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INDEMNIFICATION

Hedge Fund Managers Must Exercise Restraint in Deploying Indemnification Provisions

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Indemnification provisions are the forbidden fruit in every hedge fund partnership agreement. On the one hand, they are typically drafted in such a broad fashion as to protect the general partner and its affiliates from seemingly any issue arising out of the partnership, provided that their actions do not constitute gross negligence, willful misconduct, fraud or bad faith. On the other hand, utilizing an indemnification provision almost always places the general partner and investment adviser's fiduciary duties at risk.

In one decision, a court held a fund's investment adviser, general partner and the individual who made the decisions on behalf of the general partner liable for wrongfully converting over $5.8 million from the fund despite their claims that the indemnification provision protected their conduct.[1] In a guest article, David T. Martin, a partner at Cummings & Lockwood, explains how courts have analyzed indemnification provisions under Delaware law and offers some fundamental principles that every fund counsel should consider before deploying an indemnification provision. For more on indemnification, see "*Stanley Druckenmiller's Counsel Provides a Tutorial for Negotiating Exculpation, Indemnification, Redemption, Withdrawal and Amendment Provisions in Hedge Fund Governing Documents*," The Hedge Fund Law Report, Vol. 7, No. 5 (Feb. 6, 2014). For a Cayman Islands perspective, see our two-part series on *"Exculpation and Indemnity Clauses in the Hedge Fund Context": Part One*, Vol. 3, No. 50 (Dec. 29, 2010); and *Part Two*, Vol. 4, No. 1 (Jan. 7, 2011).

Indemnification Under Delaware Law

The Delaware Revised Uniform Limited Partnership Act (DRULPA) provides a limited partnership with the ability to create broadly drafted indemnification provisions. 6 Del. C. §17-108 provides:

> Subject to such standards and restrictions, if any, as are set forth in its partnership agreement, a limited partnership may, and shall have the power to, indemnify and hold harmless any partner or other person from and against any and all claims and demands whatsoever.

The majority of hedge fund partnership agreements contain an indemnification provision that typically requires that the partnership indemnify the general partner, its investment adviser and associated officers, directors and agents from losses, claims, liabilities, expenses and costs (including reasonable attorneys' fees) incurred by those indemnified parties in connection with their good faith performance of their responsibilities to the partnership, provided, however, that an indemnitee shall not be indemnified for any conduct which constitutes fraud, gross negligence, willful misconduct, bad faith or violation of other applicable law.

Under the plain language of this standard provision, indemnification is permitted when two conditions are met:

1. The charges incurred must have been a result of a general partner or investment adviser's good faith performance of their responsibilities to the fund. The expenses must have some relationship or benefit to the fund.
2. The general partner or investment adviser's conduct cannot constitute fraud, gross negligence, willful misconduct, bad faith or violate other applicable laws. Effectively, one cannot be a bad actor and seek indemnification for those bad acts.

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If these two requirements are satisfied, then indemnification is typically permitted.

However, it should also be noted that there is often a third requirement in some partnership agreements: that the indemnification claim arise out of the defense of an action or proceeding. This limitation significantly restricts indemnifiable expenses.

Given the broad indemnification rights afforded by the DRULPA, fund counsel should carefully review any and all indemnification restrictions in their limited partnership agreements.

Refinements to Indemnification Under Delaware Case Law

Fund counsel should also be cognizant of how Delaware case law further shapes the scope of indemnification. "The touchstone for awarding fees in an indemnification action is reasonableness."[2] Indemnified parties are entitled to damages that are "actually and reasonably incurred."[3]

In a recent decision applying Delaware law, a Connecticut court held that an investment adviser's claimed lost management fees – purportedly "lost" as a result of one limited partner's decision to withdraw from the partnership – were not indemnifiable "losses" under the partnership agreement.[4] These were not damages that were "actually and reasonably incurred." The limited partner had a "negotiated right" to withdraw, and the partnership did not incur any actual loss. It was not permitted to take its alleged future lost management fees from the fund.

Similarly, the court found that the investment adviser was not permitted to take a monthly "litigation management fee."[5] This monthly fee was not charged based on any actual legal services rendered for the fund, as there were no invoices or retainer agreements concerning these charges.[6] Instead, the individual who controlled the general partner and investment adviser took these fees for his time spent managing certain litigation between the general partner and two of the fund's limited partners.[7] The court determined that these claimed "litigation management fees" were not indemnifiable.

In evaluating an indemnification claim, a further important consideration is whether the expense was incurred "for the preservation of the partnership business or property."[8] In other words, is there a benefit conveyed to the partnership, or is the indemnitee actually obtaining the benefit? In one of the most prominent indemnification cases, *Paige Capital Management, LLC v. Lerner Master Fund*, the Delaware Court of Chancery held that an investment adviser was not permitted to indemnify[9] itself for its litigation costs incurred in an action that it affirmatively commenced against the fund's seed investor, because the litigation commenced was "partisan" in nature and sought to benefit the investment adviser at the expense of the fund.[10] The litigation was not "in connection with" the adviser's performance of its duties, and there was no benefit to the fund.[11] Therefore, the litigation expenses were not indemnifiable.

Suggested Principles for Indemnification Provisions

While indemnification provisions in limited partnership agreements come in many forms, similar guiding principles apply in interpreting these provisions. Prior to even considering using an indemnification provision, management should first determine whether or not the fund's insurance would afford coverage. If the claim is not covered by insurance, then the fund's indemnification provision should be examined.

Management should further review the partnership agreement's exculpation provision to determine whether or not they can obtain an opinion of counsel that would further protect their actions if they sought indemnification.[12]

In considering a claim for indemnification, fund counsel should review the follow rubric:

- Does the indemnification claim fall within the coverage of the fund's indemnification provision as

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set forth in the partnership agreement?
- Would the indemnification cover charges that were reasonably and actually incurred by the fund?
- Would taking indemnification provide a benefit to the fund?
- Would taking indemnification help to preserve or protect the fund's assets?

Indemnification should never be a first line of defense. That is the purpose of insurance. However, in some situations, outlined above, it may be appropriate to seek indemnification. Fund counsel must have a sound understanding of the scope of the fund's indemnification provision and Delaware law in order to feel secure about utilizing a fund's indemnification provision.

While the saying goes that "forbidden fruit tastes the sweetest," that taste may quickly turn bitter if an indemnification mistake is made.

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[1] Tuckerbrook Alternative Investments, LP v. Alkek & Williams, LTD, 2015 WL 1588550 (Conn. Super. Mar. 16, 2015).
[2] May v. Bigmar, Inc., 838 A.2d 285, 289 (Del. Ch. 2003) aff'd, 854 A.2d 1158 (Del. 2004).
[3] Id.
[4] Tuckerbrook, 2015 WL 1588550 at *14-*15.
[5] Id. at *16.
[6] Id. at *16-*17.
[7] Id.
[8] Active Asset Recovery, Inc. v. Real Estate Asset Recovery Servs., 1999 WL 743479,
*19 (Del. Ch. 1999) (internal citation and quotation marks omitted).
[9] In Paige Capital, the applicable indemnification provision provided: "[Paige] General Partner, [Paige Capital Management], each of their respective directors, members, partners, shareholders, officers, employees, agents and affiliates . . . (each an "Indemnitee") shall be indemnified and held harmless by the [Hedge Fund] to the fullest extent legally permissible under and by virtue of the laws of the State of Delaware, as amended from time to time, from and against any and all loss, liability and expense (including, without limitation, losses due to trade errors caused by such persons, judgments, fines, amounts paid or to be paid in settlement and reasonable attorney's fees and expenses) incurred, or suffered by the Indemnitee in connection with the good faith performance by the Indemnitee of his, her or its responsibilities to the [Hedge Fund] provided, however, that an Indemnitee shall not be indemnified for losses resulting from his, her or its gross negligence, willful misconduct or violation of applicable laws . . . ."
[10] 2011 WL 3505355, *43 (Del. Ch. 2011).
[11] Id.
[12] This subject is worthy of an article itself; however, it is beyond the scope of this article.

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