[2] Note: This SBAI Toolbox Memo is for guidance purposes only and does not represent the views of the SBAI or any specific signatory. It does not constitute legal advice nor advocate any specific language. For drafting advice on indemnification clauses, please consult your legal advisor.
[3] In some instances (more prevalent in private markets funds), the manager will be indemnified until "a court of competent jurisdiction, in a judgement that has become final and non-appealable" determines that the bad act has occurred. In those instances, the manager may have to return all previously advanced indemnification proceeds to the fund.

indemnity language in a side letter agreement with the asset manager. However, there have been challenges to the enforceability of side letters in Cayman Island courts[4].

For discretionary or separately managed accounts ("SMAs"), an Investment Management Agreement ("IMA") is drawn up between the two parties that will contain the indemnification language and can be negotiated fully by the investor. Based on those negotiations, an IMA may include different contractual obligations than a commingled fund, potentially providing more limited benefits to the manager from indemnification wording.

3. Indemnification as a Sub-Set of Liability

Indemnification is a sub-set of the liability clauses that will be contained in a fund's Governing Documents. The asset manager will also have contractual obligations to the fund. In a commingled fund, the obligations may be quite broad for example, language such as the asset manager will have an obligation to "manage assets to a reasonable standard". Within an IMA for an SMA, the language is likely to be more specific and include specific contractual obligations in areas such as:

- FX hedging
- Cash management
- Middle office services
- Trade or valuation errors

Contractual Obligations	Indemnification
The first step is to identify whether the thing that went wrong was the asset manager's obligation *contractually*. In the case that it was, then the standard of care (e.g., negligence, gross negligence etc.) will be considered. For a contractual obligation to be claimed against, the standard of care must have been breached. Once a contractual obligation and a breach of standard of care have been identified, the losses must be quantified and whether they were: ▪ Direct losses – for example where an investment was made that shouldn't have been and resulted in a loss, or ▪ Indirect losses – for example reputational damage. Most governing documents will cover direct losses only and some may include a financial liability cap	Indemnities are a promise to be responsible for a certain type of loss and in its purest form would not require the same steps as described in the case of a Contractual Obligation. In practice, most indemnification wording will be drafted in the style of a Contractual Obligation and as such the same steps may be required in order to claim.

[4] https://www.ogier.com/publications/ruling-on-rights-of-non-registered-investors-to-enforce-shareholder-rights

4. Spectrum of Wording

As mentioned in the introduction, there is no standard or agreed upon indemnification wording for all fund Governing Documents. Wording will differ between jurisdictions and asset managers. Language regarding the asset manager's standard of care and exculpation will also dictate what actions are indemnifiable.

4.1 Standard of Care and Exculpation:

Within the IMA or Governing Documents, it is common to include language providing that the manager shall not be liable for losses of the fund unless the losses are caused by the manager's failure to adhere to a specified standard of care. For example, such a clause might say that the manager shall not be liable for losses unless the losses result from the manager's gross negligence, wilful misconduct, or fraud. These are referred to as exculpation clauses and typically reference standards of care such as negligence, gross negligence, intentional misconduct, fraud, material violations of applicable law, and others.

4.2 Indemnification:

The indemnification provisions detail in which circumstances the manager may receive reimbursement for expenses related to its management of the fund or SMA. Investors should pay particular attention to situations where the manager is not permitted to claim indemnification against the fund. Carve-outs which can negate a manager's indemnification benefit are broad and can include:

- Gross Negligence or Negligence
- Wilful Misconduct
- Fraud
- Violation of Securities Laws
- Material breach of the Fund's Governing Documents

More robust indemnification wording may include details of claims that are excluded from the indemnity, for example intra-manager disputes such as employment disputes and workplace harassment.

Where the word "material" is used in any part of the indemnification clause, investors should seek to understand what the asset manager means by this term and what type of events would and wouldn't be considered material relating to the indemnity.

Whilst this document is typically referring to the indemnification of the asset manager, there will also be indemnification wording within the Governing Documents for service providers such as directors, prime brokers, and administrators. These clauses should be reviewed in the same way as the asset manager indemnification clause.

5. Regulatory Guidance

As with all legal considerations there are differences between jurisdictions both in specific regulations on the topic, or individual regulatory approaches and guidance. On the topic of indemnification wording between the US, Europe, and the Cayman Islands these differences exist:

Cayman Islands	In the Cayman Islands, there is no legislation governing director indemnities under Cayman Islands law. As a general matter, directors and officers may be indemnified against personal liability for any loss that the company might incur in the course of its business as long as the loss was not caused by fraud, dishonesty or wilful neglect on the part of the director or officer.

Europe	In the UK, the FCA has not expressed a view on this. In addition, currently there is no distinction between "Negligence" and "Gross Negligence" with gross negligence not yet recognised under English law. In Ireland, the Central Bank of Ireland (CBI) does not permit "Gross Negligence" to be used as a standard of care for administrators or depositories, it has however permitted its use where an asset manager runs a QIAIF but not for UCITs products. In Europe more broadly there are differing national interpretations of the term negligence. In some Member States, the courts distinguish between gross negligence and "simple" negligence. Where if the former is proven, the erring party would be required to make full redress and might also be fined by the Regulator. In some circumstances European funds may include "Gross Negligence" as a standard of care and reference New York law to avoid the problem that this is not defined in some jurisdictions
United States	Under New York law, to prove simple negligence, an investor would need to show that a manager failed to exercise reasonable care under the circumstances. This is usually with hindsight, typically following a material loss event in the fund. In contrast, gross negligence requires that there be some indication of actual wrong doing by the manager. The SEC has not publicly stated a stance on the standard of care that should be used, but may view clauses as deficient when they do not specifically state that the asset manager is liable for breach of fiduciary duty (under the Advisers Act).

6. What are the Potential Issues?

There are several potential issues that should be considered from both an asset manager and an investor perspective relating to indemnification wording in Governing Documents.

6.1 Scope of the Indemnity:

If an indemnity clause is written with wide or vague language, then it may allow for a fuller recovery of losses than would be obtained in a breach of contract claim. For instance, it may allow for the recovery of all associated costs including legal fees. This could lead to the concern that investors are required to bear legal fees even in the event of subsequent proven wrongdoing of the asset manager.

Where the Governing Documents restrict the indemnification for a combination of, for example, wilful misconduct and/or gross negligence, this raises the question of which party determines that a bad act has occurred (or not). Some indemnification language may state how this is determined, for example where a settlement is reached or where there is a court decision[5]. Where such language is used, the

[5] See Hirschler Law: https://www.hirschlerlaw.com/newsroom-publications-a-private-fund-managers-right-to-indemnification-the-finally-adjudicated-cl

burden of proof to determine whether a bad act has occurred can vary, for example, the language may state that the decision must be finally adjudicated in a court of law with no recourse to appeal. Whilst having to fully exhaust all legal avenues could be viewed as a relatively higher barrier to prevent use of the indemnification by the manager, it also preserves the manager's ability to appeal an incorrect initial court decision where in fact there has been no wrongdoing.

6.2 Indemnifications by Investors rather than the Fund:

There may be indemnification wording within subscription documents that favour the fund rather than the manager. The most common language relates to ERISA regulations where the investor indemnifies the fund for any misrepresentation in ERISA related information which would cause a regulatory cost to the fund. There may also be situations where the investors indemnify the fund for misrepresentations, such as on tax disclosures, which could harm all fund investors. Without the indemnification by the investors, the fund (and therefore all investors) would be required to absorb any potential fines.

There are some challenges with this type of indemnification for certain investor types. Pension fund trustees are typically personally liable, and these indemnifications essentially mean the trustee has an uncapped personal liability. This may be addressed by capping the value of any reimbursements to the value of the pension assets and the trustee obtaining an indemnification from the pension (adjustments of this type are typically made within subscription documents).

6.3 Consistency between Articles of Association and Offering Documents:

Indemnification wording is usually included in multiple Governing Documents, for example in both the Offering Memorandum and Articles of Association. It is important that any standard of care or other limitations on the indemnification are consistent across these documents. Any legal challenges to indemnification clause wording could be disadvantaged (on either side) by inconsistent wording.

6.4 Investor's Ability to Sue a Manager:

There are challenges when investors seek to sue the asset manager. Typically, there is no contractual relationship between the manager and the investor meaning the fund would be required to sue the manager (privity of contract[6]). An exception to this maybe within an SMA where there may be a contractual relationship between the investor and the manager directly.

As described above, investors should also be aware that any legal defence costs for the manager in such litigation may be paid out of the fund.

6.5 Insurance and Advances:

Insurance:

In most cases the manager (and related parties) will have insurance policies in place such as Directors & Officers or Errors & Omissions insurance. It is also common that the Fund pays a portion of the insurance premiums. In such cases, the Fund's share of the expense is typically disclosed in the Fund's Governing Documents.

In many cases, the Fund is one of the insured parties under the policy, such that indemnification payments made by the Fund can be subsequently recovered from the insurer, subject to having first satisfied the retention or deductible amount and subject to the other terms of the policy (such as exclusions).

It is sometimes argued that asset managers should fully exhaust any insurance options ***before*** claiming on indemnification by the fund but there are challenges to this:

[6] The doctrine of privity of contract is a common law principle which provides that a contract cannot confer rights or impose obligations upon any person who is not a party to the contract (https://www.lexisnexis.co.uk/legal/glossary/privity-of-contract#:~:text=Privity%20of%20contract%20is%20a,or%20be%20sued%20under%20it.)

- Insurance may not cover former employees or directors of the fund.
- The insurance may only be able to be used if an actual claim has been made against the manager.
- Insurance policies typically have retention or deductible amounts that the insured party must satisfy before making a claim under the policy. The recent trend has been for these amounts to get bigger rather than smaller.
- Insurance companies sometimes delay advancing defence costs pending an evaluation of the circumstances of the claim. In a fast-moving situation, this may prejudice the outcome if the manager lacks sufficient resources to defend itself.

Indemnification provisions may sometimes include an ordering of provisions to outline priority, for example, that insurance would be used before any fund indemnity (acknowledging that an advance may be needed as discussed below).

Indemnification Advances:

In certain circumstances, a manager may need to take an advance on the indemnification during the claim to cover, for example legal costs, if mandated by the fund's Governing Documents. Investors should review this language with several considerations in mind including things such as:

- Are managers allowed to take an advance when a majority of the investors are suing the fund?
- Is there a requirement to commit in writing to return any advance if it is ultimately determined that the claim is not covered by the indemnity?

Governance:

Managers should consider having a written policy that outlines the following points which should provide more detail than, but be consistent with, the fund's Governing Documents:

- Circumstances where the manager will claim first on insurance.
- Circumstances where the manager would claim against the fund indemnity.
- Details of when an advance would be taken against the indemnification.
- Situations where the manager would need to return any monies, claimed under the indemnity, advanced by the fund or SMA.

6.6 Survivability of Indemnifications:

The fund's offering documents should make clear any survivability of indemnifications i.e., whether there is a claw back where a fully redeemed investor can be liable for the costs and when any unused reserves held against redemptions will be returned. The documents should make clear whether there is time limit on this clawback, or it is indefinite.

7. Questions for Investors to Ask During Due Diligence

Fund Governing Documents:

- What are the liability terms in the Articles of Association (for a corporate fund)?
- What are the indemnification clauses relating to the General Partner in a Limited Partnership Agreement?
- Are the provisions for indemnification consistent across all the fund's Governing Documents?
- Is the indemnification language consistent with Trade Error language and applying the same standard of care?
- What is the survivability of the indemnity – is there a clawback post full redemption and if yes, is this time limited or indefinite?
- Has the manager ever claimed against an indemnity on this fund or any other fund it manages?
- Is the manager allowed to take an advance against this indemnity? If yes, are there restrictions on this such as it is not allowed if a majority of the investors are suing the fund?

Standard of Care and Exculpation:

- What standard of care is being applied i.e., negligence or gross negligence?
- What carve outs are in place stating where the manager would not be indemnified?
- What determines when a “bad act” has taken place?
- What is the asset manager’s definition of “material” if this wording is used?

Insurance:

- What insurance does the manager have in place?
- Is there a clearly detailed policy on when insurance would be used in the first instance?