Outsourcing
by Advisers and Affiliated Service Providers

Liability and Insurance Considerations
Introduction

In recent years, it has become more common for mutual fund investment advisers and other major service providers affiliated with funds (collectively, “Advisers”) to subcontract specialized functions to unaffiliated third-party vendors (“Agents”). As operations and associated technology in the fund industry grow more complex, such outsourcing can increase efficiencies, reduce operational risk, and generate savings for both Advisers and their funds. Indeed, separate and apart from any financial savings, it may arguably be more prudent for an Adviser, in appropriate cases, to outsource certain functions to an Agent with relevant expertise and experience than for the Adviser to continue to perform the functions in-house.

At the same time, however, outsourcing creates unique operational risks that have received increasing attention from industry regulators and other observers. Moreover, when an operations-based loss arising from an outsourced function (“Outsource Loss”) occurs, there may be uncertainty as to (1) when an Adviser may be held financially responsible to the fund, and (2) the availability of directors and officers/errors and omissions (“D&O/E&O”) liability insurance coverage for the Adviser with respect to such loss.

This report is intended to assist Advisers in evaluating liability and D&O/E&O insurance concerns associated with outsourcing. Although designed primarily for legal personnel and risk managers, this report may also be of interest to senior management. Part I identifies and discusses considerations that may be relevant to analyzing Advisers’ financial responsibility for Outsource Losses. Part II describes when insurance coverage may be available to an Adviser for an Outsource Loss, with particular attention to the potential for insurance coverage in the absence of litigation against the Adviser by a fund or fund shareholders.

This report is not intended to—and does not—recommend any single structure or set of “best practices” for addressing risks associated with Outsource Losses. Given the diversity of the investment management industry, it is not practical or advisable to seek a one-size-fits-all approach to managing risks in this area. Moreover, nothing in this report should be considered legal advice; rather, Advisers should look to their counsel for such advice.

Advisers’ Responsibility for Outsource Losses

Among the considerations that may be relevant in analyzing whether an Adviser has financial responsibility for a particular Outsource Loss are the following:

1. Impact of Federal Securities Laws and Regulations. Of course, as the investment management industry is heavily regulated, it is always necessary to consider the potential impact of federal securities laws and regulations. For example, statutory provisions and regulatory guidance may in some cases affect the scope of permissible delegation by an Adviser to an Agent, and limit an Adviser’s ability to reduce its liability exposure.

2. The Applicable Standard of Care. Although the Investment Advisers Act does not impose a specific duty of care, an Adviser’s contract with the fund ordinarily does, such that the Adviser is not liable for an operational error unless it has violated that standard. The standard of care may be expressly stated (e.g., specify a standard of ordinary “negligence”) and/or be implied by a clause providing some degree of exculpation in favor of the Adviser (e.g., excuse the Adviser from liability for ordinary negligence).
3. The Adviser’s Conduct with Respect to the Delegation. General fiduciary principles can be instructive in assessing whether an Adviser’s conduct has satisfied the applicable standard of care, inasmuch as (1) certain Advisers are considered fiduciaries under applicable law and (2) adherence to such principles would in any event be indicative of a high standard of conduct. Under those principles, the question of an Adviser’s liability for an Outsource Loss is not whether the Adviser delegated, but rather whether it did so with requisite care, skill, and caution. Relevant considerations in this regard may include the Adviser’s process for selection of the Agent, the negotiation and establishment of the terms of the delegation, and the monitoring of the Agent’s performance. Where the Adviser has satisfied its standard of care, then modern fiduciary principles would place liability for the Outsource Loss not on the Adviser but rather on the Agent.

4. Relevant Contractual Provisions. In addition to specifying the Adviser’s applicable standard of care, other provisions in the Adviser’s contract with a fund may likewise bear on the Adviser’s financial responsibility for an Outsource Loss. For example, the contract may or may not (1) expressly assign responsibility to the Adviser for the outsourced function, (2) permit the delegation at issue, and/or (3) expressly assign the risk of Outsource Losses. Similarly, the Adviser’s subcontract with the Agent, in turn, may or may not (1) contain some degree of exculpation in favor of the Agent for the Agent’s own lack of prudence, and/or (2) “cap” the Agent’s potential liability.

Quite apart from these legal considerations, an Adviser may face a number of business and/or reputational pressures to assume financial responsibility for an Outsource Loss. For example, an Adviser’s business interest in maintaining goodwill with a fund board may encourage the Adviser to accept financial responsibility. Indeed, some fund boards may be inclined to view their Advisers as virtual guarantors of operational losses impacting their funds, notwithstanding the applicable standard of care. As a result, Advisers may sometimes agree to compensate funds even when the Advisers are not legally at fault (or, similarly, may agree to make payments in excess of the amounts for which the Advisers may otherwise be legally responsible).

Insurance Coverage for Outsource Losses

Most D&O/E&O insurance policies are “claims made” policies, meaning that potential coverage is triggered by the filing of a lawsuit or other “claim” against the insured during the policy period. Accordingly, if a disagreement over financial responsibility for a particular Outsource Loss leads to an actual lawsuit being filed against an Adviser, insurance coverage for the Adviser may be available under the Adviser’s D&O/E&O policy. Depending on the facts and circumstances involved, and on the particular terms and conditions of the policy, the Adviser may have coverage for its costs of defending the lawsuit, and for any judgment (or reasonable settlement) for which it may ultimately be responsible.

As a practical matter, however, most disagreements between Advisers and funds over financial responsibility for particular Outsource Losses are likely to be resolved without litigation, through a process of negotiation between the particular Adviser and the board of the affected fund(s). In the absence of actual litigation being brought against an Adviser, the issue of whether insurance coverage is available to the Adviser for an Outsource Loss will typically depend, in the first instance, on whether the Adviser has “costs-of-correction” or analogous coverage under its D&O/E&O insurance policy. Such costs-of-correction coverage is standard in ICI Mutual’s...
D&amp;O/E&amp;O policy ("ICIM Policy"), but is not always available from commercial insurers.

Under the costs-of-correction insuring agreement in the ICIM Policy, an insured Adviser18 may generally seek recovery for a payment made to correct an operational loss where the Adviser has actual legal liability for the loss. However, the insuring agreement does not provide for recovery for any payment—or for such portion of any payment—that is made by the Adviser as a business accommodation, to avoid reputational damage, or for any other reason apart from its own actual legal liability.

In the context of Outsource Losses, it follows that coverage under the ICIM Policy is intended to respond only to the actual legal liabilities of insured Advisers themselves, and not to the legal liabilities of Agents. Thus, cost-of-corrections coverage could potentially be available where the Adviser itself has actual legal liability for the Outsource Loss (e.g., by reason of the Adviser having itself breached the applicable standard of care with respect to the Adviser’s delegation of the outsourced function to the Agent). Conversely, costs-of-correction coverage would generally not be available to an Adviser for an Agent’s mistake.19

Endnotes

1 For ease of reference, this report uses the term “Adviser” to refer to both a fund investment adviser and any other affiliated fund service providers (e.g., an affiliated administrator, an affiliated transfer agent). Thus, notwithstanding the convenience of the term “Adviser,” this report’s discussion applies to both contexts.

2 As used in this report, “outsourcing” focuses on the subcontracting of specialized functions by Advisers to Agents (e.g., fund accounting, class action settlement processing), rather than on funds’ own direct contracts with unaffiliated service providers or third-party vendors (e.g., custodians). This second type of “outsourcing” raises distinct issues and is outside the scope of this report.

3 Cf. Restatement (Third) of Trusts § 80 cmt. d(1) (Tentative Draft No. 4, 2005) (“A trustee’s discretionary authority in matters of delegation may be abused by imprudent failure to delegate . . . .”). Restatements are influential treatises published by the American Law Institute, each of which describes the law in a given area and guides its development.

increasingly contracted to third parties, gaps are created within the operational process and perfect coordination becomes more difficult.”); Thorough Vendor Reviews Are Key, Says Panel, FUND ACTION, June 11, 2007, at 7, 7 (reporting panel’s view that onsite review of service providers “greatly reduces the risk of outsourcing”). The banking industry has likewise demonstrated concern in this area. See generally Oliver Prior, Risk and Insurance Considerations in Outsourcing Banking and Related Financial Services, in OUTSOURCING AND HUMAN RESOURCE MANAGEMENT 106, 106 (Ruth Taplin ed., 2008) (“The Basel Committee on Banking Supervision . . . has focused on the increased use of outsourcing and cited this as one example of the need to introduce a new capital charge for operational risk event losses.”).

Section 205(a)(2) of the Investment Advisers Act generally makes it unlawful for investment advisers to enter into or perform any investment advisory contract unless the contract provides that no assignment of the contract shall be made by the adviser without the consent of the client. 15 U.S.C.S. § 80b-5(a)(2) (LexisNexis, LEXIS through Pub. L. No. 110-26). Similarly, section 15(a)(4) and section 15(b)(2) of the Investment Company Act make it unlawful for any person to serve as an investment adviser or principal underwriter, respectively, to a registered investment company except pursuant to a written contract that provides for its automatic termination in the event of its assignment. 15 U.S.C.S. § 80a-15(a)(4), (b)(2).

Section 17(i) of the Investment Company Act prohibits contracts of registered investment companies from containing provisions protecting investment advisers and principal underwriters against liability to the companies and their shareholders “by reason of willful misfeasance, bad faith, . . . gross negligence, . . . or . . . reckless disregard” in the course of their duties. 15 U.S.C.S. § 80a-17(i).


Under a contract specifying a “negligence” standard of care, for example, an Adviser is liable for an operations-based loss only where the Adviser has been negligent (i.e., failed to use ordinary care).

Under this example, an Adviser would be liable for an operations-based loss only where the Adviser has been grossly negligent or worse; the Adviser in this example would not be liable for ordinary negligence.


Thus, while it is not certain that common-law fiduciary principles necessarily constitute binding authority in the context of the investment management industry, such principles are clearly instructive. For example, in holding that the SEC could require investment advisers to disclose to their clients a practice known as “scalping” (whereby an adviser deals in recommended securities just before and after the issuance of its recommendations), the
U.S. Supreme Court relied in part on the content of common-law fiduciary duty. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) ("Nor is it necessary in a suit against a fiduciary, which Congress recognized the investment adviser to be, to establish all the elements required in a suit against a party to an arm's-length transaction. Courts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients.") (footnotes omitted).

12 Outsourcing by fiduciaries is entirely consistent with modern trust principles, under which prudent delegation of fiduciary authority is permissible. See generally RESTATEMENT, supra note 3, § 80 cmt. e ("A delegation of fiduciary authority is proper when it is prudently arranged and is reasonably intended to further sound administration of the trust."). National banks, for example, have express authority to delegate fiduciary functions. 12 C.F.R. § 9.4(c) (2007) ("Pursuant to a written agreement, a national bank exercising fiduciary powers . . . may purchase services related to the exercise of fiduciary powers from another bank or entity.").

13 Informal consultation with outside counsel to fund groups and ICI Mutual's own review of a sample of service contracts suggests that there may exist an array of practices in the industry with regard to outsourcing. For example, it is not clear to what extent, if any, common practices may have emerged among Advisers with regard to (1) review of the financial soundness of prospective Agents, (2) assessment of whether prospective Agents carry appropriate limits of liability insurance for their professional services, and (3) the scope of any exculpatory clauses in favor of Agents. To the extent that there exists an industry "custom" in any of these regards, such custom may be a factor to be taken into account in determining whether an Adviser's conduct satisfied the standard of care required by fiduciary principles or contractual provisions. See RESTATEMENT (SECOND) TORTS § 295A (1965) cmt. b ("Any such custom of the community in general, or of other persons under like circumstances, is always a factor to be taken into account in determining whether the actor has been negligent."). Another relevant consideration may be whether the Adviser received the fund's consent to the Agent's selection. See RESTATEMENT (SECOND) TRUSTS § 216(1) (1959) (providing, subject to certain exceptions, that "a beneficiary cannot hold the trustee liable for an act or omission of the trustee as a breach of trust if the beneficiary prior to or at the time of the act or omission consented to it").

14 Although common-law rules may have varied from state to state, or may have been unclear, the modern view is that a fiduciary is not liable to beneficiaries for actions of an agent so long as the fiduciary delegated prudently. See, e.g., Livick v. Gillette Co., 492 F. Supp. 2d 1, 9 (D. Mass. 2007) ("Unless the named [ERISA] fiduciary was itself negligent, a named fiduciary is not liable for the breaches of one to whom power is delegated.") (citing 29 U.S.C. § 1105(c)(2)); In re Mushroom Transp. Co., 366 B.R. 414, 455 (Bankr. E.D. Pa. 2007) ("[U]nder state law, a fiduciary may not be liable for the improper acts of an agent attorney."); UNIF. TRUST CODE § 807(c) (amended 2005) ("A trustee who complies [with specified duties regarding delegation] is not liable to the beneficiaries or to the trust for an action of the agent to whom the function was delegated."); UNIF. PRUDENT INVESTOR ACT § 9(e) (1995) (same);
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RESTATEMENT, supra note 3, § 80 cmt. g (“A trustee who acts with prudence . . . is not personally liable to the trust or its beneficiaries for the decisions or actions of the agent to whom the function was delegated.”).

15 See generally RESTATEMENT, supra note 3, § 80 cmt. g (“[T]he agent has a duty to the trust and its beneficiaries to act with reasonable care . . . in performing a delegated function and in complying with the instructions and other provisions in the terms of the delegation, with potential liability for breach of duty.”).

16 See generally Nat’l Union Fire Ins. Co. v. Willis, 139 F. Supp. 2d 827, 832 (S.D. Tex. 2001) (“Under claims made policies, the mere fact that an ‘act, error, or omission’ occurs during the policy period is not sufficient to trigger insurance coverage. Instead, in order to invoke coverage under such policies, a claim must be made against the insured during the policy period . . . .”) (citation omitted).

17 Under such coverage, insurance may potentially be available for costs incurred by an insured entity to correct certain situations even in the absence of a lawsuit or other “claim” (typically subject to the insured obtaining advance consent from the insurer before incurring the costs).

18 ICI Mutual, of course, does not insure Agents or any other service providers that are unaffiliated with ICI Mutual-insured funds.

19 This result—no coverage for an Outsource Loss where, notwithstanding the Agent’s mistake, the Adviser adhered to the relevant standard of care to which the Adviser itself is subject—is underscored by an exclusion in the ICIM Policy for claims “[a]rising out of . . . any provision of any agreement under which the [Adviser] . . . assumes the liability of any party [e.g., the Agent].” Such exclusions are common in D&O/E&O policies and are consistent with general principles of insurance. See generally 23 APPLEMAN ON INSURANCE 2d § 146.6, at 120-21 (Eric Mills Holmes ed., 2003) (“Professional liability policies often contain an exclusion for ‘any ‘claim’ arising out of a breach of contract, or out of liability assumed under any contract or agreement.’ Even in the absence of an express exclusion, courts have held that a claim alleging breach of contract is not covered under a professional liability policy because there is no ‘wrongful act’ and no ‘loss’ since the insured is simply being required to pay an amount it agreed to pay.”) (footnote omitted).
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