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ARBITRATION

What Hedge Fund Managers Need to Know About Arbitration of Disputes

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Increasingly, hedge fund managers are choosing to require disputes – whether involving members of a fund's management firm complex or a fund's investors – to be resolved through arbitration. Although an arbitration provision may be a relatively brief part of a hedge fund's constituent documents, care should be taken to ensure it serves the interests of those who may use it. A well-thought-out, carefully crafted arbitration provision will provide the benefits a manager seeks without unpleasant surprises in terms of cost, process or outcome.

This article explains the basics of arbitration and explores key factors to be considered when deciding whether to designate arbitration as a mechanism for resolving disputes and crafting an arbitration provision.

What Is Arbitration?

When considering whether to require arbitration, it is important for fund managers to understand how it differs from other commonly used dispute-resolution methods, particularly litigation and mediation.

Differences From Litigation

The essential differences from litigation are that:

- arbitration is conducted in a private arbitral forum instead of a public courtroom; and
- arbitration is presided over and decided by one or more arbitrators selected and paid by the parties, rather than by a judge or jury.

There can be other differences as well. For example, arbitration may provide for less – or sometimes no – discovery, and some procedures that are available in court, such as motions to dismiss or for summary judgment, may be scaled down or unavailable in arbitration. Like litigation, however, an arbitration decision – which is called an "award" – is as binding and enforceable as a court judgment, although it may be necessary to file a lawsuit to enforce it.

See "How Fund Managers Can Mitigate the Impact of Litigation on Their Transactions and Relationships" (Apr. 4, 2019); and "Contractual Provisions That Matter in Litigation Between a Fund Manager and an Investor" (Oct. 2, 2014).

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Differences From Mediation

Mediation, although often discussed in the same breath as arbitration, is very different from both litigation and arbitration. Mediation is not a binding dispute-resolution process. Rather, parties use mediation to resolve a dispute consensually with the assistance of a neutral third-party mediator. Unlike a judge, jury or arbitrator, a mediator does not "decide" anything, and the outcome of a mediation is only binding on the participants if they agree that it is.

Participants in a mediation are not required to do anything other than attend and participate in good faith according to the rules the parties establish for the mediation; if a party does not wish to resolve the case, the mediator cannot force them to do so. If the parties agree to a resolution through mediation, it ordinarily will be memorialized in the form of a written agreement, which is an enforceable contract but does not, by itself, allow for entry of a judgment that could readily be enforced against the losing party's assets. In addition, that agreement does not give a creditor a legal priority claim to those assets should the debtor file a bankruptcy petition, for example.

Who Can Arbitrate?

Arbitration is a matter of contract. Disputes among hedge fund principals or with a fund's investors typically are governed by the agreements pursuant to which the fund and its management entities have been formed or the limited liability company agreements, limited partnership agreements, private placement memoranda and subscription agreements applicable to investors in the relevant fund. In general, individuals and entities that are not parties to an agreement containing an arbitration provision are not required to arbitrate their disputes with parties that are subject to that agreement, although there can be exceptions. Nonetheless, even if arbitration is not required by an existing agreement, parties can agree after a dispute arises to submit it to arbitration for resolution, but again, their agreement will not bind anyone else.

See "Illinois Appellate Court Rules on Whether a Hedge Fund Manager Can Compel Arbitration Based on an Agreement Between a Fund Investor and a Clearing Broker" (Sep. 20, 2012); and "Can an Arbitration Provision Signed by a Hedge Fund Manager, but Not by a Hedge Fund Director, Bind a Hedge Fund?" (Nov. 3, 2011).

Pros and Cons of Arbitration

Before mandating arbitration, a fund manager should make an informed decision whether arbitration is, in fact, desirable and, in particular, preferable to litigation in court. There are several factors to consider when making that decision.

Cost

One of the reasons most frequently given for choosing arbitration is that it will cost less than litigation. More specifically, arbitration cases are generally thought to involve less discovery and move more quickly, thus limiting the overall time and money spent. That is not always the case, however. It is important to factor into the cost analysis the fact that, unlike a court proceeding in which the judge and jury are provided basically free of charge, in arbitration, the parties pay:

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- substantial fees to the arbitral forum; and
- even more substantial hourly fees to the arbitrator(s) for administering the case; preparing for and participating in hearings; and rendering a decision.

In certain situations, such as when a specialist arbitrator is involved, hourly fees can be comparable to those of large-firm lawyers. In addition, using an arbitration panel (typically consisting of three arbitrators) instead of a single arbitrator means those fees will be multiplied accordingly. Indeed, arbitration fees can easily eliminate any cost savings from other factors.

Discovery

One of the primary downsides of litigation is discovery, with the attendant costs and business disruption. Conventional wisdom is that arbitration addresses that issue by providing for more limited discovery, but that is not uniformly the case – and less discovery is not always advantageous. For one, arbitral forums vary in the types and scope of discovery they permit, which can range from virtually none to full-blown discovery with document production and depositions.

Indeed, for certain types of claims, arbitration discovery can be more extensive than in litigation. For example, certain types of ERISA claims may be limited in court to the so-called "administrative record," which consists of a handful of documents, and virtually no additional discovery (including depositions) is conducted. By contrast, in arbitration, that limitation may not apply. Moreover, notwithstanding the arbitral forum's rules, parties may agree to limit discovery further than – or conduct additional discovery beyond – what the forum provides because it is viewed by both parties as desirable.

Thus, it is critical to review the rules of the applicable arbitral forum to determine what types and scope of discovery normally are allowed and to consider whether an arbitration provision should allow for more or less discovery than what the forum rules provide. Also, it is important to keep in mind that not having full-blown discovery can be a significant disadvantage. Discovery generally benefits all parties by giving them a preview of the evidence, which can facilitate settlement and streamline trial proceedings.

Speed

Another widely touted benefit of arbitration is that cases tend to be resolved more quickly than they might be in court. Again, whether that benefit can be realized depends on various factors, including the duration of discovery and – perhaps unexpectedly – the number of arbitrators. Just as in court, discovery is one of the main determinants of the pace and duration of arbitration, so as discussed above, it is essential to understand to what extent discovery actually will be truncated to assess whether arbitration is likely to produce a faster outcome.

In addition, when multiple arbitrators are involved, their individual schedules will need to be coordinated, making it harder to schedule conferences and hearings. That problem is exacerbated when members of an arbitration panel are in various locations and time zones. If a case is complex, such that the hearings – *i.e.*, the trial of the arbitration case – can be

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expected to take more than a week or so, a multi-arbitrator case can turn out to take much longer than a trial in court.

A judge can conduct trial proceedings more or less every business day until completion, and when a jury is involved, there is a particularly strong incentive to do so. In contrast, arbitrators usually have other demands on their time, whether from their "day jobs" or simply other cases in which they are serving as arbitrators. In one rather extreme situation in which certain of the author's colleagues were involved, what might have been a two- or three-month trial in court took over a year in arbitration because the three arbitrators on the panel were available at the same time for only a week or so each month. Thus, it cannot be assumed that arbitration will be a quicker process.

Quality of the Decision Making

It is commonly believed (or at least said) that arbitrators tend to avoid all-or-nothing outcomes, "splitting the difference" in most cases. That perception does not always bear out in reality, however, and whether it is beneficial in an individual case will vary.

One thing arbitration can offer, though, is the opportunity – if the applicable arbitration agreement provides for it – to have a case decided by one or more arbitrators with specialized knowledge or experience, which cannot be ensured in litigation. That may produce a more informed and, it is hoped, more just outcome for the parties.

If an arbitration provision includes special qualifications for the arbitrator(s), it is necessary to consider which qualifications are essential, as requirements that are too many or too specific can make it difficult or impossible to find a compliant arbitrator(s). For example, one common arbitration provision requires the arbitrator to be "an attorney experienced in the investment management industry and who shall have prior experience arbitrating investment management disputes as an arbitrator." At first blush, that requirement seems reasonable, but in practice, the universe of individuals who both are experienced investment management attorneys and have previously served as arbitrators in investment management disputes is very small – in some arbitral forums, it may be a null set.

Also, that expertise might not always be necessary or helpful, such as in a dispute involving interpretation of a contract. Moreover, parties can use the arbitrator-selection process to designate candidates who do have expertise appropriate to a particular case without limiting themselves in advance to a potentially unachievable set of qualifications.

Confidentiality and Lack of Precedential Impact

Arbitrators ordinarily do not write detailed explanations for their decisions (although some will at the parties' request), and at least in the first instance, arbitration awards usually are not public. For those reasons, another perceived benefit of arbitration is that the existence, subject matter and outcome of the case will be confidential, which minimizes headline risk and avoids creating a precedent. Nevertheless, arbitration awards routinely do become public because a party may need to file a lawsuit to either enforce the award or seek to overturn it. Thus, arbitration should not be chosen with the expectation that it can keep the existence of a dispute, its subject matter or its outcome confidential forever.

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Moreover, even an arbitration award that does not contain any explanation of the arbitrators' reasons may create a precedent of sorts if it becomes public. Take, for example, the recent FINRA arbitration award of more than $30,000 to a retail customer of Robinhood, who brought the arbitration concerning restrictions the brokerage placed on trading certain stocks during the "meme stock" market events of January 2021. Although the award contained no explanation of the reasons for the decision, it received substantial media coverage, which might be expected to embolden other similarly situated customers to file claims.

See "Federal District Court Enjoins a Hedge Fund and Its Manager From Pursuing FINRA Arbitration Claims Against a Broker-Dealer Because They Were Not 'Customers' of the Broker-Dealer" (May 30, 2013).

Recognizing that confidentiality cannot be guaranteed, another consideration is how to craft language in an arbitration provision that appropriately limits disclosures concerning any arbitration while the case is pending. Although it is common to forbid the parties to the arbitration to disclose either the fact or subject matter of the arbitration, that language can create serious problems for a manager.

First, it generally is necessary to disclose any dispute involving the payment of legal fees to the auditor of the relevant entity, so at a minimum, the auditor should be permitted to receive information about any arbitration. In addition, a manager likely must be free to discuss an arbitration case involving itself or the fund with the fund's independent directors and perhaps other third parties, such as regulators.

Also, perhaps less obviously, it may be necessary for a manager to be able to communicate with existing, and perhaps even potential, investors about an arbitration case involving a fund or its manager. Among other things, many due diligence questionnaires ask for information about the existence and nature of such disputes, and a refusal to respond or a response of "no comment" is likely to raise serious concerns, perhaps unnecessarily. For that reason, a manager should consider carving out communications with directors, investors (both prospective and current), regulators and perhaps others from any confidentiality restrictions that may be applicable to arbitration.

For an enforcement action involving misleading disclosure of an arbitration award, see "SEC Sanctions Adviser for Registration, Disclosure and Compliance Violations and Bars Its Inexperienced CCO" (Oct. 28, 2021).

Finality

Arbitration awards usually cannot be appealed to the arbitral forum itself, except to correct clerical, typographical or computational errors. An arbitration award can be appealed to a court, but a court will not disturb an award unless a party meets certain very demanding requirements. For example, under the Federal Arbitration Act, a federal district court is permitted to vacate an arbitration award only in the event of specified circumstances, including:

- fraud;
- "evident partiality or corruption in the arbitrators"; or
- "misbehavior [by the arbitrator(s)] by which the rights of any party have been prejudiced."

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In addition to those and other similar statutory bases, a court also may vacate an arbitration award based on "manifest disregard of the law" by the arbitrator(s), which is a notoriously difficult standard to meet. For those reasons, arbitration generally is viewed as providing for a more "final" decision. Even those challenging limitations, however, may not discourage a losing party from appealing an award when a sufficiently large sum or otherwise problematic outcome is at stake. And as with other perceived advantages of arbitration, whether that finality is advantageous depends on one's perspective.

Key Elements of an Arbitration Provision

A contractual arbitration provision may cover a variety of matters. Arbitration provisions generally are very strictly enforced as written, and a manager therefore should be prepared to abide by any arbitration provision included in the documents of the manager or any of its funds.

Forum Choice

Perhaps the first and most important provision is the choice of arbitral forum. Some arbitral forums that are commonly specified in fund documents include the American Arbitration Association (AAA), JAMS and P.R.I.M.E. Finance.

When choosing a forum, it is helpful to:

- consider the types of disputes that might be expected to be brought under the relevant arbitration provision, including whether the disputes most likely to materialize will require specialized knowledge or expertise;
- research the backgrounds of the arbitrators a forum offers to determine whether they will be suitable for the most likely disputes;
- determine whether the forum conducts arbitrations, and there are qualified arbitrators available, in potentially relevant geographic locations;
- review the arbitral forum's fee schedules to estimate likely costs; and
- review the forum's other procedural rules to assess whether any of them may be problematic or require adaptation in the arbitration provision.

Importantly, some arbitral forums have multiple sets of rules for different types of disputes and proceedings, and those may be updated periodically. For example, the AAA currently has seven sets of rules for everything from commercial disputes to construction industry matters, some of which, in turn, have additional subrules. Thus, it is important to specify the particular forum rules (and, where applicable, subrules) that will be used, including the version of the rules. Most arbitral forums also offer model contract provisions that may be used to select their forum.

See "Second Circuit Rules That Contract Dispute Between Hedge Fund Manager and its Placement Agent Over Proper Arbitration Venue Does Not Permit Federal Intervention" (Oct. 7, 2009).

Other Matters

Although in many instances an arbitral forum's rules and procedures can be used "as is," that should be done on a fully informed basis after reviewing those rules as noted above and considering whether it is necessary and appropriate to tailor them to the types of

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disputes that may arise through the relevant arbitration provision. There are multiple options for each of the matters that may be covered by an arbitration provision; no one set of terms is yet industry standard. Terms should be chosen carefully because they are likely to be enforced strictly and may significantly impact the outcome of disputes that are arbitrated.

Among the matters that may be addressed or customized in a contractual arbitration provision are the following:

- what disputes may be arbitrated;
- which parties may invoke arbitration;
- whether there will be a requirement for informal negotiation or mediation before arbitration may be commenced (including timeframes);
- how many arbitrators will be selected (usually one or three);
- what the arbitrators' qualifications or characteristics must or should be;
- how arbitrators will be chosen;
- where the arbitrators will be located;
- where the arbitration hearing will be conducted;
- what substantive law will apply to the arbitration;
- whether any limits will be imposed on the arbitrators' authority, including what matters they may (or may not) decide or the types of remedies or damages they may (or may not) award;
- what matters may be litigated in court notwithstanding the arbitration provision;
- what the scope and limits of discovery are, including documents, depositions and interrogatories;
- whether the parties may opt for expedited or abbreviated proceedings or mediation;
- whether the arbitrators will issue a written statement of the reasons for their decision;
- what the time limits to bring or complete the arbitration are;
- what the rights of and grounds for appeal are, including any requirement that an appealing party must post a bond;
- whether there is any fee-shifting, including of arbitration fees, legal fees and disbursements; and
- what the scope of confidentiality is.

For more on arbitration clauses, see "HFLR Program Looks at Recent Developments and Trends in Employment Law Relevant to Fund Managers" (Jul. 26, 2018); and "Ten Key Policies Fund Managers Should Include in Their Employee Handbooks (Part Two of Three)" (May 17, 2018).

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