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IN THIS ISSUE

The Delaware Court of Chancery Makes Clear that Default Fiduciary Duties Apply To Managers of LLCs

Earlier this year, the Delaware Court of Chancery issued an opinion explicitly stating that the managers of limited liability companies (LLCs) have fiduciary duties to members in the absence of express statements to the contrary in the LLC agreement. Generally, Delaware gives considerable deference to the contractual nature of LLC agreements and allows the agreements to shape the duties of the managers. It has been unclear, however, what the default rule is when the agreement is silent on the matter of fiduciary duties. Although a few prior cases suggested that the duties apply in these cases, they were not explicit.

The new ruling makes clear that, where an LLC agreement is silent, fiduciary duties apply, including the duty of loyalty and the duty of care. In its decision in *Auriga Capital Corporation v. Gatz Properties*, 40 A.3d 839 (Del. Ch. 2012), the Chancery Court relied on the language of the Delaware LLC Act, legislative history, and policy to determine that the duties applied and were breached by Gatz.

Statutory Background

The Delaware LLC Act allows an LLC agreement to modify the duties of a manager, member or other person by allowing those duties to be "expanded or restricted or eliminated by provisions in the limited liability company agreement; provided that limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing." 6 *Del. C.* § 18-1101(c). The language expressly permitting the elimination of duties was added by the Delaware General Assembly in 2004 in response to a Delaware Supreme Court ruling that questioned whether fiduciary duties could be eliminated in limited liability partnerships. 40 A.3d 839, 851.

The new ruling makes clear that, where an LLC agreement is silent, fiduciary duties apply, including the duty of loyalty and the duty of care.

The Suit in *Auriga Capital*

The suit in *Auriga Capital* arose out of the development and operation of a golf course built on land on Long Island that had long been owned by the Gatz family. William Gatz wanted to develop the land and specifically wanted to build a golf course on it. To do so, he established Gatz Properties, LLC and began working with other parties, including Auriga Capital. Together they formed Peconic Bay, LLC, of which Gatz Properties was named manager. Gatz Properties held title to the land, and Peconic Bay held a ground lease on the property. Peconic Bay took out a roughly $6 million note to finance construction of the facility, and then sublet the property to a third party who operated the course. Peconic Bay largely served as a way to take rents from the operator and distribute them to the investors.

Although they initially held only 85.07% of the Class A interests and 39.6% of the Class B interests in Peconic Bay, Gatz Properties, Gatz, and members of Gatz's family eventually increased their total Class B holdings to 52.8%. This gave them the ability to grant "Majority Approval," which was necessary for the manager to take action on major decisions as defined in the LLC agreement. Throughout the period in question, this group of owners voted as a block, and as such had control of the company.

After several years, the third party operating the course wished to exercise its early termination option. Rather than find a replacement operator, Gatz worked to make the value of the property seem lower than it was and made it difficult for potential buyers to get information on the property or on Peconic Bay. Ultimately, Gatz oversaw what the court regarded as a "sham" auction of Peconic Bay. At the auction, he was the sole bidder and purchased the company. The minority members sued for breach of fiduciary duties and breach of contract under the LLC agreement, which stated that the manager could only engage in self-dealing transactions if it proved that the terms were fair. The Chancery Court found for the minority members on both grounds.

The Court's Reasoning in Finding that the Default Duties Apply

While the court acknowledged that the "Delaware LLC Act does not plainly state that the traditional fiduciary duties … apply by default to managers or members of a limited liability company," it noted that neither does the Delaware General Corporation Law (DGCL). Nevertheless the Delaware Supreme Court has held that the DGCL was to be "read in concert with equitable fiduciary duties."

Furthermore, the court noted that unlike the DGCL, the LLC Act explicitly states that, where not provided for elsewhere, rules of law and equity shall govern. Under Delaware law, a fiduciary relationship is one "where a special duty exists on the part of one person to protect the interests of another." (*Metro Ambulance, Inc. v. E. Med. Billing, Inc.*, 1995 Del. Ch. LEXIS 84, 1995 WL 409015, at *2 (Del. Ch. July 5, 1995)). Noting the discretionary power of the manager of an LLC to manage the business, and relying on the rules of equity, the court concluded that the manager of an LLC is a fiduciary and fiduciary duties are owed, so the LLC Act starts with the default view that managers owe those duties.

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The court also found support for its conclusion in the legislative history, noting that if the default was no duties were owed, it would not make sense for the General Assembly to amend the law to expressly state that parties can "*eliminate*" the duties of managers and members. According to the court, granting the ability to eliminate the duties must mean that as a default the duties apply.

Finally, the court found that failing to apply a default rule would harm those who relied on the application of the principles of equity in creating their LLCs, and that not applying the default would erode the confidence of investors in Delaware entities as "reasonable investors . . . would . . . understand . . . that they were protected by fiduciary duty review unless the LLC agreement provided to the contrary. . . ."

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The court then determined how the default duties were modified by the language of the Peconic Bay LLC agreement. It found that although the agreement allowed Gatz to be exculpated for breaches of the duty of loyalty, the exculpation did not apply here because it was limited by its language only to good faith breaches. *Id.* at 856-58.

In summary, although it was previously unclear, the Delaware Chancery Court has made it explicit that as a default rule, fiduciary duties of loyalty and care apply to the managers of limited liability companies. If parties want to eliminate these duties, they must do so explicitly in the LLC agreement. However, the LLC agreement cannot eliminate the obligations of good faith and fair dealing, which are protected in the LLC Act. Managers of Delaware LLCs should be aware of the duties they subject themselves to by accepting such roles.

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PRC Court Challenges Net Profit Guarantee Arrangement

A recent high-profile PRC case calls into question the enforceability of an arrangement where cash "compensation" to a financial investor from a portfolio company would be triggered if the company fails to achieve a certain net profit target. Investors should be aware of this development and structure their incentive and downside protection arrangements with extra caution.

Private equity and venture capital funds often propose various arrangements that are intended to incentivize portfolio companies and their management to achieve specific operations and financial results, capture upside reward and protect against downside risks. *Haifu v. Gansu Shiheng*, pending before the Supreme People's Court of the People's Republic of China, calls into question the enforceability of one such form of arrangement where cash "compensation" to a financial investor from its portfolio company is triggered if the company fails to achieve a certain net profit target.

The key facts, as outlined in the written judgment issued by the High People's Court of Gansu Province, are summarized below.

In 2007, Chinese venture capital investor Suzhou Industrial Park Haifu Investment (Haifu) invested RMB20 million in Gansu Shiheng, a foreign-invested company based in Gansu Province (the Company). Of the RMB20 million total investment, RMB1,147,717 went into the Company's registered capital, representing a 3.85% equity interest in the Company; the remaining RMB18,852,283—94% of Haifu's total investment in the Company—was recorded as capital surplus.

The investment agreement between Haifu and the Company contains the following provision: "The Company's net profit in 2008 shall not be less than RMB30 million. If the Company's 2008 actual net profit is less than the target amount, Haifu shall have the right to demand 'compensation' from the Company, in an amount equal to (1-2008 actual NP / 30,000,000) x 20,000,000; in the event that the Company fails to fulfill the obligation, Haifu shall have the right to demand such 'compensation' from the Hong Kong parent that holds most of the equity interest in the Company."

It turned out that the Company made almost no net profit in 2008. Relying on the above net profit requirement provision, Haifu then demanded compensation from the Company and the Hong Kong parent in an amount equal to nearly its entire RMB20 million investment amount.

The Intermediate People's Court of Lanzhou found that the net profit requirement provision violated the profit distribution provision of the Sino-Foreign Equity Joint Venture Enterprise Law (the EJV Law), which requires profit distribution to each joint venture partner in proportion to such partner's registered capital contribution.

The court deemed the "compensation" scheme under the net profit requirement provision a distribution of the net profit of the Company to Haifu disproportionate to, and higher than, it's registered capital contribution, in violation of the EJV Law, and thus invalid. The court recognized and treated Haifu's entire RMB20 million funding as an equity investment. Consequently, the court dismissed Haifu's claim for compensation and Haifu appealed to the High People's Court of Gansu Province.

The Provincial High Court also found the net profit requirement provision to be invalid, though not because it shared the lower court's belief that such provision violates the profit distribution provision of the EJV Law. Instead, citing doctrine that investors should share their investment risk, which appears to be a general business principle rather than a statutory provision, the Provincial High Court held that the net profit requirement provision is invalid. This interesting reasoning laid the groundwork for the court's ruling.

Citing an antiquated judicial interpretation of the adjudication of joint cooperation contract disputes, the Provincial High Court held that the RMB18,852,283 capital surplus portion of Haifu's funding was not equity investment, but should be characterized as a loan to the Company, and ordered that the Company and the Hong Kong Parent return such loan to Haifu, together with interest accrued at the term deposit rate. In essence, Haifu lost its contract-based claim, but won the case nonetheless.

The Company has since appealed to the Supreme People's Court at the national level, which accepted the case and commenced retrial. The Supreme People's Court only accepts cases for retrial if it believes, based on its preliminary review, that there may have been mistakes or flaws in the fact finding, application of law or procedural matters in the original proceeding. Depending on its finding, the Supreme People's Court may affirm, reverse, vacate or amend the decision of the Provincial High Court.

Although court decisions in China do not technically have precedential value as is the case in common law countries, business and legal communities in China are still closely watching further development of this case. The ultimate outcome of this case will signal the attitude of Chinese courts towards these kinds of net profit requirement provisions. One should take note that both the intermediate court in Lanzhou and the Provincial High Court challenged and invalidated the type of net profit requirement arrangement adopted in this case, even though they applied different theories leading to drastically different outcomes.

Many non-PRC private equity and venture capital funds are well aware of the uncertainty surrounding the validity and enforceability of this type of arrangement (where cash payment is required from a Chinese company to a foreign financial investor when the company misses its profit target), as well as PRC foreign exchange control-related difficulties in implementing such an arrangement.

As a result, they would normally adopt various forms of incentive and downside protection arrangements through an offshore holding vehicle that owns Chinese operating companies. Through such offshore holding vehicles, they may also opt for incentive and protection in the form of shares instead of cash, or put in place a share redemption or purchase arrangement. In light of the Haifu case, foreign private equity and venture capital investors may wish to continue using this offshore holding vehicle structure when available.

Furthermore, as the base of Chinese domestic investors grows and as Chinese capital markets becomes a realistic exiting venue, more and more foreign fund managers may elect to set up RMB funds and making their investments and exits all in China. In such case, financial investors would no longer be able to rely on the flexibility and predictability of laws of a more mature foreign jurisdiction to design and implement incentive and downside protection arrangements. Instead, they would have to deal with the labyrinth of PRC laws, regulations and dispute resolution processes, along with their attendant unpredictability.

While investors may be quite happy with the outcome of this case as determined by the Provincial High Court case – Haifu would get its "loan" back while still holding its original equity stake – it is certainly no cause for celebration. This outcome hinges on a thin thread—a doctrine that investors should share their investment risk and an antiquated judicial interpretation.

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This kind of doctrine and antiquated judicial interpretation are ranked low in the hierarchy of PRC sources of laws, the application of which may easily be challenged by conflicting or different provisions of higher ranking laws or regulations. The fact that the Provincial High Court would even apply this doctrine and judicial interpretation is a surprise and a cause for concern over the predictability of the Chinese legal system. Even Haifu's lawyers didn't raise these arguments or attempt to re-characterize Haifu's investment as a "loan" – they probably never thought of these as winning arguments.

Nonetheless, until the Supreme People's Court rules otherwise, the Gansu case tells us that cash compensation provided by a Chinese company to a financial investor when the company misses its profit target is invalid. The question also remains whether this case may have a broader impact. For example, what happens, if, instead of paying cash to a financial investor when the company misses its performance target, the company would issue additional shares at a lower valuation or would redeem shares of an investor?

Indeed, investors should be careful in structuring these incentive and downside protection arrangements to ensure their enforceability. For example, the downside protection may need to be provided by founders or other shareholders of the portfolio company rather than by the company itself. If, for any reason, the downside protection must come from the portfolio company, the funding could, through careful planning, be structured as a loan which would be repaid or converted into equity, depending on whether the target is met. Another alternative is to structure the portfolio company as a joint stock company that is allowed to adopt a disproportionate profit distribution scheme.

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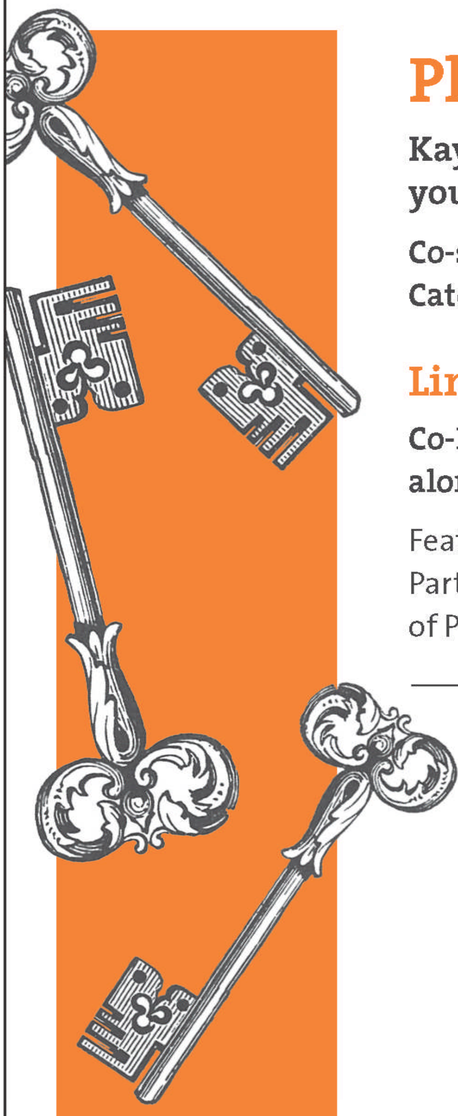

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SEC Scrutiny Focuses on Asset Valuation and Private Equity Funds

Historically overlooked by law enforcement, private equity funds may receive greater scrutiny due to the SEC's renewed focus on asset valuation. New rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) have increased the number of private equity firms required to register as investment advisers. There are now 4,000 investment advisers that manage private funds registered with the SEC—an increase of 34 percent since Dodd-Frank became effective.

Increase in Scrutiny of Private Equity Firms

The SEC's increased scrutiny has focused on, among other things, how private equity firms value their investments, how they report their performance to investors, and how firms address conflicts of interest. As widely reported, this increased scrutiny is based on a fear that private equity firms may use inflated valuation numbers in order to both attract new investment and to increase the fees they receive. Robert Kaplan, co-chief of the SEC's Asset Management Unit, warned that private equity firms should expect more enforcement actions in the years ahead, similar to the increased enforcement environment that hedge funds faced five or six years ago.

In addition to whistleblowers and other investigatory tools available to the SEC, the SEC Enforcement Division's Asset Management Unit began using a new tool in 2011 called the Aberrational Performance Inquiry. As the SEC explains, the Aberrational Performance Inquiry initiative "uses proprietary risk analytics to evaluate returns. Performance that appears inconsistent with a fund's investment strategy or other benchmarks forms a basis for further scrutiny." The SEC has already attributed six enforcement cases to this new initiative.

... this increased scrutiny is based on a fear that private equity firms may use inflated valuation numbers in order to both attract new investment and to increase the fees they receive.

In the Matter of Oxford Investment Partners LLC and Walter J. Clarke

Recently, the SEC instituted administrative proceedings against Oxford Investment Partners (Oxford) and, its owner and principal, Walter J. Clarke. The SEC's allegations focused on Clarke's conflicts of interest and his over-valuation of an ownership interest in Oxford, which he sold to a client.

In finding that Clarke over-valued the ownership interest, the SEC noted that he failed to offer any documentation or plausible explanation to support his valuation. Clarke also had no basis for a $1 million "premium," and no explanation for basing his valuation on Oxford's Q4 revenue (the most profitable quarter) to the exclusion of Q1 - Q3.

Other Recent SEC Enforcement Actions and Investigations

Other recent SEC enforcement actions involving private equity firms and hedge funds have also focused on asset valuation. A non-exhaustive list of these actions includes:

- *Oppenheimer Global Resource Private Equity Fund LP*. In early 2012, the SEC and Massachusetts Attorney General began investigating Oppenheimer Global Resource Private Equity Fund LP for overstating the value of its holdings by as much as $4 million.
- *SEC v. Michael Balboa and Gilles De Charsonville*. In December 2011, the SEC brought a civil action against former Millennium Global Investments Ltd. portfolio manager Michael Balboa. The Department of Justice brought a criminal action against Balboa as well, charging him with securities fraud. Balboa allegedly instructed brokers to inflate the value of Nigerian sovereign debt owned by the firm. This inflation of value allegedly attracted $410 million in new investments, prevented $230 million in redemptions, and generated millions in inflated management and performance fees.
- *ThinkStrategy Capital Management and Chetan Kapur*. In November 2011, the SEC commenced a civil action against ThinkStrategy Capital Management and Chetan Kapur alleging that the fund materially overstated its performance and assets.
- *Morgan Keegan & Company*. In June 2011, the SEC and other regulators settled an action with Morgan Asset Management, Morgan Keegan & Company and two Morgan executives for $200 million. The SEC's order settling the matter found that Morgan Keegan "failed to employ reasonable pricing procedures" and thus did not calculate accurate net asset values (NAV) for the fund.

Best Practices for Providing Transparency to Regulators and Investors

Although not as prolific a source of enforcement actions as other areas, such as insider trading, valuations of investments form the pattern of recent enforcement actions, indicating that the SEC is clearly focused on them. Even in situations where a regulatory investigation does not lead to an actual enforcement action, the reputational costs of merely being subject to a lengthy public investigation can be significant. There are a number of actions private equity firms can take in order to ensure their valuation methods are transparent to both regulators and investors:

Well-documented valuations

It is important for a firm to be able to articulate to both regulators and investors how assets are valued. In order to increase the transparency of these calculations, it may be appropriate to use an independent third-party valuation specialist to conduct any necessary analysis, especially where assets are illiquid. If a firm is being investigated, having good records of valuations can help assist and expedite the process.

Consistent valuation methodologies

Valuation methodologies should be applied consistently to different classes of assets within a company. Inconsistent application of methodologies may raise red flags to regulators.

Internal review of valuation policies

It may be helpful to conduct an internal review of firm policies and procedures for estimating value. Industry best practices for valuations are published by organizations such as International Private Equity and Venture Capital Association. The use of widely accepted valuation methodologies and policies will help deflect allegations that such policies are malleable.

Consider alternative fee structure

Fees at private equity firms are often tied to NAV, which can create an incentive to inflate a firm's value. It may be worthwhile to consider alternative fee structures that are more objective.

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Conclusion

Ultimately, no practice or policy can guarantee freedom from regulatory scrutiny. However, where sound and defensible valuation policies exist, alerting a regulator to such policies can yield substantial benefits. In the current environment of increased regulatory scrutiny of private equity firms and hedge funds, it is important for firms to be proactive in ensuring their policies and procedures are transparent to both regulators and investors. Strong policies and risk controls can help firms avoid attracting the attention of regulators, and hasten the end of regulatory inquiries.

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New Opportunity to Participate in Capital Raises in the United States and Avoid Registration as a Broker-Dealer

The Jumpstart Our Business Startups (JOBS) Act of 2012 has garnered much attention for its private offering reforms, particularly, the use of general advertising in Rule 506 offerings sold only to accredited investors (AIs) and qualified institutional buyers (QIBs), as well as for the scaled disclosure and other IPO concessions extended to emerging growth companies. Less attention has been paid to provisions in the JOBS Act which create significant opportunities for broker-dealer and financial firms outside the US, and for financial firms inside the US, to take a commercially meaningful role in the capital raising process while avoiding the need to register as broker-dealers here—typically a time-consuming (six months), expensive and burdensome result.

For reasons visible in the chart below, a funding portal for a new Section 4(a)(6) exemption for small capital raises ("crowdfunding") seems of little interest following amendments made to the House bill by Senator Merkley during the Senate approval process.

506 Intermediary

<table>
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US or non-US (including 15a-6 broker-dealer arrangements) financial institutions
no US Federal registration; however, may be at State level

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<tr><td><u>can</u></td><td><u>can't</u></td></tr>
<tr><td>

make coinvestments with clients
facilitate or solicit offers and sales of securities, assist in negotiations
offer investment advice if a registered investment adviser here or exempt from registration
provide ancillary services such as due diligence and standardized documentation
advertise services

</td><td>

be compensated based on sales of shares
have possession of customer funds
be subject to any disqualification under section 3(a)(39) "bad actor" provisions
be separately compensated for assistance in negotiating with prospective investors

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Funding Portal

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- *US entities only*
- *US Federal registration*

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must

- register with the US SEC
- obtain membership in an NSA[1] (currently, only FINRA)
- ensure that all investors positively affirm risk of loss, have ability to bear loss and can demonstrate their understanding of risks and illiquidity

</td><td>

can't

- advertise (no solicitation of sales)
- provide investment advice
- engage in other activities which the SEC may later prohibit
- involve a non-US issuer or portal
- make any coinvestment or make a loan to or take equity interest in client

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- obtain a background and securities regulatory enforcement check of all directors, officers (not just executive officers) and 20% holders

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- meet other SEC and FINRA requirements to be promulgated

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Although the legislative history does not indicate a purposeful rebuke by Congress, the effect of the JOBS Act is to overturn a series of no-action letters holding that persons actively involved at any significant step in the offering process are required to register as broker-dealers, even if they are not receiving transaction-based compensation. When the SEC releases its enabling regulations (at the date of this article, the SEC has announced that it will "consider" such regulations at an open meeting on August 22) to launch capital raises in the United States via general advertising (provided all sales are only to AIs or QIBs), the expectation is that significant opportunities should develop for 506 Intermediaries, both domestic and ex-US (where, for example, home country broker-dealers could orchestrate and facilitate issuers in their home country, or regional issuers, in accessing the US capital markets).

It should be noted that the SEC has not addressed the utility of non-US broker-dealers which have Rule 15a-6 arrangements in place to also act as 506 Intermediaries, whether through a wholly owned affiliate or otherwise. Yet there is nothing in the JOBS Act's provisions or in its legislative history that would support an SEC initiative to do so. Further, although the JOBS Act speaks of a platform or mechanism serving as a 506 Intermediary, the explicit reference to assistance in negotiations should be read as an affirmation that Congress did not intend for 506 Intermediaries to be solely passive websites as in the case of Funding Portals.

Interested US financial institutions and non-US financial institutions and broker-dealers are well advised to begin affirmatively positioning their systems and marketing personnel so as to be able to roll out a competitive product during 3Q12 when the ban on general advertising and solicitation is expected to be lifted.

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1 National Securities Association.