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SEC/CORPORATE

Delaware Chancery Court Clarifies Fiduciary Duties of LLC Managers and their Controlling Affiliates

Fiduciary duties waivers in limited liability company (LLC) operating agreements can effectively shield managers from claims by members. However, as the Delaware Chancery Court illustrated in an April 20 decision, if such waivers are not carefully drafted, managing members and their controlling affiliates may be exposed to liability for breach of fiduciary duties.

The case arose from a real estate development transaction in which Bay Center provided the property and a portion of the debt financing, and the defendants were to provide development and property management expertise. In that transaction, Bay Center and defendant PKI formed Emery Bay Member, LLC (Bay LLC), a Delaware LLC, with PKI as its managing member. Bay Center brought suit against Bay LLC, its managing member PKI, its development manager and the owner of the managing member in Delaware in March 2008, claiming breach of contract, breach of the implied covenant of good faith and fair dealing, breach of fiduciary duties and common law fraud. The defendants moved to dismiss all claims other than the breach of contract claims. The court denied the motion in its entirety, in essence, holding that the actions of a controlling affiliate in managing an LLC through an entity may give rise to liability to the other members of the LLC.

The court began by noting that "the Delaware LLC Act gives members of an LLC wide latitude to order their relationships, including the flexibility to limit or eliminate fiduciary duties. But, in the absence of a contrary provision in the LLC agreement, the manager of an LLC owes the traditional fiduciary duties of loyalty and care to the members of the LLC." Because of two contradictory provisions relating to member duties, the court determined that the LLC's operating agreement may not have eliminated the fiduciary duties of the managing member, stating that "drafters of chartering documents must make their intent to eliminate fiduciary duties plain and unambiguous." The court then examined whether, assuming such duties exist, the defendants' conduct constituted breaches of fiduciary duties. The court dealt with the managing member summarily, noting that its alleged diversion of rental income to avoid capital calls, modification of a senior loan without Bay Center's consent and other matters would, if proven, constitute breaches of its fiduciary duties.

The claim against the owner of the managing member, who was also a personal guarantor of the LLC's senior loan, was less straightforward. The owner was not a member or officer of the LLC, and thus beyond the normal scope of those who owe fiduciary duties in the corporate context. However, the court noted that "affiliates of a general partner who exercise control over the partnership's property may find themselves owing fiduciary duties to both the partnership and its limited partners," and that those affiliates have "the duty not to use control over the partnership's property to advantage the corporate director at the expense of the partnership." The court then held that, given the benefit to the owner in avoiding liability under his personal guarantee, and the actions taken by the managing member at his direction in order to do so, Bay Center had alleged sufficient facts to state a claim and denied the motion to dismiss.

The impact of this decision could be very broad. For example, if affiliates of a controlling preferred investor use their position to maximize the investor's return to the detriment of minority common investors, and such actions benefit the controlling investor's affiliates (increasing their carried interest, for example), the affiliates may be personally liable to the minority as fiduciaries. This highlights the need for careful drafting and negotiation in LLC operating agreements. (*Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, Del. Ch., No. 3658-VCS (April 20, 2009))

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LITIGATION

District Court Reserves Issue of Whether PSLRA Bars Plaintiff's RICO Claims

A District Court denied a motion to dismiss claims asserted under the Racketeer Influenced and Corrupt Organization Act (RICO). The plaintiff alleged that he had obtained a business loan from the defendants with respect to which he transferred stock to the defendants to hold as collateral. Defendants represented that they would not sell the stock and would return it upon repayment of the loan. The plaintiff further alleged that, in breach of their representations, defendants sold the pledged stock despite his timely repayment. The plaintiff asserted claims under RICO, Section 10(b) of the Securities Exchange Act of 1934, and Securities and Exchange Commission Rule 10b-5.

Defendants moved to dismiss the RICO claim, arguing, among other things, that the plaintiff's claim was barred by the Private Securities Litigation Reform Act (PSLRA), which prohibits using "any conduct actionable as fraud in the purchase or sale of securities" to satisfy RICO's "predicate act" requirement. The District Court agreed that under the PSLRA, securities fraud claims cannot be used to satisfy the predicate act element of a RICO claim. However, the court denied the motion after noting that the predicate acts in the complaint were alleged to arise from wire and mail fraud in connection with a fraudulent "loan scheme"—and not in connection with any securities fraud. The court held that before it could determine whether the plaintiff's claims were barred by the PSLRA, it had to determine whether the plaintiff's allegations were, in fact, based upon securities fraud, which it ruled could not occur prior to discovery. Accordingly, because the claim, as alleged, sufficiently pleaded plausible claims under RICO, dismissal was unwarranted. (*Amari v. Spillan*, 2009 WL 995627 (S.D. Ohio Apr. 14, 2009))

District Court Grants Summary Judgment for Failure to Show Loss Causation

A District Court granted summary judgment to a corporate defendant and its officers in a class action securities fraud lawsuit. The corporate defendant sold supply chain software to retail companies. Plaintiffs asserted claims under Section 10(b) of the Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 in which they alleged that the corporation's stock price had been artificially inflated by defendants' failure to disclose the company's "true financial condition" for a two-year period ending on July 8, 2008. On July 8, 2002, the company issued a press release stating that it was disappointed with the volume of new business from one of its joint ventures and would have to write off deferred revenue from the transaction. The following day the stock price fell more than 60%. Plaintiffs claimed that the company's pre-disclosure stock price was based upon misleading statements made in connection with five different transactions (including the joint venture referred to in the July 8 press release) and that even though the press release only referred to the joint venture transaction, it indirectly disclosed the company's alleged misrepresentations relating to the other four transactions.

The court found that the "true financial condition" theory permits a plaintiff *at the pleading stage* to withstand a motion to dismiss by alleging that a corrective disclosure revealed the true financial results and condition of the defendant company, even if the alleged disclosure did not also identify the misrepresentations that allegedly concealed the company's actual condition. However, the court ruled that at the *summary judgment stage* a plaintiff must produce evidence that the public became aware of the alleged misrepresentation through the alleged corrective disclosure and that the claimed loss was caused by the alleged misrepresentation. The court held that the plaintiffs failed to meet this burden with respect to any of the five transactions underlying their claim.

With respect to the joint venture transaction mentioned in the July 8 press release, the court found two deficiencies: (i) all of the information disclosed in the press release had been disclosed months earlier in two analyst reports that predicted the write-off, and (ii) the release did not reveal any misrepresentations about the defendant's accounting practices or disclosures relating to the joint venture. With respect to the other transactions, where the plaintiffs alleged that the misrepresentations regarding those transactions were indirectly corrected by the press release, the court also found the evidence lacking for two reasons: (i) because no evidence had been presented that the public recognized a relationship between the alleged "corrective disclosures" in the July 8 press release and any misrepresentations concerning any of the four transactions, and (ii) because there was no evidence of any connection between the stock price drop and any such misrepresentations. (*In re Retek, Inc.*, 2009 WL 928483 (D. Minn Apr. 10, 2009))

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BROKER DEALER

FINRA Proposes Rule Governing Personal Securities Transactions of Associated Persons

The Financial Industry Regulatory Authority issued Regulatory Notice 09-22 requesting comment on its proposal to adopt new FINRA Rule 3210 in the Consolidated FINRA Rulebook in an effort to promote more effective oversight of the personal trading activities of associated persons of FINRA member firms. Proposed FINRA Rule 3210 combines and streamlines certain provisions of National Association of Securities Dealers Rule 3050 and New York Stock Exchange Rule 407 and adopts certain additional requirements.

Similar to NYSE Rule 407, proposed FINRA Rule 3210 will require associated persons of FINRA member firms to obtain the prior written consent of their employers before opening or otherwise establishing at another FINRA member firm (referred to as the executing member) or at any other financial institution any account in which securities transactions can be effected and in which such an associated person has a personal financial interest. The proposed rule would require associated persons to provide notice of their association with an employer member to executing members or other financial institutions, who would be prohibited from executing securities transactions in the associated person's account without first obtaining the employer member's written consent. Additionally, the proposed rule requires an employer member to instruct an associated person to have the executing member provide duplicate account statements and confirmations to the employer member. In replacing NASD Rule 3050 and corresponding provisions in NYSE Rule 407, proposed FINRA Rule 3210 also deletes a number of requirements of these rules that would be rendered outdated by the new rule or otherwise addressed elsewhere by new FINRA rules.

Comments must be received by FINRA by June 5.

Click here to read the FINRA Regulatory Notice.

CBOE Clarifies Eligible Expiration Date and Exercise Settlement Value for FLEX Options

On April 20, the Chicago Board Options Exchange (CBOE) issued Regulatory Circular Number RG09-55, which states that FLEX Options on Volatility Indexes may only expire on business days that non-FLEX options on Volatility Indexes expire. According to the Regulatory Circular, this is because the term "Exercise Settlement Value," with respect to such FLEX Options, has the same meaning as set forth in CBOE Rule 24.9(5). CBOE Rule 24.9(5) provides that the Exercise Settlement Value of a Volatility Index option for all purposes under CBOE Rules shall be calculated as of the Wednesday that is 30 days prior to the third Friday of the calendar month immediately following the month in which the Volatility Index option expires.

To read the CBOE Regulatory Circular, click here.

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PRIVATE INVESTMENT FUNDS

CalPERS Issues Hedge Fund "Governance" Memorandum

The California Public Employees' Retirement System (CalPERS) has issued a Memorandum to hedge funds in which the CalPERS Risk Managed Absolute Return Strategies (RMARS) program invests. The Memorandum focuses on the following three areas:

- Alignment of Interests: RMARS will no longer partner with managers whose fee structures result in a clear misalignment of interest between managers and investors. In this regard, (i) management fees must be designed to sustain the business without encouraging asset gathering at the expense of returns, and managers of funds without hurdle rates (cash or otherwise) must provide a valid explanation for maintaining a fee structure which calls for a performance fee to be paid even when a fund returns more than zero but less than cash; (ii) managers will no longer be permitted to crystallize all accrued performance fees prior to the conclusion of RMARS's relationship with the manager; and (iii) managers must demonstrate how the firm will retain talent in the event of a difficult year for the manager's funds.

- Control of Investments: CalPERS will seek to gain greater control over RMARS investments by increasing its use of separate or managed accounts and by entering into account relationships tailored to a manager's strategy and investment approach, especially as to investment type, time horizon and liquidity, including the ability to gate or suspend redemptions.

- Transparency of Information and Risks: RMARS will no longer invest with managers who do not provide "security-level" transparency on a more or less contemporaneous basis. To provide such transparency, RMARS suggests that hedge funds offer a managed or separate account over which CalPERS maintains control and/or custody of investments or provide complete transparency through channels to be determined (e.g., prime broker feeds, risk aggregators, etc.).

Click here to read the press release from CalPERS.

SEC Proceedings in Connection With Recommendations to Invest in Bayou

On April 22, the Securities and Exchange Commission issued an Order Instituting Administrative Cease-And-Desist Proceedings in the matter of Hennessee Group LLC and its principal, Charles Gradante, in connection with Hennessee's recommendations to clients to invest in the Bayou funds. Although Hennessee did perform certain parts of the due diligence review that it represented that it would undertake, the SEC found that Hennessee and Mr. Gradante made misrepresentations to clients and thereby violated their fiduciary duties and Section 206(2) of the Investment Advisers Act of 1940 by failing to conduct a portfolio-trading analysis and to verify Bayou's relationship with its purported independent auditor. In addition, the SEC found that Hennessee and Mr. Gradante failed to adequately respond to information casting doubt on the auditor's identity and suggesting a conflict of interest between the auditor and a Bayou principal, including by failing to investigate inconsistencies in various documents provided by Bayou to Hennessee.

Click here to read the SEC press release and click here to access the SEC Administrative Proceeding Release. See also the April 10, 2009, edition of *Corporate and Financial Weekly Digest*, covering certain lawsuits against advisors of "feeder funds" (conduits for investment) associated with Bernard Madoff, based in part on alleged failures to perform due diligence and ignoring warning signs of fraud.

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FINANCIAL MARKETS

Senate Mortgage Fraud Bill Amended to Include Proposal for Creation of Financial Markets Commission

On April 22, the Senate approved an amendment to S. 386, the Fraud Enforcement and Recovery Act of 2009 (FERA), offered by Senator John Isakson, which provides for the establishment of a Financial Markets Commission (FMC). The FMC would be a congressionally appointed commission whose members would be drawn from the private sector and required to have significant experience in fields such as banking, regulation of markets, taxation, finance, economics and housing. The FMC would have a broad charter to "examine all causes, domestic and global, of the current financial and economic crisis in the United States," including investigating the causes of collapse of major financial institutions that failed (or likely would have failed if not for government intervention). The FMC would be empowered to hold hearings, issue subpoenas and refer potential cases of wrongdoing to the Department of Justice or appropriate state attorney general. A report of the FMC's findings and conclusions would be required to be submitted to the President and Congress on December 15, 2010. Senate consideration of S. 386 continues.

For more information on FERA and the amendment, click here.

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INVESTMENT COMPANIES AND INVESTMENT ADVISORS

Eighth Circuit Weighs in on Proper Standard of Review Regarding Excessive Fund Advisory Fees

The U.S. Court of Appeals for the Eighth Circuit recently added another possibility to be considered by the U.S. Supreme Court in its October 2009 term when it decides *Jones v. Harris Associates L.P.*, 527 F.3d 627 (7th Cir. 2008), *cert. granted*, (U.S. Mar. 9, 2009) (No. 08-586). At issue is what standard of review should be applied in reviewing claims of excessive compensation under Section 36(b) of the Investment Company Act of 1940, as amended.

For many years, mutual fund directors have evaluated advisory agreements and the fees charged by the investment advisor using a multi-factor test established by the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982). In 2008, the Seventh Circuit decided *Jones* and repudiated *Gartenberg*, stating that as long as an investment advisor "make[s] full disclosure and play[s] no tricks . . . [t]he trustees (and in the end the investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth."

In *Gallus v. Ameriprise Financial, Inc.*, No. 07-2945 (8th Cir. Apr. 8, 2009), the Eighth Circuit offered its own interpretation, and while the Court approved of the lower court's analysis using the *Gartenberg* factors, unlike in other cases, the Court concluded that a Section 36(b) review should include a comparison of the fees charged by the advisor to mutual fund clients and institutional clients, particularly where "the investment advice may have been essentially the same for both accounts." The Court further held that dishonesty or unscrupulous behavior with respect to either the negotiation of fees or the end result (i.e., the reasonableness of the amount of advisory fees) can constitute a breach of fiduciary duty under Section 36(b).

The *Gallus* opinion is available here.

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BANKING

Banking Agencies Propose Clarifications to Credit Card Rules

On April 21, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision and the National Credit Union Administration (collectively, the Banking Agencies) released proposed amendments to final rules issued by the Banking Agencies in December 2008 regarding certain unfair credit card practices.

The newly released proposals intend to clarify that (i) the key protections in the final rules previously announced apply to balances on a consumer credit card account when the account is closed or acquired by a different institution or when balances are transferred to another account issued by the same institution; and (ii) deferred interest and similar programs offered by institutions and retailers are subject to all of the protections in the final rules, and pertinent information must be supplied to consumers throughout the life of a deferred or waived interest promotion.

According to the accompanying press release, the proposed amendments will "facilitate compliance with the December 2008 final rules without reducing protections to consumers."

Comments are due within 30 days after publication in the Federal Register.

Read more.

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STRUCTURED FINANCE AND SECURITIZATION

Treasury Clarifies Executive Compensation Treatment of Legacy Securities PPIFs

On April 21, the U.S. Treasury Department provided an update to its frequently asked questions document concerning the Legacy Securities Public-Private Investment Program (PPIP). The Treasury answered the question "Will the Legacy Securities PPIFs (Public-Private Investment Funds) be subject to executive compensation restrictions?" with the following statement: "Treasury developed the PPIP to leverage private sector resources and expertise for purchasing legacy assets and the TALF [Term Asset-Backed Securities Loan Facility] with the Federal Reserve for funding legacy assets. Executive compensation restrictions will not apply to asset managers or private investors provided the PPIFs are structured such that the asset managers themselves and their employees are not employees of or controlling investors in the PPIFs, and other investors are purely passive."

Click here for the updated FAQ regarding the Legacy Securities PPIP program.

Oversight Authorities Raise Concerns on TARP, TALF and PPIP

On April 21, Neil Barofksy, the Special Inspector General for the Troubled Asset Relief Program (SIGTARP), issued his quarterly report to Congress as required by the Emergency Economic Stabilization Act of 2008 (EESA). The report notes the "tremendous expansion in the scope, scale and complexity of TARP" and makes the following recommendations:

i. All TARP recipients should be required to report on their actual use of funds.

ii. A number of steps should be taken in order to mitigate the potential for fraud and abuse related to the Troubled Asset Relief Program, Public-Private Investment Program and Home Affordable Modification Program.

On the same day, the Congressional Oversight Panel, which was created pursuant to EESA and is chaired by Professor Elizabeth Warren, held a hearing at which Treasury Secretary Timothy Geithner testified about the Treasury's use of TARP funds. Chairman Warren noted in her opening remarks that there was significant public "anger and frustration" regarding the TARP program. Treasury Secretary Geithner defended the Treasury's use of the TARP funds, in part, by stating that a failure to take the actions it has taken would have "resulted in higher unemployment and more business failure, greater damage to our future growth and productivity, and as a result higher long term budget deficits."

Click here for the SIGTARP website and here for the quarterly report.
Click here for information on the Congressional Oversight Panel hearing.

FRBNY Posts Updates to TALF Program Terms and Documents

On April 21, the Federal Reserve Bank of New York released updated terms and revised documents, including a revised Master Loan and Security Agreement, regarding its Term Asset-Backed Securities Loan Facility (TALF). The changes include (i) the creation of two new interest rates applicable to TALF loans with weighted average lives to maturity of less than two years, (ii) clarifications regarding the effective dates for issuer assertions and auditor attestations, and (iii) a clarification that the phrase "U.S. domiciled obligor" includes persons domiciled in U.S. territories and possessions.

Click here for information regarding the updated TALF terms and documents.

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EU DEVELOPMENTS

European Parliament and European Council Approve New Regulation on Credit Rating Agencies

On April 23, the European Commission announced that the European Parliament and the Council of the European Union have approved a new regulation on credit rating agencies (CRAs). The regulation will be directly applicable in EU member states. It will not require implementation by national legislation.

The regulation introduces a common regulatory regime across the EU for CRAs. It includes the following requirements:

- The Committee of European Securities Regulators will operate a registration process. Applications will be decided upon by the relevant securities regulators grouped into a college. (Colleges of regulators will also be involved in the day-to-day supervision of CRAs.)
- CRAs are not permitted to provide advisory services.
- CRAs are required to disclose the models, methodologies and key assumptions on which they base their ratings and to publish an annual transparency report.
- CRAs must create a department akin to internal audit to review the quality of their ratings.
- CRAs must differentiate the ratings of more complex products by adding a specific symbol.
- CRAs are to have at least two independent directors, at least one of whom must have expertise in securitization. Their remuneration must not be linked to the business performance of the rating agency. They must be appointed for a single term of office of no more than five years and the agency may only dismiss them for misconduct.

The requirements imposed on CRAs are largely based on the standards set out in a voluntary code of conduct for CRAs published by the International Organisation of Securities Commissions in 2004 and revised in May 2008.

The regulation will be directly applicable across the EU 20 days after it is published in the Official Journal of the European Union. There will be a six-month transition period before its provisions become fully effective.

Read more.

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