

Corporate & Financial Weekly Digest

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Delaware Chancery Court Orders Hedge Fund to Return \$40 Million Seed Investment

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An investment fund (the Lerner Fund) controlled by Randy Lerner, the owner of the Cleveland Browns, recently obtained a court order for the return of the remainder of its \$40 million seed investment in a hedge fund (the Paige Fund) managed by Paige Capital Management LLC. After the expiration of the three year lock-up period, the Lerner Fund sought to redeem its full investment. The Paige Fund and its managers (the Paiges) refused to allow the full redemption and instead attempted to apply a “gate” provision in the Paige Fund’s partnership agreement that limited redemptions if they would cause more than 20% of the fund’s assets to be withdrawn. The Lerner Fund was the only investor in the fund other than a principal of the Paiges, and its redemption request, if honored, would have resulted in the withdrawal of 99.9% of the Paige Fund’s assets.

The Delaware Chancery Court ruled that the Paiges’ attempted use of the gate provision was improper on two independent grounds. First, the court ruled that the Lerner Fund’s withdrawal rights were not governed by the Paige Fund’s partnership agreement, but instead were governed by a separate seeder agreement between the parties that permitted withdrawal after the three-year lock-up period, without any gate. In doing so, the court rejected the Paiges’ argument that the gate provision in the partnership agreement controlled because the seeder agreement contained a provision specifically stating that it was not amending the partnership agreement “in any manner.” The court determined that the seeder agreement was not inconsistent with, or an amendment of, the partnership agreement, but rather was an agreement made pursuant to the partnership agreement’s grant of authority to the Paige Fund’s general partner to modify its terms relating to withdrawals for “certain large or strategic investors.”

Second, the court ruled that even if the partnership agreement’s gate provision governed, it was a breach of fiduciary duty for the Paiges to impose the gate because it was utilized solely to protect the Paiges’ interests. The court ruled that because the Paige Fund had no outside investors to protect, and had not even introduced any evidence that its principal’s own \$40 thousand dollar investment would be harmed by the withdrawal of the Lerner Fund’s investment, the imposition of the gate was nothing

more than an improper attempt to continue obtaining management fees. The court also pointed out that the language in the partnership agreement giving the fund the “sole discretion” to determine whether to impose the gate did not alter the analysis or relieve the fund and its principals from exercising that discretion in a manner consistent with its fiduciary duties.

Paige Capital Management, LLC v. Lerner Master Fund, LLC, C.A. No. 5502-CS (Del. Ch. Aug. 8, 2011).

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