

# HOW PRIVATE FUNDS CAN TACKLE BOOKS AND RECORDS DEMANDS

BY ALEX J. KAPLAN AND JAMES HEYWORTH OF SIDLEY AUSTIN LLP



As the markets continue to experience volatility and regulators examine fund disclosures ever more closely, private investment firms should anticipate that some investors may explore potential litigation options—including, depending on the circumstances, for alleged breach of fiduciary duty or mismanagement.

Before launching a lawsuit, investors often pursue pre-litigation books and records demands pursuant to the law of the governing state, often Delaware, or provisions in governing agreements. These demands typically are relatively inexpensive for plaintiffs to make, but potentially onerous for the responding party to comply with. Fund principals and their legal and compliance teams should be aware of their obligations concerning these pre-litigation tools, as well as the legal positions that investors may assert and the defenses a fund might use.

By understanding the applicable rules and bases for contesting and/or limiting those demands, and acting quickly on that knowledge, fund principals potentially can avoid costly litigation.

## WHAT IS A BOOKS AND RECORDS DEMAND?

An investor may not bring a lawsuit based on vague or conclusory allegations. As a result, an investor who is considering asserting claims will often use the pre-litigation tactic of seeking access to the fund's books and records in order to investigate—and later support—potential claims, such as breach of fiduciary duty or mismanagement of the fund. Another common goal of such demands is to obtain a list of other investors in the fund so that the investor can solicit support from other investors for an anticipated lawsuit.

The Delaware Revised Uniform Limited Partnership Act ("DRULPA" or "Act") provides the default rules for funds structured as limited partnerships under Delaware law. Subject to certain procedural and substantive limitations, the Act provides that each limited partner, in person or through an attorney or other agent, has the right to obtain from the general partners the following:

- | Information regarding the status of the business and financial condition of the limited partnership
- | Copies of the limited partnership's federal, state and local income tax returns
- | A current list of the name and address of each partner
- | A copy of any written partnership agreement and certificate of limited partnership and all amendments thereto

- | Information regarding the amount of cash and a description and statement of the agreed value of any other property or services contributed by each partner
- | Other information regarding the affairs of the limited partnership, as is just and reasonable

Demands under this portion of DRULPA are known as Section 17-305 demands, based on Del. Code. Ann. tit. 6 § 17-305. (Similar rules apply to entities structured as limited liability companies under the Delaware LLC Act. See Del. Code Ann. tit. 6, § 18-305.)

## DO I NEED TO RESPOND?

Yes, and you must do so promptly. Delaware law provides that a general partner must respond to a books and records demand within five business days, absent the fund's partnership agreement providing for additional time. Even if it does, the longest funds can have to respond is 30 business days.

The DRULPA vests the **Delaware Chancery Court** with exclusive jurisdiction over actions to enforce a limited partner's rights to inspect the partnership's books and records. The Act provides that, if the general partner has not responded within the applicable time frame, the limited partner seeking inspection may apply to the Chancery Court for an order to compel, and that the Chancery Court may summarily order the general partner to provide the requested information.

Fund principals and counsel should reply expeditiously to avoid the investor taking his or her demand to court. But be aware that even after the fund responds to the demand, an investor who is dissatisfied with the response may seek to compel production through a books and records action in the Chancery Court.

## GROUND TO REJECT OR LIMIT THE DEMAND

There are several grounds on which a general partner may reject or limit a books and records demand. Upon receipt of a demand, fund counsel should ask the following questions:

*Is the person or entity seeking books and records a limited partner?*

Section 17-305 of the DRULPA states that, in appropriate circumstances, "each limited partner" of a particular partnership is afforded access to books and records. But it does not in any way suggest that persons other than the limited partners have any rights to demand or receive books and records.

Delaware courts require strict adherence to the procedural requirements of the Act. Fund counsel

should pay close attention to the formalities of the demand and ensure that the individual or entity making the demand is, in fact, a limited partner. Moreover, in any instance where an attorney or agent seeks the information on behalf of a limited partner, the DRULPA requires that the demand be accompanied by a power of attorney or such other written instrument duly authorizing the attorney or agent to act on behalf of the limited partner.

Given Delaware courts' respect for the procedural formalities, any technical deficiencies, such as a demand that lacks a proper power of attorney, are grounds for fund counsel to reject the demand.

*Does the demand state a "proper purpose"?*

A limited partner (investor) seeking access to books and records bears the burden of establishing in the demand that it is seeking the materials for a "proper purpose." Fund counsel should therefore be aware of those purposes that Delaware courts regard as proper, as well as those regarded as improper and thus objectionable.

Delaware law provides that a proper purpose is any that is "reasonably related to the limited partner's interest as a limited partner"—a standard that is analogous to that set forth for corporate stockholders seeking to inspect books and records under Section 220 of the Delaware General Corporation Law's analogue to Section 17-305. For that reason, courts routinely apply case law interpreting Section 220 to claims under Section 17-305.

The proper/improper purpose inquiry is fact-sensitive and will depend on the circumstances of the particular demand. But at a high level, Delaware courts have found the following to be proper purposes:

- | Valuation of partnership interests, assuming that information provided previously is not adequate
- | Investigation of potential mismanagement or self-dealing, if the limited partner can suggest a credible basis from which a court could infer such conduct
- | Assessment of the partnership's condition or affairs such that the limited partner can exercise their rights in an informed manner
- | Identification of other limited partners to communicate regarding partnership matters

The following are examples of improper purposes:

- | Using the demand as a pretext to extract a settlement from the general partner
- | Obtaining a list of limited partners to sell it for commercial purposes

*Continued on page 15*

| REGULATOR                                      | REGION               | TOPIC                           | DETAILS  | DEADLINE                           |
|--|----------------------|---------------------------------|--|------------------------------------|
| <b>Municipal Securities Rulemaking Board</b>   | <b>North America</b> | <b>Board membership service</b> | The MSRB received approval from the Securities and Exchange Commission on its proposal to amend Rule A-3 to lengthen the term of board member service. | <b>Became effective March 17.</b>  |
| <b>Financial Industry Regulatory Authority</b> | <b>North America</b> | <b>Rule 4554</b>                | Filed with the SEC a proposal to adopt Rule 4554 to require alternative trading systems to submit additional order information.                        | <b>Comments were due March 28.</b> |
| <b>SEC</b>                                     | <b>North America</b> | <b>Derivatives</b>              | The SEC proposed Rule 18f-4 to provide a more comprehensive approach to the regulation of funds' use of derivatives.                                   | <b>Comments were due March 28.</b> |
| <b>NYSE Arca</b>                               | <b>North America</b> | <b>Rule 7.21</b>                | Filed with the SEC a proposal to amend Rule 7.21 regarding the obligations of market maker authorized traders.   | <b>Comments were due March 28.</b> |

(CONTINUED FROM PAGE 11)

## HOW PRIVATE FUNDS CAN TACKLE BOOKS AND RECORDS DEMANDS

- Requesting documents out of sheer curiosity, unrelated to any legitimate interest of the partnership, or where the purpose is to harass the partnership
- Gathering documents and information concerning disputes between the limited partner and a third party, as opposed to the partnership itself
- Obtaining books and records for reasons personal to the requesting limited partner, as opposed to the partnership as a whole

Moreover, the Chancery Court has repeatedly denied inspection demands under Section 17-305 where a limited partner's *stated* purpose is not, in fact, its *true* purpose, and the true purpose is not reasonably related to the limited partner's interests in the limited partnership. If the purpose stated in the demand is specious, fund counsel can and should push back.

*Is the demand narrowly tailored for the stated purpose?*

Delaware courts hold that a limited partner's right to inspect books and records is limited to those documents that are necessary, essential and sufficient for the limited partner's stated proper purpose. Therefore, fund counsel should reject broad, "fishing expedition" demands not reasonably focused on materials relevant to a proper purpose.

As recently articulated by the Chancery Court, books and records demands "should be circumscribed with rifled precision to target the plaintiff's proper purpose," rather than a "sawed-off shotgun blast." Fund counsel should contest demand letters that fail to explain with sufficient particularity why the requested documents are essential to the accomplishment of the limited partner's articulated purpose for the inspection.

Nonetheless, even where the demand is not

narrowly tailored (either in whole or in part) and objections are properly made, fund counsel should consider expressing a willingness to confer regarding production of materials that are reasonably requested or where the requesting party reasonably modifies its initial demand. Delaware courts are likely to view unfavorably a stubborn refusal to produce *anything* where some of the requested information is within a limited partner's inspection rights.

*Does the demand seek trade secrets or other confidential information?*

Finally, even if a proper purpose is stated, Section 17-305 provides that certain documents may be withheld as confidential. For example, the general partner may withhold documents where it has a good faith belief that disclosure of certain information is not in the best interest of the limited partnership or could damage the limited partnership or its business.

A limited partner's right to inspection must be balanced against the partnership's legitimate interest in protecting its proprietary information or legal advice received from counsel, and fund counsel may assert that specific documents requested are, for example, confidential trade secrets or subject to attorney-client privilege. At a minimum, fund counsel should condition the production of partnership books and records on the execution of a mutually agreeable confidentiality agreement.

### STEPS TO TAKE BEFORE RECEIVING A DEMAND

Fund counsel should be familiar with DRULPA Section 17-305 as well as any relevant provisions of the fund's own formation documents. Indeed, the Act generally controls where the relevant limited partnership agreement is silent on an issue.

The Chancery Court has held that books and records provisions in a fund's governing agreements may provide investors with certain rights greater or less than those afforded under Delaware law, and so it is important that fund counsel understand the potential implication of those provisions. For instance, as noted above, a partnership agreement may provide additional time (though not more than 30 business days) for the general partner to respond to a books and records demand.

Also, while the DRULPA gives the Chancery Court exclusive jurisdiction over disputes concerning entitlement to a limited partnership's books and records, courts have held that Delaware law also permits parties to agree contractually to submit such disputes to arbitration.

In addition, some fund documentation suggests that limited partners may physically inspect books and records—in other words, send their attorney to the fund to review and copy materials—and while it will often suffice simply to produce the requested materials, an investor or its counsel who insists on physical access would be distracting to the business. Based on just these examples, fund principals and fund counsel should review the limited partnership agreement and other applicable documentation that address books and records access.

*Alex J. Kaplan is a partner and James Heyworth is an associate with Sidley Austin LLP in New York. They are members of Sidley's Securities and Shareholder Litigation group.*

*The views expressed in this article are those of the authors and not necessarily those of Sidley Austin LLP or its clients. This article is for general information purposes and is not intended to be and should not be taken as legal advice.*