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# Client Alert

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# DELAWARE COURT REQUIRES CONFLICTED HEDGE FUND MANAGER TO RETURN SEED CAPITAL

*Tainted with self-interest, hedge fund manager also loses exculpation claim and bid for indemnification of litigation-related expenses*

In *Paige Capital Management, LLC v. Lerner Master Fund, LLC*,[1] the Delaware Court of Chancery recently confronted a dispute over a hedge fund manager's decision to "gate" the release of a major investor's seed money, consistent with the hedge fund's partnership agreement but in apparent violation of a side agreement with the investor. In a lengthy, fact-intensive opinion in which the hedge fund manager was ordered to return the investor's capital, Chancellor Strine waded through the personal drama of the litigants to provide a helpful refresher on both New York contract interpretation principles and fiduciary duties in the context of limited partnerships.

## *Background*

In 2006, Michele and Christopher Paige formed their own hedge fund (the "Hedge Fund") to focus on "distressed and special situation investments." With the goal of "raising billions" to enable the Hedge Fund to become "an activist investor who could influence issuers to take value-maximizing action," the Paiges secured the Lerner Fund as a seed investor to "provide a base of core capital for operations and also give the hedge fund manager some … credibility." On October 31, 2007, the Lerner Fund invested $40 million and entered into both a Partnership Agreement and a Seeder Agreement with the Hedge Fund.

The Partnership Agreement was designed to apply to all Hedge Fund investors, including the Lerner Fund. With respect to withdrawal of capital, the Partnership Agreement "allows limited partners like the Lerner Fund to withdraw their capital from the Hedge Fund at any time, but forces them to pay an early withdrawal fee that gets less expensive the longer the capital is left in the Fund and eventually allows for penalty-free withdrawal after the three-year anniversary of the initial capital

[1] C.A. No. 5502-CS (Del. Ch. August 8, 2011).

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contribution." However, to prevent a "run on the bank," the Partnership Agreement also included a "Gate Provision" which "enabled the hedge fund manager to restrict a withdrawal of capital if it would result in more than 20% of the total assets of the Hedge Fund being withdrawn in any six-month period." Notably, the Partnership Agreement "allows the Paiges to waive or modify the withdrawal provisions for … *certain large or strategic investors*."

The Seeder Agreement "outlined the special terms of the Lerner Fund's seed investment," based on "[t]he basic premise . . . that the Lerner Fund agreed to 'lock up' its capital in the Hedge Fund for three years … in exchange for more favorable investment terms," including paying lower fees, sharing in fees earned by the Paiges and significant information rights. Any withdrawal prior to the end of this three-year period would trigger "a severe liquidated damages provision" unless, among other "limited" circumstances, the Paiges had "breached their fiduciary duties" or "materially breached the Seeder Agreement." On the other hand, the Seeder Agreement neither restricted withdrawals after the end of the three-year lock-up period nor made any reference to the Partnership Agreement's Gates Provision, but rather, it permitted the Lerner Fund "to withdraw all of its invested capital, at which point either party may terminate the Seeder Agreement."

During negotiation of its seed investment, the Lerner Fund sought inclusion of a provision in the Seeder Agreement acknowledging "that the Seeder Agreement was amending the Partnership Agreement to ensure the primacy of the Seeder Agreement." The Paiges rejected this request, including instead "a provision stating that the Seeder Agreement 'shall not be deemed to amend in any manner' the Partnership Agreement." The Lerner Fund acceded to this provision after the Paiges and their legal counsel provided separate assurances that the Partnership Agreement contemplated separate arrangements for "certain large or strategic investors" and that the Seeder Agreement was such an arrangement intended to "govern[ ] the specific relationship between the Paiges and the Lerner Fund."

Due to the economic turmoil of 2008, and consistent with their belief that the markets "had not hit bottom and there was going to be an even greater crash," the Paiges deployed little of the Hedge Fund's capital. In addition, the Paiges failed to attract any outside investors other than the Lerner Fund. Thus, the only investors in the Hedge Fund were Michele Paige with a $40,000 investment and the Lerner Fund with its $40,000,000 investment, "representing over 99.9% of the Fund's invested capital."

As part of a reevaluation of "the fund's overall investment strategy," the Lerner Fund met multiple times with Michele Paige in late 2008. These meetings did little to satisfy growing concerns of the Lerner Fund, whose representatives "perceived that in a challenging marketplace, a nascent fund manager like Michele Paige was going to have great trouble raising funds." After multiple back-and-forth meetings and correspondence, the Lerner Fund came to the conclusion that "it did not intend to stay invested in the Hedge Fund after the expiration of the three-year lock up period contained in the Seeder Agreement." The Lerner Fund communicated its intentions to the Paiges, prompting Christopher Paige to declare that they were now in "litigation mode."

With the relationship continuing to deteriorate, the Lerner Fund offered "to pay the Paiges the management fees that the Paiges would collect on the Lerner Fund's capital between January and October [of 2010] (the end of the three-year lock up) if the Paiges would allow the Lerner Fund to withdraw its capital immediately." The Paiges refused this offer, and instead took the position that the Lerner Fund would have to pay early withdrawal fees totaling "5% of its capital balance in the Hedge Fund plus legal and accounting fees in order to withdraw its money immediately."[2]

[2] The 5% fee "represented the sum of the fees required for an early withdrawal in the third year under the Partnership Agreement (2%) and the liquidated damages that were the remedy for a violation of the three-year lock up in the Seeder Agreement (3%)."

Then, "on March 11, 2010, the Lerner Fund sent the Paiges formal notice of its intention to withdraw all of its capital from the Hedge Fund on October 31, 2010." The Paiges response was "a hostile screed rather than a healing, conciliatory overture" which "surface[d] for the first time the prospect of using the Gate Provision in the Partnership Agreement to tie up the Lerner Fund's investment and to mire them in lengthy litigation …."

The dispute next moved to litigation when, "on May 18, 2010, the Paiges filed the first complaint in this lawsuit, seeking: 1) a declaratory judgment that the Partnership Agreement's Gate Provision allowed them to restrict the Lerner Fund's ability to withdraw all of its capital on October 31, 2010 notwithstanding the existence of the Seeder Agreement; and 2) a declaratory judgment that they were entitled to indemnification from the Hedge Fund for the prosecution of their lawsuit." The Lerner Fund responded with counterclaims against the Paiges, including for breach of contract and breach of fiduciary duty. The Court of Chancery sided with the Lerner Fund on nearly all counts, ruling that "the Lerner Fund was entitled to withdraw all of its capital from the Hedge Fund on October 31, 2010" and requiring the Paiges to "repay the Hedge Fund any management and incentive fees earned on the Lerner Fund's capital since October 31, 2010" as well as "any fees and expenses advanced by the Hedge Fund related to this litigation."

## *The Court's Analysis*

The Court began with "the issue of whether the Paiges' decision to gate the Lerner Fund's capital was: 1) within its contractual authority under the Partnership Agreement in light of the parties' execution of the Seeder Agreement; and 2) whether that decision complied with the fiduciary duties owed by the Paiges to the Lerner Fund as an investor of the Hedge Fund." Put more broadly, in the context of an "examination of a business law case challenging the actions of a fiduciary, [the Court] first determine[s] whether the fiduciary had the legal authority to make the decision in question, the source of the legal authority in this case being a contract. After doing that, [the Court] determine[s] whether, assuming there was proper legal authority, that authority was used in conformity with the fiduciary duties owed by the fiduciary."

### *Breach of Contract Claims*

The Court noted that because "the Lerner Fund is the only investor in the Hedge Fund other than Michele Paige, the Gate Provision would, in essence, only allow the Lerner Fund to withdraw 20% of its capital every six months." With respect to the relationship between the capital withdrawal provisions of the Partnership Agreement and the Seeder Agreement, the Court explained that while the parties agreed that the Lerner Fund was a "large or strategic investor," they disagreed on "whether by executing the Seeder Agreement, the Paiges used the authority granted to them in [the Partnership Agreement] and 'waived or modified' the conditions relating to the withdrawal of the Lerner Fund's capital from the Hedge Fund."

Applying well-known New York contract interpretation principles, the Court concluded that because (i) "[t]he Partnership Agreement specifically contemplates that the Paiges may modify that Agreement's terms for 'certain large or strategic investors'" with respect to management fees and withdrawal restrictions, and (ii) "the Lerner Fund was just the type of 'large and strategic investor' that the Partnership Agreement allowed the Paiges to make accommodations for without any explicit amendment," the Seeder Agreement had in fact modified the Partnership Agreement. To support this conclusion, the Court noted that during the negotiations, "Michele Paige told the Lerner Fund that [a clarification that the Seeder Agreement amended the Partnership Agreement] was not necessary precisely because the Partnership Agreement allowed for separately negotiated side deals like the Seeder Agreement."

The Court also rejected the Paiges' argument that an amendment to the Partnership Agreement was necessary to effectuate the terms of the Seeder Agreement. Instead, in the Court's view, "the Seeder Agreement is best viewed exactly as the Paiges described it during negotiations, as a side letter permitted by the Partnership Agreement; a side letter that contains the specific terms of the deal between the Lerner Fund and the Paiges." As a result, "by executing the Seeder Agreement with the Lerner Fund, the Paiges waived their right under the Partnership Agreement to wield the Gate Provision of that Agreement against the Lerner Fund." Accordingly, the Paiges' refusal to return the Lerner Fund's capital at the end of the three-year lock up provided in the Seeder Agreement was, in the Court's view, a breach of the Paiges' contractual obligations to the Lerner Fund.

*Breach of Fiduciary Duty Claims*

The Court then went further to point out that, even if the Paiges were not contractually obligated to waive the Gate Provision, their fiduciary duties obligated them to do so. With respect to the question whether Michele Paige herself – "the managing member of the Hedge Fund's general partner" – owed fiduciary duties to the Hedge Fund's limited partners, the Court explained that under controlling Delaware law, "a director, member, or officer of a corporate entity serving as the general partner of a limited partnership, like Michele Paige, who exercises control over the partnership's property owes fiduciary duties directly to the partnership and its limited partners."

Because the Partnership Agreement did not (as would have been permitted by Delaware law) waive the fiduciary duties owed by the general partner to the Hedge Fund and its investors, the Court observed that "when Paige General Partner acts as the general partner, it must do so in the good faith belief that it is advancing the best interests of the Fund and its investors." Applying an "entire fairness" standard to the actions of the Paiges as conflicted fiduciaries, the Court found that "[t]he record is uncontroverted that the Paiges' decision to gate the Lerner Fund's capital was entirely self-interested and not justified by the best interests of the Hedge Fund and its investors." There was "no 'run on the bank'" that might have required the Paiges to protect other investors because Michele Paige was the only other investor and she "never attempted to justify her refusal to waive the Gates on the basis that it was necessary to protect herself as an investor in the Fund." Rather, "she put her self-interest ahead of her fiduciary duties" when she sought to protect her stream of management fees.

*Exculpation and Indemnification*

Next, the Court turned to the Paiges' argument "that even if the decision not to waive the Gate Provision was self-interested, they were statutorily exculpated from liability by … §17-1101(e) [of the Delaware Limited Partnership Act]." That Section provides that a general partner is not liable for breaches of fiduciary duty for actions taken in "the partner's . . . good faith reliance on the provisions of the partnership agreement." The Court found little support for this argument, noting that "the Paiges' reading of the Partnership Agreement was not a good faith fiduciary grappling with the meaning of an ambiguous partnership agreement, but of self-interested minds bent on protecting their own financial interests." The Court explained that "Section 17-1101(e) is not a license to exculpate fiduciaries for self-serving interpretations of governing instruments. It is best read as ensuring that fiduciaries who take action to advance a proper partnership purpose but do so based on a good faith misreading of the agreement are not tagged for liability for a breach of fiduciary duty."

Finally, the Court addressed the Paiges' claim that they were entitled under the Partnership Agreement to indemnification from the Hedge Fund for expenses incurred in the litigation with the Lerner Fund, as well as for

"their 'loss of reputation, emotional distress, and decreased ability to attract investors ….'"[3] The Partnership Agreement premised the Paiges' right to indemnification on "the good faith performance by the Indemnitee of his, her or its responsibilities to the Hedge Fund." Referring to its analysis of the breach of fiduciary duty claim, the Court stated that "the Paiges have not persuaded me that their decision to … impose the Gates was one made in good faith, as opposed to one made to advance their own selfish ends." Accordingly, the Court determined that "the Paiges have not met their burden, and are not entitled to indemnification under . . . the Partnership Agreement."

## *Conclusion*

This case – although full of personality-driven drama – focuses our attention on two key legal points: (1) the importance of clear and explicit drafting of contractual arrangements to ensure that there is no "ambiguity" as to the intentions of the parties, particularly in situations where multiple agreements are used to document the understanding of the parties; and (2) that the protections afforded to fiduciaries under both Delaware law and contractual indemnity provisions are not a free pass, but rather require fiduciaries to act in good faith and to tread carefully when engaging in actions possibly conflicted with self-interest. The Paiges paid a heavy price for their failure to convince the Court that they had acted in good faith either in interpreting the Hedge Fund's operative documentation or in their treatment of their limited partner.

[3] The Court characterized this maneuver as "in essence a request to shift the costs and other losses incurred in this litigation to the Lerner Fund" in its capacity as the supplier of "over 99.9% of the Fund's invested capital."

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