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In Wake of Severe Market Dislocation, Court of Chancery Addresses Investor Demands for Judicial Dissolution of Funds and Alternative Management Proposal for Restructuring

During the severe market dislocation of the past year, many investment funds faced unprecedented requests for redemptions and withdrawals that could not be satisfied in the usual course. Dissatisfied investors have pressured the funds to dissolve or otherwise provide liquidity. Many funds have attempted restructurings to address the liquidity demands.

Claims arising from such circumstances were addressed by the Delaware Court of Chancery's Chancellor William B. Chandler III in two, coordinated test cases. *Bank of America, N.A. v. Steel Partners II (Offshore), Ltd. et al.* (Del. Ch. C.A. No. 4465-CC) and *Archstone Partners, L.P. et al. v. Lichtenstein, et al.* (Del. Ch. C.A. 4284-CC) (consolidated as Cons. C.A. No. 4465-CC). The cases sought to enjoin the restructuring of the defendant investment funds, including a Delaware limited partnership, that had suspended redemptions and withdrawals in the wake of an unprecedented increase in redemption and withdrawal requests following the severe market dislocation. After the suspension of redemptions, the defendant general partner proposed a restructuring that was designed to treat all investors fairly, while attempting to meet the conflicting needs of differently situated investors. Certain minority investors sought a preliminary injunction to enjoin the restructuring pending a trial on an application for judicial dissolution of the limited partnership.

On June 19, 2009, Chancellor Chandler conducted a hearing and denied the plaintiffs' motion for a preliminary injunction on the grounds that the plaintiffs failed to establish that they would suffer imminent irreparable harm in the absence of a preliminary injunction and that the plaintiffs had failed to establish a probability of ultimate success on the merits of their claim for a judicial dissolution.

In ruling, the Court suggested that, despite its severity, the market dislocation was not so unusual as to permit investors to force judicial dissolution of the funds or to warrant other departures from the usual rights and remedies provided by the governing documents of the funds. The Court further suggested that a fund's management may have substantial latitude, under the governing agreements, to redeem with in-kind distributions investors pressing for liquidation of the fund.

The Court determined that the restructuring would not cause irreparable harm by depriving the plaintiffs of the remedy of judicial dissolution because the plaintiffs were not entitled to a judicial dissolution. As detailed below, the Court rejected the plaintiffs' contention that the disparity between their desires for immediate liquidity and the limited partnership's long-term investment strategy established that it was "not reasonably practical" for the limited partnership "to carry on business" as required for judicial dissolution under 6 *Del. C.* § 17-802. As the Chancellor explained: "[T]he not reasonably practicable standard does not permit dissolution of entities that are struggling with the challenges of a difficult economic environment, but are still being operated in conformity with the agreement." Transcript of Bench Ruling at 9 (cited as "Tr. at __")

The Court buttressed its conclusion that the plaintiffs had failed to demonstrate that they would suffer imminent irreparable harm by noting that the plaintiffs had failed to establish that they would receive any different distribution in a judicial dissolution than the distribution proposed in the challenged restructuring. In the proposed restructuring, the interests of investors who did not affirmatively elect to participate in the restructuring would be redeemed in exchange for a pro-rata distribution of securities held by the funds. As explained by the Court, absent a restructuring, the investors could be redeemed for the same securities. The Court relied upon a provision in the limited partnership agreement granting the general partner "sole discretion" to redeem limited partners if their "continued participation" in the limited partnership "would be detrimental" to the partnership, and concluded that the provision appeared sufficiently broad to permit the general partner to compel the redemption of the interests of the minority investors who were pressing for a judicial dissolution.

Subsequently, the Court issued a formal Opinion addressing the plaintiffs' request for an interlocutory appeal. *See Archstone Partners, L.P. et al. v. Lichtenstein, et al.*, 2009 Del. Ch. LEXIS 130 (Del. Ch. July 10, 2009). In denying the plaintiffs' request for certification of an interlocutory appeal, the Court concluded that its irreparable harm determination did not determine a "substantial issue" as required by Delaware Supreme Court Rule 42 for the certification of an interlocutory appeal. The Delaware Supreme Court agreed, issuing a one-page Order denying the plaintiffs' appeal application. *Archstone Partners, L.P. et al. v. Lichtenstein, et al.*, 2009 Del. LEXIS 357 (Del. July 14, 2009).

Background

Following the extreme market dislocation of 2008, many investment funds received a high volume of requests for redemption and/or withdrawal. In this case, which involved certain investment funds affiliated with Steel Partners, such requests were made by investors whose investments represented approximately 38 percent of assets under management. (Tr. at 3-4) The requests prompted the funds to impose a temporary suspension of redemptions and withdrawals pursuant to the terms of the funds' governing agreements. (Tr. at 4) In addition, to meet certain investors' desire for liquidity, the funds

announced a restructuring plan, under which investors would receive both (i) a cash distribution, and (ii) a choice between receiving publicly tradable limited partnership interests in an entity to which the funds would transfer assets ("Option A"), or a pro rata distribution of securities held by the funds in full satisfaction of their interests in the funds ("Option B"). (*Id.* at 4-5) Those investors who chose neither option were deemed to have chosen Option B. (*Id.* at 5) Certain minority investors sought to enjoin the proposed restructuring and to compel an "orderly liquidation" of the funds. (Tr. at 3-6)

Motion for Preliminary Injunction

The Court denied the plaintiffs' motion for preliminary injunction based primarily upon the plaintiffs' failure to establish that they would suffer irreparable harm in the absence of an injunction. The Court identified three bases for this conclusion:

First, the plaintiffs failed to demonstrate that the "orderly liquidation" requested "would produce an amount greater for plaintiffs than what they [would] receive under the [restructuring plan]." (Tr. at 7)

Second, the plaintiffs "utterly failed to establish their right to force such a liquidation" under the governing agreements or under Delaware law. (Tr. at 7) In this context, the Court addressed the standard for seeking judicial dissolution under 6 *Del. C.* § 17-802, which requires a showing that "it is not reasonably practicable to carry on the business in conformity with the partnership agreement." 6 *Del. C.* § 17-802. The plaintiffs argued that the general partner had conceded that it was not reasonably practical to carry on the business by allegedly acknowledging a "mismatch" between the investors' desire for liquidity and redemption and the limited partnerships' long-term investment philosophy. The Court rejected this argument, explaining: "Judicial dissolution is an extreme remedy that will be granted sparingly. It is not a tool by which the Court will dissolve struggling entities or rescue investors who no longer want to be governed by the terms of the contracts to which they entered." (Tr. at 8) The Court further observed:

> Many investment funds are similarly dealing with liquidity or other serious issues. These problems are properly resolved by business solutions, and the not reasonably practicable standard does not permit dissolution of entities that are struggling with the challenges of a difficult economic environment, but are still being operated in conformity with the agreement. The [governing agreement] contains the tools and flexibility necessary to deal with unexpected economic conditions, such as the suspension of redemptions, involuntary redemptions, and payments in-kind. (Tr. 9)

Third, the Court held that it seemed probable that the general partner, in its discretion, could forcibly redeem the limited partners who were pressing for an orderly liquidation – even in the absence of the restructuring. The Court explained that the general partner probably could do so on the ground that those limited partners' actions were detrimental to the partnership. In support of this third point, the Court highlighted a section of the limited partnership agreement that permitted the general partner "in its sole discretion" to require a limited partner to withdraw if "continued participation of such Limited Partner would be detrimental to the Partnership or its interests or would interfere with the business of the Partnership."

Application for Certification of Interlocutory Appeal

Following the Court's bench ruling denying preliminary injunctive relief, the Court issued a rare formal Opinion declining certification of the plaintiffs' application for an interlocutory appeal. Delaware Supreme Court Rule 42 provides that "[n]o interlocutory appeal will be certified by the trial court or accepted by [the Supreme] Court unless the order of the trial court determines a substantial issue, establishes a legal right and meets 1 or more of the [five] criteria" outlined in subparts (b)(i) through (b)(v) of Rule 42. The Court held that the determination that the plaintiffs had failed to establish a sufficient threat of irreparable injury did not "determine a substantial issue" or "establish a legal right" upon which to certify interlocutory appeal. *Archstone Partners,* 2009 Del. Ch. LEXIS 130, at *9 (citation omitted). In the Opinion, the Chancellor explained: "The Court did not rule on the merits of the plaintiffs' claims. Rather the Court applied equitable principles to determine whether the extraordinary remedy of a preliminary injunction was warranted." (*Id.*) The Chancellor further wrote that "the 'establishment' of such a 'non-right' cannot satisfy Rule 42."

Also notable, the Court rejected the notion that its observations regarding the probable enforceability of the redemption provision constituted a "question of law in the first instance" for the purpose of satisfying Rule 42(b)(i). In this regard, the Chancellor explained that "a context specific observation about the potential application" of a contract provision does not necessarily give rise to a question of law in the first instance. (*Id.* at *16)[1]

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[1] *Defendants in both actions were represented by Young Conaway Stargatt & Taylor LLP, led by Bruce Silverstein and Martin Lessner. YCST would be pleased to provide a copy of the Bench Ruling and Order upon request.*