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Investor, Beware: Was Your Fund Really Formed in an Investor Friendly Forum?

SHUTTERSTOCK

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Few investors consider the legal implications associated with the investment managers' choice of entity and the state in which that entity was formed and what all that might have to do with their investment. Those choices may have significant ramifications.

Investors are solicited every day by professionals looking for investments in vehicles where capital is raised, put into a common fund or pool, possibly leveraged, and then invested in private or public securities. This is how venture capital, angel investing, private equity, and hedge funds all work. Investors usually don't invest their money in these funds without considering the investment goals and strategies of the investment professionals. That's sensible. Rational investors consider their risk tolerance, their comfort with the strategy to be deployed, and the different circumstances under which they can get their money back as they may desire. Few investors, however, consider the legal implications associated with the investment managers' choice of entity and the state in which that entity was formed and what all that might have to do with their investment. Those choices may have significant ramifications.

Delaware is a very popular choice for state of formation for investment funds. A common structure is that the fund takes the form of a limited partnership and the investor becomes a limited partner in that fund. The fund is managed by one or more general partners and those may take the form of limited liability companies (LLCs). The funds may be advised by yet other LLCs and the managing members of the general partners may be other LLCs. You may need a chart in order to understand the corporate web into which you have invested your money.

But even without a chart or a sophisticated understanding of the corporate relationships surrounding your investment, the investor may feel safe because, he

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or she reasons, the investment professional is a fiduciary to the investor and has to put the investor's interests first and the investor is entitled to rely upon that duty. Well, maybe not. And that's where the higher level of due diligence may be required.

The choice of the state of incorporation or formation for the legal entities concerned with the investment may dictate what duties the fund managers owe to the investor. The law is clear that under the "internal affairs doctrine," the law of the state of incorporation or formation governs the internal affairs of the entity in question, not the state where the investor resides nor the state where the fund's offices may be located. This means that if the funds (and the associated corporate entities) were formed in Delaware, then the parties must look to Delaware law to understand the duties owed by the managers to the investors. New York law, even though the firm has offices on Fifth Avenue, has no relationship.

Delaware law is more favorable, under certain circumstances, to the manager than it is to the investor or limited partner. A recent case decided in New York State Supreme Court, Commercial Division, New York County, illustrates this point. In *Storper v. WL Ross & Co., LLC*, 2018 NY Slip Op. 32235(U) (S. Ct. NY Co. Sept. 5, 2018), plaintiffs alleged that the managers of the various funds "siphoned off" some $48 million in management fees in violation of their fiduciary duties and by hiding those fees from the limited partners. Plaintiffs were themselves former employees of the general partners and they brought the action in a derivative capacity because they alleged that the charging and concealment of the management fees was a breach of duty owed to the general partners. The court, however, dismissed the complaint at the pleading stage, finding, among other things, that the managers of the various corporate entities were protected by the operating agreements governing those entities and that Delaware law otherwise provided a complete legal defense to the claims.

The first point of interest for investors is the exculpation provision in the corporate documents of the various entities—the limited partnerships and the general partnerships. Delaware law permits managers of entities like this to disclaim or simply alter the fiduciary duties a managing member of an LLC owes to the LLC's other members. In *Storper*, the defendants did just that in a provision that the court cites, in relevant part, as follows:

> [T]he Controlling Members and their respective Affiliates shall not be liable to the Company or any Member for any loss suffered by the Company or by any Member which arises out of any investment or any action taken or omission suffered by such Controlling Member without gross negligence or a willful disregard of his or her duties"

Storper at p. 7-8.

The court, in interpreting this exculpatory language, found that gross negligence under Delaware law would be conduct equivalent to "reckless indifference or actions that are without the bounds of reason." Id. at 8. (citations and internal quotation omitted). The court then held that "[t]he exculpatory provisions clearly include within their scope defendants' payment, or receipt, of management fees, and protect defendants against the claims and allegations of improper conduct asserted by plaintiffs." Id.

Thus, in the face of allegations (allegations which have to be accepted as true at this stage of the pleading) that the managers illicitly took $48 million in fees and concealed that diversion of fees, the court held that the managers effectively insulated themselves from suit in the corporate documents at the very beginning. It is likely that a limited partner would have fared the same under the court's analysis.

The court then held that the claims were infirm on the grounds that the Delaware business judgment rule protected the managers. That rule protects decisions made by directors of a board of a Delaware entity if those decisions, according to the court, "can be attributed to any rational business purpose." Id. at 9. Putting to one side the fact that the court may have overlooked significant precedent that holds that this presumption may not be applicable where the directors are engaged in an interested transaction, this holding by the court is a warning sign to investors that if a managing member of a general partner takes an action in contravention, allegedly, of his or her fiduciary duties, recourse for the damages caused by that decision may be barred simply by operation of this rule under Delaware law.

While there are undoubtedly other examples of how an investor should consider, as part of his or her due diligence, the effect of the laws of the state of formation of the corporate entities and the choices set forth in the operating documents of the entities, the holdings in *Storper* act to illustrate for the investor, in fairly stark terms, that there are very real consequences that may eventuate from the things that an investor may be told not to worry about, that those are just "legal things" that our lawyers put in.

Beyond the scope of this comment, but worth mentioning, is that an investor may wish to try to negotiate around some of the terms that bother him or her and have that memorialized in a side letter agreement. A side letter is a binding contract that can vary the terms of the operating agreements, for instance, or the partnership agreements. But to even get to a point of asking for a side letter, an investor should probably do his or her due diligence and get into the weeds at the legal documentation level, possibly with the help of their legal advisor.