

# Planning for Disputes Among Fund Managers

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PROFESSIONAL CORPORATION

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## Introduction

- Disputes among fund managers are not rare and can be very damaging to venture capital firms
- Protecting against some common claims advanced in disputes among fund managers
  - Fiduciary duty claims
  - Undocumented partnership claims

## Frequency of Disputes

- Disruptive disputes among fund managers are more common than generally recognized
  - Most are resolved quietly, which creates a misleading impression of their (in)frequency
  - Fund manager disputes form a meaningful part of the Fund Services Group practice at WSGR
    - ▶ This is a significant change from pre-bubble activity

## Damage from Disputes

- Disputes among fund managers can be very damaging
  - Dollar amounts in settlement can be quite large
  - May affect relationships with limited partners
    - ▶ May impact capital call compliance
    - ▶ May threaten stability/existence of fund
      - e.g. key-man event or no-fault termination
  - May disrupt fund-raising efforts and investment opportunities
  - Management may be paralyzed

8 SUPERIOR COURT - STATE OF CALIFORNIA

9 COUNTY OF SANTA CLARA - UNLIMITED CIVIL JURISDICTION

10 CV 800869

11 BY FAX

11 JAMES WICKETT, an individual,  
12 Plaintiff,

13 v.

14 JOHN FREIDENRICH, an individual; NEAL  
15 DEMPSEY, an individual; ROBERT  
16 WILLIAMS, an individual; LORING  
17 KNOBLAUCH, an individual;  
18 CHRISTOPHER NOBLE, an individual; DINO  
19 VENDETTI, an individual; BAY PARTNERS,  
a California general partnership; and DOES 1-  
100.  
20 Defendants.

CASE NO.

COMPLAINT FOR DAMAGES

(Jury Trial Demanded)

- (1) Declaratory and Injunctive Relief;
- (2) Breach of Fiduciary Duty;
- (3) Constructive Fraud;
- (4) Misrepresentation;
- (5) Breach of Contract;
- (6) Breach of the Implied Covenant of Good Faith and Fair Dealing;
- (7) Accounting; and
- (8) Unfair Competition

21 INTRODUCTION

22 1. Bay Partners ("Bay Partners" or the "Firm") is a California general partnership  
23 established to organize, form and administer various venture capital funds. Plaintiff Wickett and



## Fiduciary Duties

- Ann, Brad and Chuck are equal members of ABC LLC, the general partner of ABC Ventures Fund I
- Ann and Brad want to eliminate Chuck's right to vote on investments and to reduce his share of the carry for one of the following reasons
  - Chuck's investment performance has been sub-par
  - Chuck is retired or dead
  - Ann and Brad discover that Chuck was implicated in a pyramid scheme before he joined ABC
  - Ann and Brad simply don't like Chuck



## Fiduciary Duty Law

- As members of ABC LLC, Ann and Brad may have fiduciary duties to Chuck
  - Fiduciary duties may include the duties of loyalty and care, of which the duty of loyalty is most topical
  - Duty of loyalty: a duty to act in good faith and in the best interests of the company and the other members
- If Ann and Brad amend the ABC LLC operating agreement or otherwise apply it in a manner disadvantageous to Chuck, they may be violating their fiduciary duties to Chuck

## Fiduciary Duty Analysis

- From a business perspective, requiring Ann and Brad to analyze their fiduciary duties to Chuck is unsatisfying
  - The law, by itself, does not always clearly define the scope and applicability of fiduciary duties
  - Analysis can be costly and time-consuming, yet still fail to yield certainty as to fiduciary duties
  - The lack of clarity about fiduciary duties may itself exacerbate disputes
- The need for a fiduciary duty analysis can be avoided if the ABC LLC operating agreement clearly narrows the scope of fiduciary duties in appropriate situations



## Narrowing Fiduciary Duties in the Operating Agreement

- Circumstances where it often is appropriate to narrow fiduciary duties
  - Removal of a fund manager
  - Amendment of the operating agreement
  - Other discretionary dilution or reduction of a fund manager's interest
    - ▶ For example, the admission of a new fund manager

## Narrowing Fiduciary Duties in the Operating Agreement (Cont'd)

- Consider one of the following standards to narrow fiduciary duties
  - A fund manager may act solely in his own interest
  - A fund manager may act solely in the interest of the General Partner, without considering the adverse effects upon any other fund manager
  - A fund manager need not consider the interests of any fund manager that has engaged in misconduct or has not met performance goals

## Narrowing Fiduciary Duties in the Operating Agreement (Cont'd)

- When considering the standard of fiduciary duties, remember that it may be difficult to establish
  - Misconduct or poor performance on the part of a fund manager
  - The best interests of the General Partner
- For this reason, many operating agreements provide fund managers with unfettered discretion when considering the removal of, or remedial action against, another fund manager

## Delaware Law and Fiduciary Duties

- Delaware law is especially clear on the ability to narrow fiduciary duties in an operating agreement



## Applying Fiduciary Duties

- The ABC LLC operating agreement provides that it may be amended by a majority of the fund managers and that when voting to amend, each fund manager “may act solely in its own interest”
- Ann and Brad have a very strong position to resist a fiduciary duty claim from Chuck without having to establish Chuck’s nonperformance or that their actions are in best interests of the General Partner



## Undocumented Partnership

- Upon learning Ann's and Brad's plans, Chuck claims that, independent of the ABC LLC operating agreement, he owns an interest in the ABC name, ABC goodwill and an equal share in the carry from all future ABC funds as a result of an undocumented partnership among the fund managers
- Chuck offers the following evidence supporting his claim of an undocumented partnership
  - At the time ABC Ventures Fund I was formed, Ann, Brad and Chuck discussed raising future funds together and intended to do so if possible
  - The ABC Ventures Fund I annual report, signed by Ann, Brad and Chuck states that "we expect to form ABC Ventures Fund II within the next 12 months"
  - The ABC business cards describe Ann, Brad and Chuck as "general partners"

## Undocumented Partnership Law

- In most jurisdictions, including California, a general partnership can exist based solely on an oral agreement without any written documents
  - Unwritten partnership terms may supplement or displace the terms of the General Partner operating agreement
  - The law generally will supply (often inappropriate) terms to fill any gaps in the unwritten partnership agreement
- Disproving the existence of an oral agreement can be very difficult
- Undocumented partnership claims have been the basis of some very public litigation against venture capital firms; as a result, many plaintiffs lawyers are familiar with this technique

## Protecting Against an Undocumented Partnership

- The operating agreements of both the General Partner and the Management Company should contain an affirmative statement that there are no undocumented partnerships
  - Many typical "integration" clauses don't cover items outside the scope of the operating agreement
- Fund managers should avoid using "general partner" as a title
- Intangible assets, such as the firm name, should be documented as owned by a specific entity, usually the Management Company



## Other Points Regarding Undocumented P'ship

- Fund managers that are “general partners” of an undocumented partnership have unlimited personal liability for the debts and obligations of the partnership
- An undocumented partnership claim can be used by third parties against fund managers, not only by other fund managers

## Employment Claims

- Fund managers may also assert claims based upon employment law
- A full discussion is beyond the scope of this presentation; for more details, see the FSG presentation: "Fund Managers as Employees"
- Bottom line
  - Fund managers should have an employment relationship with the Management Company documented in a separate employment agreement
  - The General Partner operating agreement should specifically disclaim an employment relationship

## Conclusion

- Damaging disputes among fund managers are more common than is generally thought
- Planning can substantially mitigate the risks arising from some common claims
  - Fund managers may owe each other fiduciary duties; however the duties can be limited in the operating agreement
  - A partnership can exist without any written agreement; mitigate risks by taking some precautions
- Appendix I contains a checklist that summarizes the planning recommendations in this presentation

**This presentation is intended only as a general discussion and should not be regarded as legal advice. For more information, please contact your Fund Services Group attorney.**

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# Appendix I: Planning Checklist

## Fiduciary Duty Claims

1. Operating agreement provisions where narrowing of fiduciary duties is often appropriate
  - Amendment of the operating agreement
  - Removal of a member
  - Other discretionary dilution or reduction in interest
2. Standards to narrow fiduciary duties
  - A member may act solely in his own interest
  - A member may act solely in the interest of the General Partner, without considering the adverse effects upon any other member
  - A member need not consider the interests of any member that has engaged in misconduct or has not met performance goals
3. Delaware Law
  - General Partner entity should be formed in Delaware and governed by Delaware law

## Undocumented Partnership Claims

1. Operating agreement of General Partner
  - Affirmative statement that there are no undocumented partnerships
  - Affirmative statement that members have no right to participate in future funds
2. Operating agreement of Management Company
  - Affirmative statement that there are no undocumented partnerships
  - Intangible assets documented as owned by Management Company (or other entity), including firm name
3. Fund managers should avoid using "general partner" as a title

## Employment Law Claims

1. Fund managers should have an employment relationship with the Management Company documented in a separate employment agreement
2. Operating agreement of General Partner disclaims an employment relationship