PRIVATE FUND DISPUTE RESOLUTION

A practical guide to managing and reducing litigation risk at the fund, investor and portfolio-company level

Edited by
Hilton Mervis, King & Wood Mallesons LLP

14 Disputes involving the United States (Delaware)

By Ellisa Opstbaum Habbart and Elizabeth M. Bennett, The Delaware Counsel Group, LLP

Introduction

The unique character of the US state of Delaware can be illustrated by a few simple figures. As of the 2010 Census, performed by the federal government, the population of Delaware was roughly 900,000. In March 2013, the Delaware Secretary of State announced a significant milestone - on that day, there were one million active legal entities domiciled in the state.

The king of the business entity is, of course, the publicly traded corporation, and Delaware is home to more than half of all such corporations in the United States, as well as 64 percent of the Fortune 500. The bulk of the businesses formed in Delaware, however, are highly flexible alternative entities: general partnerships, limited partnerships, limited liability companies and statutory business trusts. Any private fund (private equity and hedge funds, for example) domiciled in Delaware is likely to be one of these entities.

The main reasons Delaware is home to more business entities than people are the reliability of the law and the high quality of the judiciary, as this chapter highlights.

Hallmarks of Delaware

The hallmarks of Delaware law are flexibility, responsiveness and predictability, underpinned by a strong belief in the legal principle of private ordering. This principle holds that business people should be as free as possible to make decisions because this fosters competition, innovation and prosperity.

The Delaware statutes that govern corporations and alternative entities are designed to impose as little regulation as possible. For example, the acts that govern alternative entities allow such entities to expand, restrict or eliminate the fiduciary duties of the parties bound by the partnership or operating agreement. The exception is the 'implied contractual covenant of good faith and fair dealing,'[1] which cannot be eliminated.

Private equity funds or hedge funds are most commonly structured as limited partnerships or limited liability companies. These entity types afford an enormous amount of flexibility to structure a fund by contract, according to the needs of the investors. They also offer protection from liability. A common model is to structure the fund as a limited partnership, with the investors as limited partners (LPs) holding interests and

[1] 6 Delaware Code (Del C.) 17 § 1101(d); 6 Del C. 18 § 1101(e).

another entity serving as general partner (GP).[2] The management team, in turn, holds an interest in the GP. This structure eliminates entity-level tax while protecting the investors in the fund from personal liability.[3] An LP is not liable for the obligations of the entity unless it is also a GP or participates in the control of the business.[4] The GP may be liable, however.[5]

Many of the benefits of a limited partnership are also found in the limited liability company structure, and neither the manager nor the members of a limited liability company are exposed to liability. In fact, except for violations of the implied contractual covenant of good faith and fair dealing,

> *the debts, obligations and liabilities of a limited liability company, whether arising in contract, tort or otherwise, shall be solely the debts, obligations and liabilities of the limited liability company, and no member or manager of a limited liability company shall be obligated personally for any such debt, obligation or liability of the limited liability company solely by reason of being a member or acting as a manager of the limited liability company.*[6]

Limited liability companies have been the most popular entity type in Delaware in recent years. According to the latest available Annual Report from the state's Division of Corporations, limited liability company formation increased by nearly 10.8 percent from 2011 to 2012, while new entity formation grew by 8.9 percent overall. Limited partnerships and limited liability partnerships grew almost as much, however. Their numbers increased by slightly more than 10 percent.

In addition to flexibility and protection from liability, the statutes that govern alternative entities in Delaware undergo a process of constant improvement. The stewards of the law in Delaware know what is at stake. Not only does Delaware play an important role in the global economy, a full third of the state's operating budget is generated through business formation activity in some fashion, whether it is the payment of corporate franchise taxes or the provision of registered agent services or legal services.

Frontline responsibility for revisions to the law lies with Council of the Corporation Law Section of the Delaware State Bar Association. The Council consists of Delaware attorneys whose knowledge of business law has been honed through years of daily interactions with their clients. As a result, they know what is effective in a statute and what needs to be improved. The members consult with each other and make recommendations to the state legislature to ensure that the statutes are updated every year to better serve the businesses that use them.

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[2] Persaud, Amanda N. and Atkinson, Adrienne, 'Private Equity Funds: Legal Analysis of Structural, ERISA, Securities and Other Regulatory Issues', *Investment Advisor Regulations*, 3 ed., Practising Law Institute, 2012, p47–4.

[3] *Id.*

[4] 6 Del C. 17 § 303 (a).

[5] 6 Del C. 17 § 403; 6 Del C. 15 § 306.

[6] 6 Del C. 18 § 303 (a).

Because state legislators can be confident that the new provisions have been carefully considered, they are often transformed into law. Citizens also have their part to play. They know they benefit from the widespread acceptance of their state's corporation and alternative entity law and they support the efforts of their legislators.

Predictability

The force behind the predictability of Delaware law, which is so beloved in business circles, is the Delaware judiciary. The judges produce an enormous body of case law set forth in detailed court opinions from the Delaware Supreme Court and the Court of Chancery, which is Delaware's specialised business court. This latter court is deeply engaged with the business and legal communities:

> *The Court's work is subject to analysis, review, and discussion in a wide range of scholarly and professional publications and blogs. Moreover, members of the Court have a long tradition of authoring and responding to scholarly articles on corporate law subjects. As [former Chief Justice Myron T. Steele of the Delaware Supreme Court] observed, Chancery judges "use ... speeches and articles to signal the evolutionary direction of Court of Chancery ... jurisprudence" in an effort to increase predictability in adjudication.*[7]

This process of careful explication of legal reasoning has refined the law and heightened understanding among practitioners.

Speed and expertise

All business people accept that disputes are inevitable and litigation is sometimes unavoidable, and many would rather come before a Delaware judge if and when they are drawn into court.

In addition to specialisation, the Court of Chancery has had the chance to develop expertise though its longevity, insofar as an American court is concerned. The Court of Chancery has operated since 1792. The state's Second Constitution states:

> *the equity jurisdiction heretofore exercised by the Judges of the Court of Common Pleas, shall be separated from the common law jurisdiction, and vested in a Chancellor, who shall hold Courts of Chancery in the several counties of this State.*[8]

Given the Court of Chancery is a court of equity, there are no juries and therefore none of their vagaries in decision-making. In addition, the court is freed from handling criminal and tort cases, matters that can create huge backlogs in other judicial systems. The Court of Chancery is therefore able to process corporate litigation quickly and effectively. As noted by one law professor:

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[7] Savitt, William, 'The Genius of the Modern Chancery System' in *Colum. Bus. L. Rev.* 570, 592 (2012) *(footnotes omitted).*

[8] Quillen, William T. and Hanrahan, Michael, 'A short history of the Delaware Court of Chancery' at: http://courts.delaware.gov/chancery/history.stm

> *The frequency with which they face such cases provides a strong incentive for Delaware's chancellors to master both doctrine and the business environment in which the doctrine works. In particular, there is a strong reputational incentive for doing so. Sitting without juries in a court of equity, Delaware chancellors put their reputation on the line whenever they make a decision. Because so many major corporations are incorporated in Delaware, Chancery Court cases are often high profile and the court's decisions therefore are subject to close scrutiny by the media, academics, and practitioners. The reputation of a Delaware chancellor thus depends on his or her ability to decide corporate law disputes quickly and carefully.*[9]

Moreover, to protect the integrity of the courts, all judges in Delaware are appointed rather than elected. The governor of the state carefully selects candidates from a list developed by the Judicial Nominating Commission, which includes the same kind of experienced attorneys who work to maintain the quality of Delaware statutes. The governor's choice is confirmed by the State Senate and political balance on the courts is dictated by the State Constitution.[10] This means that membership of the judges in one or the other of the two major American political parties is divided as evenly as possible in each court and throughout the judiciary as a whole. For example, the state Constitution dictates that three of the justices on the Delaware Supreme Court shall be from one major party, and two from the other.

The judges of the Court of Chancery and the Delaware Supreme Court (which hears appeals from the Court of Chancery) also understand how important the quick resolution of disputes is to businesses, whether they are private funds or multinational corporations. They know how important the quick resolution of disputes is to the financial wellbeing of their state.

The Delaware Supreme Court is so mindful of the need for expedient decisions it will often announce a decision quickly and follow up with a written decision later. The judges know that their decisions move markets. For example, the high court issued its recent reversal of the Court of Chancery's decision in *Activision Blizzard Inc. v. Hayes* only about one hour after it heard oral arguments.[11] The October 10, 2013, ruling removed all impediments to two transactions in which Activision was to buy back $8.2 billion of its stock from Vivendi, a majority of Vivendi's 61 percent stake.[12]

Litigation

Litigation is commenced in the Court of Chancery by filing a complaint.[13]

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[9] Bainbridge, Stephen M., 'The Business Judgment Rule as Abstention Doctrine', in *57 Vand. L. Rev.* 83, 120-21 (2004) *(footnotes omitted)*.

[10] Del. Const. Art. IV § 3.

[11] Mordock, Jeff, 'Speed of Activision Decision Not Unusual, Experts Say', in *Delaware Business Court Insider*, October 16, 2013 at: www.delbizcourt.com.

[12] Davidoff, Steven M. and de la Merced, Michael J., 'Delaware Court Lifts Injunction on Activision Blizzard's Deal With Vivendi' in *New York Times*, October 10, 2013, Web ed.

[13] Court of Chancery Rule 3.

Access to information

Generally, in American Courts, complaints are public documents, as are all other court filings. Parties may request, however, that the Court permit documents to be filed confidentially and thus unavailable to the public.[14] Such requests will be granted only for "good cause" and "only if and to the extent" that a document contains confidential information.[15] Good cause exists *"only if the public interest in access to court proceedings is outweighed by the harm that public disclosure of sensitive, non-public information would cause."*[16] Information that may qualify as confidential includes trade secrets, sensitive proprietary information, or sensitive financial, business, or personnel information.[17] The party seeking confidentiality bears the burden of establishing good cause.[18]

Local counsel must be engaged

Parties must engage local counsel when litigating in a Delaware court.[19] Attorneys not admitted to the Delaware Bar may be admitted *pro hac vice* at the Court's discretion and only upon written motion by a member of the Delaware Bar who maintains an office in the state.[20] *Pro hac vice* admission is available only to US lawyers.[21]

Fund-specific litigation

As noted, when formed in Delaware, private equity funds and hedge funds are most commonly alternative entities. Given the number of such entities formed in Delaware, disputes among them in the Court of Chancery are as varied as there are factual scenarios in business. Broadly speaking, they can be divided into three groups:

1. Contract interpretation claims.
2. Breaches of fiduciary duty.
3. Statutory claims.

Contract interpretation claims involve disputes over the meaning of provisions in transactional agreements and/or operating agreements. Breach of fiduciary duty claims concern the alleged abdication by a GP or a manager of its duties to the LP or members. Statutory claims arise from the language of statutes themselves and may concern dissolution and winding up of an entity, questions regarding management or valuation or the Uniform Commercial Code.

As with corporations, claims may be direct or derivative. Nothing precludes a complaint from including both kinds of claims, however. A direct claim arises when the holder of an equity interest in an entity is directly injured. A derivative claim arises

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[14] Court of Chancery Rule 5.1(b).
[15] *Id.* at 5.1(b)(1)
[16] *Id.* at 5.1(b)(2).
[17] *Id.*
[18] *Id.* at 5.1(b)(3).
[19] Court of Chancery Rule 170(a).
[20] Court of Chancery Rule 170(b).
[21] Court of Chancery Rule 170(c) (*"Any attorney seeking admission pro hac vice shall certify the following in a statement attached to the motion: (i) That the attorney is a member in good standing of the Bar of another state"*).

when the injury is to the entity and harms the equity holder only indirectly (as such, a derivative claim in Delaware is akin to the exception to the *Foss v. Harbottle*[22] rule in English jurisprudence).

Over the past two years, in cases in which at least one party was a private equity fund or a hedge fund, the Delaware Court of Chancery has fielded all three types of disputes. For example, *Seibold v. Camulos Partners LP*,[23] called for contract interpretation. A former partner in a limited partnership brought claims for breach of contract and tortious interference with contract against the LP, which served as an investment manager, as well as an investment fund and the fund's GP. The former partner sought repayment of its capital investment in the fund per the terms of the limited partnership agreement (LPA). After considering the terms, the court found in favour of the former partner on the majority of claims.

In *AM General Holdings, LLC v. The Renco Group, Inc.*,[24] the court denied summary judgement for one count in an action that accused defendants of making investments prohibited by the operating agreement of a jointly-owned limited liability company (LLC). These investments allegedly exposed the LLC to liability arising from the federal Employee Retirement Income Security Act (ERISA). One section of the agreement bestowed some discretion regarding investment activities, while another *"indicated their clear intent to place a blanket prohibition"* on investment activities that could lead to ERISA liability. Given the clarity of the prohibition, the court held the agreement was not ambiguous, but it denied summary judgment because *AM General's* only evidence was the defendants' own admission in a compliance report of a "possible violation" of the investment prohibition.

Some cases straddle two groups. *DiRienzo v. Lichtenstein*,[25] arose out of a transaction that converted the defendant hedge fund from a private limited partnership to a publicly traded limited partnership by making it a wholly-owned subsidiary of one of the hedge fund's publicly traded portfolio companies. A shareholder of the portfolio company who was transformed into an LP by the transaction brought direct claims against the special committee charged with evaluating the deal as well as derivative claims alleging, among other things, that the hedge fund and various directors and executives of the GP of the post-transaction entity breached their fiduciary and contractual duties. The court dismissed the case in its entirety because the plaintiff's direct claims against the special committee failed for lack of bad faith, and the plaintiff's derivative claims failed due to its failure to make a pre-litigation demand on the board.

In addition, cases featuring only breach of fiduciary claims are common. In *Forsythe v. ESC Fund Management Co. (US), Inc.*,[26] the court approved a settlement involving

[22] (1843) 67 ER 18.
[23] 2012 Del. Ch. Lexis 216 (Del. Ch. September 17, 2012).
[24] 2013 Del. Ch. Lexis 266 (Del Ch. October 31, 2013)
[25] 2013 Del. Ch. Lexis 242 (Del. Ch. September 30, 2013).
[26] 2012 Del. Ch. Lexis 98 (Del. Ch. May 9, 2012).

derivative breach of fiduciary duty claims brought on behalf of a poorly performing private equity fund. A bank had formed the fund so that senior employees could co-invest with the bank in private equity opportunities. In *Hamilton Partners, L.P. v. Highland Capital Management, L.P.*,[27] a stockholder in a home health care company filed a purported class action against a hedge fund, the controlling stockholder, for breach of its fiduciary duties in connection with a merger. The hedge fund sought to merge the company with an indirect wholly-owned subsidiary of itself. Consequently, the plaintiff stockholder alleged that the hedge fund stood on both sides of the merger and that the transaction was not entirely fair to the stockholders who were cashed out. A director of the health company was also named in the suit for allegedly aiding and abetting the hedge fund's breach of fiduciary duty. The defendants filed motions to dismiss, but the court deferred a ruling on the motions until the factual record could be further developed.

Edgewater Growth Capital Partners LP v. H.I.G. Capital, Inc.,[28] is an example of a statutory claim. A private equity firm complained that a sale of a company to its debt holder was commercially unreasonable and thus a violation of the Uniform Commercial Code. In doing so, the court said, it sought to avoid paying on a guaranty of about $4 million it made to the company's previous lenders. The sale was upheld as commercially reasonable because the company had been insolvent under the equity firm's managerial control, unable to pay its bills and thus any sales process had to be conducted in a timeframe that recognised that economic reality.

Some cases may involve claims for fraud and misrepresentation; tort claims that do not fit into the above categories. In *Metropolitan Life Insurance Co. v. Tremont Group Holdings, Inc.*,[29] insurance carriers brought suit to recover losses connected with investments in a Ponzi scheme made via an investment firm managed by defendants: a limited partnership, two related entities, and various officers, directors and managers. The court granted a motion to dismiss as to the individual defendants because of a lack of personal jurisdiction and dismissed other claims on *res judicata* grounds. The claims for fraud and intentional misrepresentation survived, however, because the plaintiffs sufficiently pled that certain statements concerning the investments were false when made. The court also said the complaint sufficiently alleged scienter (intent or knowledge of wrongdoing) based on the defendants having received millions of dollars in fees, which gave them an interest in deceiving the investors when the false and/or misleading statements were made.

Conclusion: Delaware law as national law

Finally, business entities may find that no matter what their locale, American business lawyers study Delaware law. As debates have raged about the merits of creating a US federal corporation law, Delaware law has filled this role. In recent times, however, federal law has asserted itself. The scandals of the late 1990s, including Enron,

[27] 2012 Del. Ch. Lexis 110 (Del. Ch. May 25, 2012).
[28] 2013 Del. Ch. Lexis 54 (Del. Ch. February 28, 2013).
[29] 2012 Del. Ch. Lexis 287 (Del. Ch. December 20, 2012).

WorldCom and HealthSouth, resulted in legislation imposing certification and audit requirements on companies. The financial crisis of late 2008 resulted in the federal Dodd-Frank Wall Street Reform and Consumer Protection Act of 2012, which enhanced shareholder power in the hope that this would curb abuses.[30] Nonetheless, many scholars continue to espouse the *"superiority of Delaware's approach to regulating corporate governance."*[31] □

[30] Fisch, Jill E., 'Leave it to Delaware: Why Congress Should Stay Out of Corporate Governance' in *37 Del. J. Corp. L. 731*, 734–35 (2013) *(footnotes omitted).*

[31] *Id.* at 735.

***Ellisa Opstbaum Habbart** leads The Delaware Counsel Group and assists lawyers globally on transactions and governance issues with a Delaware connection. Fortune 100 companies, major financial institutions and private equity firms worldwide rely on Ms. Habbart as their guide on Delaware law. A significant portion of Ms. Habbart's representations involve cross-border transactions. Typical representations include fund formations, mergers and acquisitions, joint ventures, recapitalisations, financings and new equity issuances. Ms. Habbart also regularly advises management on governance issues. Among her many memberships and publications, she is a member of the Council of the Corporation Law Section of the Delaware State Bar Association and co-author of the* Delaware Limited Liability Company Forms and Practice Manual, *which is updated annually and published by Data Trace Publishing Co.*

***Elizabeth M. Bennett** is a veteran journalist who became interested in the law after years of covering the Delaware courts as a correspondent for ALM Media Properties. While reporting, she gained practical knowledge of the state's statutory and case law and understood its unique qualities before she ever set foot in law school. Ms. Bennett graduated from the Temple University Beasley School of Law in Philadelphia, Pennsylvania, in 2013. She is admitted to the Pennsylvania and New Jersey bars. She is distinguished from other newly minted attorneys by her rich life experience, including extensive travel and work experience in Japan and China, as well as her decade-long career in journalism.*