Sovereign Immunity Implications for Investment Advisers

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Investment advisers seeking to advise government entities (or funds in which such entities invest) must take into consideration the potential applicability of "sovereign immunity" doctrines. Foreign states and states and localities in the United States may be protected under sovereign immunity doctrines from suits and enforcement of judgments. Investment advisers should carefully structure advisory agreements and fund investor agreements to account for such protections.

Sovereign immunity is a legal doctrine by which government entities are not subject to the jurisdiction of courts or the enforcement of the orders of such courts. The doctrine can apply to many different categories of investors or clients, which include (but are not limited to): U.S. state governments and foreign governments, sovereign wealth funds, U.S. state and foreign government pension plans, and agencies of U.S. state and foreign governments. In the U.S., governmental entities at the federal, state and tribal level generally have the benefit of sovereign immunity from lawsuits under the Eleventh Amendment to the U.S. Constitution. Foreign states and state entities enjoy sovereign immunity under the Foreign Sovereign Immunities Act of 1976 ("FSIA"), subject to limits and exceptions set forth in FSIA. Specifically, FSIA contains an exception to sovereign immunity for foreign governmental entities engaging in "commercial activity".

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1. Sovereign Immunity for U.S. States

U.S. states and state agencies enjoy sovereign immunity pursuant to the Eleventh Amendment of the U.S. Constitution. The Eleventh Amendment provides immunity from both suit (*i.e.*, immunity from jurisdiction) and enforcement (*i.e.,* immunity from collection of a judgment), subject to certain exceptions. The Eleventh Amendment does not contain an exception to sovereign immunity for "commercial activity". Therefore, the fact that the litigation at issue arises from the state entity's activities in a commercial context does not create a waiver of the state's rights to sovereign immunity under the Eleventh Amendment.

States must expressly and voluntarily consent to any waiver of immunity in order for courts to recognize that such a waiver exists. Federal courts have recognized that a "constructive waiver" of immunity exists when states take certain actions in litigation, such as bring a claim in federal court against another party, but the precedent in this area is mixed and any arguments relating to a constructive waiver of sovereign immunity will often turn on whether an explicit waiver of jurisdiction exists and whether the state entity that provided such waiver was authorized under state law to make such a waiver.

To the extent that an investment adviser advises a state entity or a fund in which a state entity invests, that investment adviser will have difficulty enforcing provisions of the applicable advisory agreements or other governing documents absent a waiver of sovereign immunity. Absent such a waiver, the applicable state entity could claim sovereign immunity in the event of a suit brought by the adviser. In addition, in the event that the state entity were to bring a suit against the adviser, it is possible that the lack of a waiver of sovereign immunity could limit the adviser's ability to bring counterclaims against the state entity in the course of such litigation.

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2. Sovereign Immunity for Foreign Governments

FSIA sets forth the circumstances under which a foreign governmental entity is immune from a suit in the U.S. and execution of a judgment on the foreign governmental entity's assets located in the U.S. A foreign state is immune from suit in the U.S. unless certain exceptions apply. Several relevant exceptions include:

- waiver of the foreign state's immunity,
- action is based on commercial activity carried on or performed in the U.S. by the foreign state (including activities conducted outside the U.S. that cause a direct effect in the U.S.), and
- action to enforce an agreement to submit to arbitration.

Under FSIA, a "foreign state" includes "a political subdivision of a foreign state or an agency or instrumentality of a foreign state", which includes:

- any entity that is a separate legal person, corporate or otherwise, and
- which is an organ of a foreign state or political subdivision thereof, or a majority of whose shares or other ownership interest is owned by a foreign state or political subdivision thereof, and
- which is neither a citizen of a state of the United States, nor created under the laws of a third country.

In practice, sovereign wealth funds generally meet the requirements to be classified as an "agency or instrumentality of a foreign state". A recent decision by the U.S. Court of Appeals for the Second Circuit held that a sovereign wealth fund was liable for securities fraud committed against a Panama-based investment fund because the sovereign wealth fund's activities had a sufficient U.S. nexus. *Atlantica Holdings, Inc. v. Sovereign Wealth Fund Samruk-Kazyna JSC,* 813 F.3d 98 (2d Cir. 2016).

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The property of a foreign state (not including the foreign state's agencies or instrumentalities) is generally subject to attachment in aid of execution, or from execution of a judgment in federal or state court if the property "is or was used for the commercial activity upon which the claim is based". The property of a foreign state's agencies or instrumentalities is generally subject to attachment in aid of execution, or from execution of a judgment in federal or state court, if the applicable agency or instrumentality is generally engaged in commercial activity, regardless of whether the specific property is or was used for the commercial activity upon which the claim is based.

Litigating a claim that the foreign state entity is engaged in commercial activity could be costly, risks publicizing a dispute with a client or investor, and may not result in a favorable disposition. Although the "commercial activity" exception to foreign state sovereign immunity under FSIA will often cover a sovereign wealth fund, the case law is well settled and as a result, obtaining a waiver of immunity from the prospective client or investor that is a foreign state entity is the preferable approach. In the next section, we address situations where such a waiver is not available.

3. Practical Considerations Arising From Sovereign Immunity

There are several considerations that investment advisers must take into account when entering into advisory relationships with U.S. state entities and foreign state entities (collectively, "Governmental Entities").

Governmental Entities frequently refuse to waive their rights under sovereign immunity in the investment advisory context. Governmental Entities may (and often do) seek to insert provisions into the applicable agreements with either the adviser, its affiliates or the fund that the Governmental Entity is investing in, stating that the adviser acknowledges that the Governmental Entity reserves all defenses, immunities, actions or rights that the Governmental Entity is entitled to (including those arising out of the Governmental Entity's ability to claim sovereign immunity) (such provision, an "Immunity Reservation Provision").

As discussed above, the lack of a waiver of sovereign immunity significantly hinders an investment adviser's ability to enforce its rights under its agreements with the Governmental Entity. An important consideration in addressing the lack of a waiver of sovereign immunity is potential causes of action an adviser may have against its client or a fund investor. While there are various potential causes of action that an adviser or its affiliates may bring against a client or fund investor, the most likely causes of action will be for (i) nonpayment of fees (typically only if these fees are billed and paid in arrears as opposed to deducted from client accounts), (ii) failure to comply with the client/fund investor's obligations under its agreement (*e.g.,* failure to fund capital calls pursuant to a subscription agreement for a private equity fund), (iii) breach of confidentiality provisions, (iv) misrepresentations in advisory or subscription agreements and (v) failure

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to indemnify the adviser, its affiliates, or the funds it advises pursuant to relevant provisions of the advisory or subscription agreements.

In the absence of a waiver of sovereign immunity, advisers should take steps to lessen the risk associated with advising a client or onboarding a fund investor that has the benefit of sovereign immunity. One step to lower risk is to not enter into a separately managed account arrangement with a Governmental Entity, but rather establish the relationship as a single-investor fund that the adviser controls. This approach generally allows the adviser to deduct its fees directly from the investor's capital account, which lowers the risk of non-payment from an arrangement where the Governmental Entity is billed in arrears (which is typical for a separately managed account arrangement where the adviser does not have custody over the client's assets).

Another step to lower the risk is to include language in the Immunity Reservation Provision referenced above that expressly states that such reservations do not reduce or modify the adviser's or the adviser's funds' or affiliates' (as applicable) rights to enforce the terms of the agreement. This lowers the risk associated with the potential failure to fund capital commitments or indemnify the adviser, its affiliates, or the funds it advises, although such risk is not wholly eliminated.

Governmental Entities will frequently seek to specify that the venue and/or governing law for all disputes relating to an advisory agreement (or other governing agreements to which the state entity is a party) is the Governmental Entity's "home" jurisdiction. This may create an advantage in litigation for the Governmental Entity and create challenges for an adviser seeking to litigate a claim under the applicable agreement (*e.g.,* engaging in litigation in a remote venue may create logistical difficulties or increased costs). Advisers typically prefer to have governing documents and advisory agreements governed under either New York or Delaware law and to specify that the venue for any disputes under such agreements is the adviser's home jurisdiction. To the extent that a Governmental Entity will not agree to these terms, advisers should seek to limit the provisions governed by the Governmental Entity's home jurisdiction and to limit venue in the Governmental Entity's home jurisdiction to suits against the investor (with a more neutral venue for suits against the investment adviser or any of its funds or affiliates).

Governmental Entities may state in negotiations that they do not have the authority to indemnify the adviser, any funds in which the Governmental Entities invest, or any of the adviser's affiliates (or that the Governmental Entity has no obligation to pay any indemnification amount). As a result, advisers should include provisions in applicable advisory or fund investor agreements stating that the Governmental Entity's accounts will bear indemnification obligations and that the adviser and/or a fund or affiliate (as applicable) has the right to bring claims against the Governmental Entity for breach of any warranties, covenants, representations, or other obligations in under the governing agreements.

Governmental Entities may be subject to public disclosure requirements (*e.g.,* FOIA, state "sunshine" laws, non-U.S. public disclosure laws) that do not allow such entities to observe the normal confidentiality obligations that non-governmental clients or investors would be expected to observe. Advisers can lower the risk associated with public disclosure by (i) specifying in advisory agreements that a Governmental Entity is only able to disclose information as legally required, (ii) delineating categories of information that the Governmental Entity may disclose, and/or (iii) requiring that the Governmental Entity notify the adviser prior to making any public disclosures.

Conclusion

Governmental Entities constitute a significant and increasing segment of clients and fund investors seeking advisory services from U.S. investment advisers. As a result, issues relating to sovereign immunity represent an increasingly important part of negotiations between advisers and their prospective clients and investors. Advisers who do not pay attention to these issues do so at their peril because the failure to obtain the appropriate contractual provisions to lessen the risks to the adviser, its affiliates and any funds it advises could hamper the adviser's ability to enforce its rights under an advisory agreement or other agreement should the need arise.

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