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Effective Delegation in Advisory Agreements

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In a recent court case captioned *Packer ex rel 1-800-Flowers.com v. Raging Capital Management, LLC*, 2020 WL 6844063, __ F.3d __ (2d Cir. Nov. 23, 2020), the United States Court of Appeals for the Second Circuit (the "Second Circuit") vacated a grant of summary judgment to plaintiffs by the lower District Court, [1] which had previously held that Raging Capital Master Fund, Ltd. ("Master Fund"), a master fund within a typical master-feeder hedge fund structure, was the beneficial owner of more than 10% of the outstanding shares of 1-800-Flowers, Inc. ("1-800-Flowers") and therefore required to disgorge alleged short-swing profits for violating Section 16(b) of the Securities Exchange Act of 1934, as amended (the "Act"). The crux of the issue on appeal was whether the Master Fund, which had effectively delegated all voting power and investment power to its advisor (the "Advisor"), could be exempt from Section 16(b) liability.

The Second Circuit answered the question in the affirmative, and its decision contains important guidance for hedge funds whose securities are managed by a registered investment advisor formed solely to service a fund or family of funds. First, it is vital that the advisor be retained through an investment management agreement that (1) delegates all voting and dispositive power over the fund's portfolio to the advisor and (2) cannot be terminated by the fund on less than 61 days' notice. Second, the hedge fund that retains the advisor must have a board that is not subject to the control of the advisor, namely, one with a majority of independent directors.

The case law developed by the Section 16(b) plaintiff's bar, which pursues disgorgement of short-swing profits from statutory corporate insiders (i.e., executive officers, directors, beneficial owners of 10% or more of a company's equity securities, and 10% owners by virtue of membership in a group as defined by Section 13(d) of the Act), is marked by a steady effort to expand the contours of liability. While efforts at the trial court level have achieved some success for plaintiff's attorneys, appellate review has shown a more cautious approach, largely because Section 16(b) of the Act imposes strict liability; that is, it does not require any wrongful motive or intent for liability.

Such tension is evident in the decision in *Packer*. In *Packer*, the plaintiff sued the Advisor, an investment advisor registered with the SEC, its customer Master Fund, a Cayman Islands master fund, and the individual ("Mr. Martin") who was the managing member of the Advisor. Mr. Martin is also one of the three directors of the Master Fund. The other two directors are independent

[1] The decision below is *Packer v. Packer ex rel 1-800-Flowers.com v. Raging Capital Management, LLC*, 2019 WL 3936813 (E.D.N.Y. Aug. 20, 2019) ("EDNY Decision"). This firm is counsel to defendants.

representatives of a Cayman director services fund. Similar to many private fund families, the Advisor and the Master Fund were branded with the same name, "Raging Capital," the Advisor's sole customer was the Master Fund, and Mr. Martin held positions with the Advisor and the Master Fund.

The relationship between the Advisor and the Master Fund is governed by an investment management agreement ("IMA"), which Mr. Martin signed on behalf of all parties. As is common practice, the IMA delegates all "control and discretion" over the purchase and sale of securities held by the Master Fund as well as "sole authority" over all other incidents of ownership, including voting power, to the Advisor. The IMA provides that any party may terminate it "effective at the close of business on the last day of any fiscal quarter by giving the other party not less than sixty-one days' written notice."

Plaintiff filed suit in October 2015, alleging that the Advisor, the Master Fund and Mr. Martin were each liable under Section 16(b) of the Act for purchases and sales of 1-800-Flowers shares during a six-month period by the Advisor for the account of the Master Fund that resulted in a purported short-swing profit of nearly $5 million. Following the close of discovery, the parties cross-moved for summary judgment. In his motion, plaintiff argued that the evidence showed that the Master Fund was a beneficial owner of the shares, was not exempt from Section 16(b), and could not delegate power over the shares to the Advisor via the IMA. Plaintiff relied heavily on the role that Mr. Martin played with both the Master Fund and the Advisor. The District Court agreed and ordered entry of judgment against the Master Fund.

Section 16 of the Act requires a "beneficial owner" of more than 10% of a company's equity securities to disgorge any profit realized on short-swing transactions (i.e., a purchase and sale, or sale and purchase, within less than six months), subject to certain exceptions. For purposes of determining whether a person is a beneficial owner of more than 10% of a company's equity securities, Rule 16a-1 defines "beneficial owner" as "any person who is deemed a beneficial owner pursuant to Section 13(d) of the Act." Rule 13d-3 provides that a beneficial owner includes persons who by contract or other arrangements, understandings or relationships has or shares voting power in a security and/or investment power in a security. This, of course, describes the relationship of an advisor to a hedge fund. In 2009, the SEC advised that if a security holder "has delegated all authority to vote and dispose of its stock to an investment advisor" and lacks "the right under the contract to rescind the authority granted … within 60 days," the security holder does not need to "report beneficial ownership" of the securities. Countless advisors and funds have structured their advisory agreements to implement this advice. [2]

Subparagraphs v and vii of Rule 16a-1(a)(1) exempt registered investment advisers ("RIAs") such as the Advisor and control persons of RIAs such as Mr. Martin from beneficial ownership of shares held for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business as long as such shares are acquired by such persons without the purpose or effect of changing or influencing control of the company. For this reason, the question of the Master Fund's liability depended on whether the Master Fund had indeed delegated all authority

[2] *See* SEC Division of Corporate Finance, Compliance and Disclosure Interpretations, Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting, Question 105.04 (Sept 14, 2009) (https://www.sec.gov/divisions/corpfin/guidance/reg13d-interp.htm.)

to the exempt Advisor, and was therefore no longer a beneficial owner for Section 16 purposes of the shares, in its portfolio.

In awarding summary judgment to plaintiff, the District Court held that the evidence did not show an effective delegation. It focused on the defendants' affiliations citing their "intertwined relationship," deemed the Advisor to be an "agent" of the Master Fund by virtue of the IMA, and deemed Mr. Martin to have the power to amend the IMA, including its requirement for sixty-one days' notice for termination, "with a few strokes of a pen."

The Second Circuit rejected the District Court's reasoning that the delegation theory fails by virtue of the defendants' close relationships. The Second Circuit stated that although the Rule 13d-3 definition of beneficial ownership includes voting or investment authority by virtue of understandings, arrangements or relationships, generalized wording such as 'intertwined' or 'not unaffiliated' to bring a person within Rule 13d-3 would extend liability "beyond the text of both the statute and the rule."

On the agency issue, the Second Circuit distinguished cases that involved state-law-based agency relationships, in which the trial court had found the general partner (and the general partner's managing member) to be the agent of a limited partnership making them all liable for Section 16(b) violations of the managing member. The Second Circuit found that the relationship between the Master Fund and Advisor was not comparable; they were "distinct corporations," and no facts had been presented to support piercing the corporate veil.

Lastly, the Second Circuit noted the District Court's focus on the fact that Mr. Martin had signed for all four parties to the IMA (Advisor, Master Fund, feeder funds) and its view that because he signed for all parties he also had the authority to unilaterally amend or terminate the agreement. The District Court reasoned that any such authority would allow him to eliminate the sixty-one day notice requirement for terminating the IMA, thereby triggering the application of the beneficial ownership definition under Rule 13d-3 and liability under Section 16(b). In this, the Second Circuit distinguished between having the authority to sign and the "authority to commit those entities to making changes in, or terminating, that document." While Mr. Martin had authority to control the Advisor, the record did not show he could control the Master Fund; nor did the record show that he controlled the decisions of the funds' independent directors.

The Second Circuit vacated the judgment against the Master Fund and remanded the case for further proceedings to resolve any factual disputes that may remain.

* * *

The District Court's decision had the potential to substantially expand Section 16(b) liability. The plaintiff did not claim that the provisions in the IMA by which investment and voting power were delegated to the Advisor were ambiguous. Rather, the District Court made factual findings that effectively nullified the IMA. The basis of those findings, such as signatory authority over more than one entity, use of professional directors for offshore funds and common branding, are commonplace in the private fund sector.

While perhaps it was inevitable that the Section 16(b) plaintiff's bar would bring a test case against a fund family, the Second Circuit opinion makes clear that the delegation stated in

advisory agreements should be credited absent unusual facts to support piercing the corporate veil.