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Making the Most of a Contractual Advice-of-Counsel Defense

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When a situation arises in which an investment manager's conduct or decision making could be subject to question – including in litigation or a regulatory investigation – the investment manager may seek outside advice from legal counsel, accountants and other professionals. In addition to the obvious benefits of that advice when determining the appropriate course of action, an investment manager also may wish to put itself in a position to take advantage of a provision routinely found in various fund documents that provides for exculpation or other limitation of liability for the manager (and sometimes others) if it consults with and acts pursuant to the advice of those outside professionals. Such a provision, however, will provide a defense to liability only when all applicable contractual and legal requirements are met; compliance with the requirements is documented and disclosed; and the defense is timely asserted.

This article highlights typical requirements of so-called "advice-of-counsel" provisions, as well as other legal requirements that frequently apply, and suggests measures for investment managers to consider to obtain maximum possible protection from a contractual advice-of-counsel defense.

Sources and Extent of Advice-of-Counsel Defenses

Generally speaking, reliance on advice of counsel only rarely provides a complete defense to liability. Rather, evidence of reliance on advice of counsel more commonly may be used to show good faith when that is a defense to a claim or to show the absence of bad faith or willfulness when either is an element of a claim. Nevertheless, a contract may provide that reliance on the advice of counsel (or other professionals) is a complete defense to a claim.

In the hedge fund context, provisions that provide exculpation to or limit the liability of an investment manager that relies on the advice of counsel (and sometimes other professionals) may be found in various fund documents, including limited partnership agreements, investment management agreements and private placement memoranda. A common formulation of such a provision is as follows:

> Each of the Investment Manager and its Affiliates may consult with counsel and accountants in respect of the Fund's affairs and, with respect to shareholders of the Fund and the Fund, will be fully

protected and justified in any action or inaction that is taken in accordance with the advice or opinion of such counsel or accountants, provided that they were selected in accordance with the standard above.

Contractual Requirements

As the above example illustrates, an advice-of-counsel provision usually imposes certain express requirements to invoke it and limits its application to specific circumstances. Some common requirements and limitations are as follows.

Who May Invoke the Provision

The provision may apply to some entities and individuals in an investment management firm and not others – and the scope of its application may not be clear. For example, the provision cited above does not say whether an individual employee of the investment manager, an offshore fund director or a management company's general partner would be among the "Affiliates" of the investment manager that can invoke the provision's protection.

Types of Professionals Covered by the Provision

Most advice-of-counsel provisions apply to advice of legal counsel, but some offer protection for other professionals as well. As an example, the provision cited above allows for exculpation based on advice of accountants as well as counsel. Other professionals whose advice may be relied on can include:

- investment bankers;
- financial advisers;
- appraisers; and
- "other specialized, reputable, professional consultants."

Although the discussion in this article focuses on advice of legal counsel and, to some degree, accountants, the applicable considerations are largely the same for other types of professionals – except that the privileges applicable to advice of legal counsel (and sometimes accountants) generally do not apply to communications with other types of professionals.

Selection of the Outside Professional

Typically, the outside professional must have been selected in accordance with a particular standard of care. This element can be difficult to apply because many fund documents do not specify clearly what the "applicable" standard of care is. For example, the provision above cites "the standard above," but in the document from which the provision is excerpted, no "standard" is actually stated in any of the preceding provisions, so it is unclear what the applicable standard is.

That sort of drafting glitch is common in many advice-of-counsel provisions in hedge fund documents. The provision may be interpreted as referring generally to a "good faith" standard, although another viable reading is that the applicable standard is the same one for which exculpation generally is available, *e.g.*, anything other than gross negligence, fraud, bad faith or willful misconduct. In fact, in many jurisdictions, including New York, public policy considerations prohibit enforcement of exculpation clauses – including advice-of-counsel defense provisions – that apply to conduct involving gross negligence, willful misconduct, fraud or bad faith. In light

of the proliferation of this type of drafting issue, when including an advice-of-counsel provision in new or amended fund documents, care should be taken to ensure the standard of care is clearly stated.

Form of Advice or Opinion

Some provisions may require that the advice relied upon be written. Even if not specifically required, however, when relying on an outside professional's advice, it is a best practice for the professional to memorialize that advice in some fashion.

Reliance on the Professional's Advice or Opinion

To invoke the protection of an advice-of-counsel provision, it is not enough merely to seek advice from a lawyer or accountant. Rather, the person who sought the advice must actually follow it for the provision to apply. In other words, the person must act – or not act – in accordance with the professional's advice or opinion.

Kind of Protection Provided

Advice-of-counsel provisions generally provide for exculpation – that is, complete protection from liability. They may limit liability in other ways, however, such as by providing for indemnification.

See "Hedge Fund Managers Must Exercise Restraint in Deploying Indemnification Provisions" (Nov. 19, 2015).

Other Legal Requirements

In addition to express contractual requirements, an advice-of-counsel defense may be subject to requirements that are not stated in the provision itself but are imposed by case law. An investment manager considering invoking an advice-of-counsel defense would do well to confirm whether any additional requirements apply in the jurisdictions whose laws may apply to a particular dispute. Typical extra-contractual requirements may include the following.

Any Applicable Privilege Must Be Waived

When a party asserts an advice-of-counsel defense in litigation, the attorney's advice is put at an issue; thus, that party must waive attorney-client privilege. The scope of the privilege waiver is frequently a matter of dispute, but it is not enough merely to show that counsel was consulted – there must be evidence of the substance of the counsel's advice.

For more on waivers of privilege, see "Understanding the Wells Process: SEC Enforcement Staff Views of the Process (Part Two of Three)" (Jun. 20, 2019).

"Complete" Information Must Be Provided

An advice-of-counsel defense may not be available if there is an indication that relevant, material information was withheld from the lawyer on whose advice the party relied. For example, in *SEC v. Meltzer*, the court ruled that the defendant could not rely on advice of counsel concerning the legality of certain misleading statements because he had not shown the attorney the statements at issue.

Reliance on the Advice Must Have Been Reasonable

When a lawyer's advice is obviously wrong or inapplicable, a client cannot avoid liability by hiding behind that advice. For example, again in SEC *v. Meltzer*, the court ruled that the defendant in a securities fraud case could not reasonably claim reliance upon an attorney's advice that certain disclaimers were not misleading when the defendant knew that the disclaimers were, in fact, misleading.

Advice Must Relate to the Specific Issues in the Case

Again, it is not enough simply to have consulted a lawyer; the person invoking the advice-of-counsel provision must have asked the lawyer for advice regarding the specific matter, event or conduct at issue. When there is a mismatch between the advice sought and the advice given or the issues in the case, an advice-of-counsel defense may not be available.

For example, in SEC *v. O'Meally*, the court denied the defendant's summary judgment motion based on an advice-of-counsel defense because the advice given related to the legality of the defendant's market-timing activities – not to the legality of his concealment of those activities, which was the focus of the SEC's claims.

Practical Considerations

In addition to satisfying the applicable legal requirements – both contractual and extra-contractual – of an advice-of-counsel provision, successfully invoking the defense requires careful planning and strategy from the first moment it appears that the defense may be relevant.

Whom to Consult

One of the first challenges is for the manager to identify the appropriate counsel (or other professional) from whom to get advice. An investment manager's instinct may be to turn to in-house counsel or the firm's day-to-day outside fund counsel or litigation counsel. Each of those choices, however, may turn out to be problematic if the dispute ripens into actual litigation.

As discussed below, an attorney who is asked to give advice that may be relied upon to establish an advice-of-counsel defense in a future lawsuit needs to understand from the outset that he or she may be called upon to disclose and testify about that advice. For an in-house lawyer or fund counsel, the lawyer's interest in maintaining the employment or client relationship may be used undermine that testimony by suggesting that the lawyer is catering to his or her employer's or client's interests rather than giving disinterested advice.

Also, using in-house counsel or fund counsel may increase the risk of a broad privilege waiver beyond the specific advice at issue. Thus, it is worthwhile for an investment manager to retain separate outside counsel other than day-to-day fund counsel or litigation counsel for the specific purpose of providing advice that may be relied on for an advice-of-counsel defense in future litigation.

For outside litigation counsel, the situation is particularly perilous. Under most applicable professional conduct rules, a lawyer cannot act as an advocate before a tribunal in a case in which that lawyer is likely to be a witness on a significant issue of fact – in most cases, even if the lawyer's testimony is not harmful to the client. Thus, a lawyer who gives advice that

may form the basis for an advice-of-counsel defense cannot represent the manager to which the lawyer has given the advice in any ensuing litigation; indeed, that restriction potentially disqualifies the lawyer's entire firm from the case.

See our three-part series on outside counsel: "How Fund Managers Can Control Legal Costs and Negotiate Outside Counsel Fees" (Oct. 1, 2020); "Ways to Approach the Process of – and Key Criteria to Consider When – Selecting Outside Counsel" (Oct. 8, 2020); and "Advice for Allocating Legal Tasks Between In-House Attorneys, Outside Counsel, Consultants and Other Vendors" (Oct. 22, 2020).

A similar, and potentially even more significant, problem can arise when an investment manager seeks to rely on the advice of an outside accountant, as some contractual provisions allow. Again, an investment manager's instinct is likely to be to turn to the firm's regular outside auditor. Although it is common for a manager to have regular communications with the firm's outside auditor, including to discuss specific accounting questions, an auditor generally does not give "advice" as such because to do so would impair its independence as an auditor. An auditor that no longer believes itself to be independent from the entity it audits generally must resign. Of course, for an investment manager, the resignation of an auditor can be catastrophic because it could be viewed as an indication of problems at the manager (even if there are none). Therefore, an investment manager that anticipates relying on an advice-of-accountant defense should retain an accountant other than its regular outside auditor for that advice.

See "Lack of Auditor Independence Continues to Plague Advisers Under the Custody Rule" (Sep. 26, 2019); and "Advisers Must Ensure Auditor Independence to Satisfy Custody Rule" (Nov. 1, 2018).

What to Document

Once an appropriate lawyer or other professional has been retained, all aspects of his or her work should be thoroughly and contemporaneously documented in writing – whether the relevant contractual provision requires written documentation or not. That means memorializing, among other things:

- the terms of the professional's retention, including who the "client" is;
- the specific advice requested, including its context and purpose;
- all information requested by and provided to the professional;
- if information is requested but not provided to the professional, that fact and any reasons for not providing it;
- the advice received, including any clarification or follow-up questions; and
- the circumstances under which – *i.e.*, how, when and by whom – the advice was followed.

All of the above should, of course, be performed with the professional's express knowledge and expectation that the documentation may, at the client's discretion, be turned over to an adversary in litigation. Moreover, it must be confirmed up front that the professional is willing and able to testify about the advice given and all matters surrounding the giving of that advice.

See our two-part series "A Roadmap to Maintaining Books and Records": Compliance With Applicable Regulations (Nov. 2, 2017); and Document Retention and SEC Expectations (Nov. 9, 2017).

What the Scope of the Privilege Waiver Is

As noted previously, it also is important to think through the scope of the potential waiver of any applicable privileges that may result from asserting the contractual defense. Although retaining a separate professional for the purpose of the advice is helpful for limiting the waiver's scope, there is always a risk the waiver may extend to matters outside the scope of the specific engagement. An investment manager that concludes it is not willing to run the risks of waiving privilege may have to forgo an otherwise available advice-of-counsel defense.

See "How Fund Managers Can Maintain Work Product Protection During Investigations After the *Herrera* Decision" (Feb. 22, 2018); and our three-part series on protecting attorney-client privilege and work product while cooperating with the government: "Establishing Privilege and Work Product in an Investigation" (Mar. 23, 2017); "Minimizing Cooperation Risks" (Mar. 30, 2017); and "Implications for Collateral Litigation" (Apr. 6, 2017).

When to Assert the Defense

Once a dispute ripens into litigation or similar proceedings, an investment manager that wishes to gain the full benefit of a contractual advice-of-counsel defense should plan to assert the defense and provide discovery relevant to the defense as early as possible in the case – without objecting on the basis of attorney-client privilege. The later in the case the defense is asserted, the greater the likelihood the defense will be found to have been waived. Moreover, even "boilerplate" objections to discovery on the basis of privilege may be found to preclude reliance on the defense.

Conclusion

Finally, it is important to recognize the potential limitations of an advice-of-counsel defense. The defense is notoriously hard to establish successfully; reported decisions in which it is found to have been established are exceedingly rare. The steps and considerations described above are designed to address the most common issues that are found to defeat the defense in litigation.

For an example of a case in which the defense was raised, see "Six Recommendations for Hedge Fund Managers Seeking to Protect Themselves from Waiver of Attorney-Client Privilege When Faced With SEC Document Requests" (Jan. 17, 2013).

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