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LITIGATION

Contractual Provisions That Matter in Litigation between a Fund Manager and an Investor

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Certain provisions in limited partnership agreements and other agreements between fund managers and investors (Fund Documents) may seem perfunctory when those agreements are drafted, but they can become significant when a fund manager finds itself in litigation with an investor. Those provisions include provisions concerning arbitration, indemnification, advancement, integration, no-reliance, choice of law and choice of forum. It is important that fund managers think through the ramifications of each of these provisions when drafting Fund Documents.

Arbitration

As an initial matter, a fund manager should consider whether it would rather have a dispute with an investor resolved in a court or in arbitration. Arbitration offers a fund manager certain advantages over litigation in court. The rules of evidence and procedure are less formal in arbitration, which means that, in general, arbitration is faster and cheaper than court litigation. This is particularly true with regard to discovery, which is typically the most expensive part of litigation. Oftentimes, discovery in an arbitration will be more limited and streamlined than in a court, which saves parties substantial costs. Arbitration is also a private proceeding, whereas court proceedings are public. Accordingly, litigants can agree to keep the arbitration proceedings and the outcome of the arbitration confidential. And litigants can attain these benefits of arbitration while still seeking substantially the same relief that would be available to them in court.

There are also disadvantages associated with arbitration as compared with litigation in a court. Most significantly, an arbitration decision, for all practical purposes, is not appealable. For this reason, there is no real check on the arbitrators' ruling, even if arbitrators do not follow the law or the plain language of the Fund Documents. Additionally, arbitrators are more likely than a judge or a jury to split the difference between the parties' competing positions and reach a decision based upon a middle ground. Moreover, the less formal evidentiary rules could result in unhelpful evidence, such as harmful hearsay evidence, being considered in arbitration that would not have been admitted in court. Finally, while courts are increasingly more willing to grant motions to dismiss, which can quickly end a dispute, or a motion for summary judgment, arbitrators are far less likely to resolve the parties' dispute at the initial stages of the litigation based upon a motion. Arbitrators will most likely require the parties to proceed with a full-blown hearing on the merits, even in the face of a meritorious motion that would summarily dispose of the dispute.

If a fund manager decides it prefers arbitration over litigation in court, it should include an arbitration provision in the Fund Documents. When drafting that provision, the fund manager should consider the following issues:

- The manager should first decide whether all or only certain disputes with investors should be submitted to arbitration, as opposed to the courts. Arbitration provisions can be drafted broadly enough to cover all disputes between the parties that relate to their contractual arrangement. Indeed, courts have held that arbitration provisions can cover not only disputes relating to breach of contract, but also disputes involving tort claims, such as claims for breach of fiduciary duty, negligence and fraud, if those tort claims relate to the parties' contractual relationship. Common wording of a broad arbitration provision intending to submit all disputes to arbitration is the following: "Any and all disputes or controversies arising out of or relating

to this Agreement or the interpretation hereof and/or the relationship among the Parties resulting from this Agreement, will be adjudicated and settled by arbitration." Parties can also draft an arbitration provision under which only particular disputes are submitted to arbitration, and the remaining disputes are left to the courts.

- It is not uncommon for Fund Documents to generally provide that disputes with investors will be resolved by arbitration, but to also provide that the parties can go to court to seek a temporary restraining order or a preliminary injunction. However, many arbitration rules, such as the rules of the American Arbitration Association (AAA), provide for the parties to obtain expedited injunction relief in arbitration. In many cases, preliminary injunctive relief can be obtained far more quickly in arbitration than in a court.

- Parties can include in an arbitration provision a statement as to whether the court or the arbitrator(s) will decide whether a particular dispute is subject to arbitration in the event there is a dispute over arbitrability. Generally, arbitrators are more inclined than courts, and indeed have personal economic incentives, to find that a given issue is subject to arbitration. Accordingly, if a fund manager wants to have the broadest possible array of disputes with investors arbitrated, it should draft the arbitration provision to provide that the arbitrator(s), and not a court, will decide whether an issue is subject to arbitration.

- If the contract is not clear on who decides whether an issue is subject to arbitration (i.e., the court or the arbitrator(s)), the applicable state law becomes important. Under the law of some states, such as Delaware, the arbitrator(s) decides whether an issue is subject to arbitration where an arbitration clause generally provides for arbitration of all disputes, and incorporates a set of arbitration rules (such as the rules of the AAA) that empowers the arbitrator(s) to decide arbitrability. Under the laws of other states, courts presume that they will decide the issue of arbitrability unless the parties affirmatively state in their contract that arbitrability will be decided by the arbitrator(s).

- The fund manager should also include a section in the arbitration provision governing how the arbitrators will be selected. For instance, parties can follow the applicable selection process provided for in the rules of the AAA, JAMS, Inc. or a similar alternative dispute forum. The parties can also specify in the agreement how many arbitrators will hear the dispute. Many agreements provide for three arbitrators. While three arbitrators would obviously be more expensive than a single arbitrator, having a three-person arbitration panel can increase the likelihood of a well-reasoned outcome. This is an important consideration given, as stated above, that there is virtually no ability to appeal from an arbitration award. Some arbitration provisions provide that each party select its own "interested" arbitrator, with the two "interested" arbitrators selecting a third, "neutral" arbitrator. This approach can put the fund manager at a disadvantage if the investor selects a stronger arbitrator, who is more able to influence the neutral arbitrator. Generally, a selection process that provides for one or three neutral arbitrators is the wisest course.

- In an arbitration provision, the fund manager can also require that the arbitrator(s) have certain experience as a prerequisite to his or her selection as an arbitrator. For instance, the fund manager may require that the arbitrator be knowledgeable about alternative investments and have previously arbitrated disputes relating to private investment funds.

- Parties can expressly state that the arbitration shall be conducted in a confidential manner. By contrast, if a dispute is resolved by a court proceeding, the result will necessarily be public.

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Indemnification, Advancement and Recovery of Attorneys' Fees

Indemnification provisions enable fund managers to obtain reimbursement from the fund for losses (including attorneys' fees and expenses) arising out of legal proceedings brought by an investor.

In addition to the right to indemnification, fund managers should also include a provision in their Fund Documents that would entitle them to advancement of attorneys' fees and costs in the event of litigation. In general, absent an advancement provision, the manager could receive indemnification from the fund only once the litigation has been resolved in the manager's favor.

Well-drafted indemnification provisions relieve managers of liability for negligent conduct, which is generally permissible under the law. Indemnification is not permitted for gross negligence or fraud. In most (if not all) jurisdictions, it is against public policy to contract away liability for gross negligence or willful misconduct. However, indemnification for attorneys' fees and other expenses incurred in successfully opposing fraud charges (as opposed to any judgment or liability for fraud) are generally permitted.

The Fund Documents should also provide that an investor who brings an unsuccessful claim against the fund manager or the fund must reimburse the fund manager and the fund for their attorneys' fees and other expenses.

Integration and "No-Reliance"

All Fund Documents should contain an "entire agreement" or "integration" clause. These clauses usually contain statements that the Fund Documents contain the entire agreement between the parties and supersede any prior written or oral agreement between the parties. An integration clause prevents a party to a contract from arguing that the terms of the contract discussed during negotiations differ from those contained in the executed Fund Documents.

An integration clause will not, however, by itself prevent an investor from arguing that it relied on representations by the fund manager that are not touched upon anywhere in the Fund Documents, which could form the basis of an investor's fraud in the inducement claim. See *Vigortone AG Prods. v. PM AG Prods., Inc.*, 316 F.3d 641, 645 (7th Cir. 2003) (rejecting argument that an integration clause was a no-reliance clause where it contained no reference to reliance). For that, an additional clause, called a "no-reliance" clause, is needed. A no-reliance clause specifically states that the investor has not relied on any representations made by the fund manager that are not set out in the Fund Documents. A no-reliance clause improves the prospects of defeating an investor's fraud in the inducement claim, particularly at the pleading stage of litigation.

Well-drafted Fund Documents contain both an integration clause and a no-reliance clause.

Choice of Law and Choice of Forum

A choice of law provision permits the parties to select which state's laws will be used to interpret the Fund Documents and govern claims between the parties. Many fund managers choose either Delaware or New York law because the laws of those states are more established, and thus offer more predictable outcomes in the event of a dispute. Delaware law is also viewed as liberal in terms of respecting the terms of the parties' agreement. In choosing the governing law, a fund manager should take care to select the law of a forum to which the fund has a substantial connection, such as where the fund is incorporated. Otherwise, a court may not uphold the choice of law provision. Courts also may refuse to uphold the parties' choice of law provision if the chosen law would contravene a fundamental policy of the state whose laws would have applied absent the choice of law provision.

Well-drafted Fund Documents should also include a choice of forum provision, setting forth where any dispute will be resolved. It is not uncommon for Fund Documents to select the law of one state to govern disputes, but choose to have the dispute resolved by

arbitration or by a court in a different state. However, parties should be aware that the law of the forum selected to resolve the dispute, and not the law selected in the choice of law provision, will apply to procedural issues. This can be significant, among other reasons, because certain courts view statute of limitations as a procedural issue. If, for example, the Fund Documents select a forum whose law applies a shorter statute of limitations period to the subject cause of action than does the law of the state whose substantive law is chosen, that could affect an investor's ability to pursue that cause of action.

Conclusion

No fund manager likes to think about the prospect of a dispute with an investor in one of its funds. But every fund manager should plan for the possibility of litigation with an investor by taking a close look at the various provisions outlined above that could affect the cost and outcome of any litigation.

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