IN THE SUPREME COURT OF THE STATE OF DELAWARE

DV REALTY ADVISORS LLC, Defendant Below, Appellant, v. POLICEMEN'S ANNUITY AND BENEFIT FUND OF CHICAGO, ILLINOIS, MUNICIPAL EMPLOYEES' ANNUITY AND BENEFIT FUND OF CHICAGO, LABORERS' AND RETIREMENT BOARD EMPLOYEES' ANNUITY AND BENEFIT FUND OF CHICAGO, RETIREMENT PLAN FOR CHICAGO TRANSIT AUTHORITY EMPLOYEES' TRUST, and PUBLIC SCHOOL TEACHERS' PENSION AND RETIREMENT FUND OF CHICAGO, Plaintiffs Below, Appellees.	§ §	No. 547, 2012 On Appeal from the Court of Chancery of the State of Delaware, C.A. No. 7204

CORRECTED OPENING BRIEF OF APPELLANT
DV REALTY ADVISORS LLC

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Dated: November 26, 2012

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NATURE AND STAGE OF THE PROCEEDINGS

This is an appeal from the Court of Chancery's post-trial decision finding effective the "without cause" removal of DV Realty Advisors LLC ("DV Realty") as the general partner of a Chicago-based Delaware limited partnership, DV Urban Realty Partners I L.P. (the "Limited Partnership").

On January 30, 2012, the plaintiff limited partners (the "Limited Partners") of the Limited Partnership delivered an executed written consent (the "Written Consent") to DV Realty. The Written Consent purported to remove DV Realty as the Limited Partnership's general partner pursuant to Section 3.10 of the Limited Partnership's Third Amended and Restated Agreement of Limited Partnership (the "LPA"). DV Realty contested the removal. Specifically, DV Realty disputed (and continues to dispute) whether the Limited Partners had in fact determined, in good faith, that removal of DV Realty was "necessary for the best interest of the [Limited] Partnership," as is required under the LPA for removal without cause. On February 1, 2012, the Limited Partners filed an action in the Court of Chancery pursuant to 6 *Del. C.* § 17-110 seeking a declaration that their without cause removal of DV Realty was valid.

Following expedited discovery, trial was held on April 2-3, 2012. After post-trial briefing and oral argument were completed, on August 16, 2012, the Court of Chancery issued a Memorandum Opinion finding that the Limited Partners' "without cause" removal of DV Realty was valid (the "Opinion," attached as Exhibit A). However, at the parties' request, the Court of Chancery delayed issuing an

implementing order while the parties discussed certain post-removal issues. (*See* Op. at 56.) On September 7, 2012, the Court of Chancery implemented the Opinion by entering an order and partial final judgment under Court of Chancery Rule 54(b) (the "Judgment," copy attached as Exhibit B). The Court of Chancery also retained jurisdiction to consider certain "follow-on" disputes that the parties anticipated might arise regarding DV Realty's capital account.

On October 5, 2012, DV Realty filed a notice of appeal from the Judgment and the Opinion. For the reasons that follow, this Court should reverse the Court of Chancery's finding that the Limited Partners' "without cause" removal of DV Realty satisfied the requirements of Section 3.10 of the LPA.

SUMMARY OF ARGUMENT

1. Section 3.10(a)(ii) of the LPA permits the Limited Partners to remove the general partner, but only if they determine in good faith that such removal is necessary to the best interest of the Limited Partnership. The Court of Chancery held, importing the definition of good faith from the Uniform Commercial Code ("UCC"), that the good faith required by the LPA has both objective and subjective components. Thus, for the removal to be upheld, not only must the Limited Partners have subjectively believed that removal of DV Realty was necessary to the best interest of the Limited Partnership, that belief must have been reasonable, as well.

2. The decision of the Court of Chancery finding that the Limited Partners' removal of DV Realty was valid should be reversed because the Court of Chancery misapplied the standard of good faith that it held was applicable. The Court of Chancery primarily based its finding of necessity upon the fact the Limited Partnership's audited financials were issued late. As the Court of Chancery recognized, however, context matters. In the specific context here, the Limited Partners could not reasonably have believed that removal of DV Realty was necessary based upon the audits. As the undisputed record shows, DV Realty was presented with a Hobson's choice between (i) issuing the audits on time, but with a catastrophic "going concern" qualification; or (ii) issuing the audits late, but without adverse consequences to the Limited Partnership. DV Realty, in its business judgment, chose the latter. But as the undisputed record further shows, DV Realty did everything that it could to get the audits issued as quickly as

possible without harming the Limited Partnership, DV Realty was transparent and forthcoming with information about the Limited Partnership's financial condition while the Limited Partners were awaiting delivery of the audited financials, and no harm befell the Limited Partnership as a result of the delay in issuing the audits. Thus, the Limited Partners' belief that removal of DV Realty was necessary to the best interest of the Limited Partnership was not reasonable, and, rather, reflects their preferences that their own interests be favored over those of the Limited Partnership.

3. The Court of Chancery also misapplied the applicable standard by affording even "slight" weight to the three additional "red flags" that supposedly led the Limited Partners to conclude that removal of DV Realty was necessary.

STATEMENT OF FACTS

A. The Parties

The Limited Partnership invests in residential and commercial real estate in Chicago, focusing on emerging and transitional neighborhoods, with a stated purpose of generating attractive risk-adjusted rates of return. (Op. at 2.) DV Realty has been the Limited Partnership's Managing General Partner since its formation in 2006. (*Id.*) DV Realty invested approximately $3.4 million and significant time in the Limited Partnership and owns 4.9% of its limited partnership interests (the "Limited Partnership Interests"). (*Id.*) Jared Davis ("Jared") is the manager of JCJ Family LLC, which is the sole member manager of DV Realty. (*Id.*) Jared's father, Allison Davis ("Allison"), is also active in the management of DV Realty. (*Id.*)

When the Limited Partnership was formed in 2006, it had two general partners, DV Realty and OCCAM-DV, LLC ("OCCAM"). (*Id.* at 2-3.) Robert Vanecko ("Vanecko") was the manager of OCCAM. (*Id.* at 3.) OCCAM voluntarily withdrew as a general partner in July 2009. (*Id.*) After OCCAM's withdrawal, DV Realty was the sole general partner. OCCAM is not a party in this action.

Each of the Limited Partners is a pension fund located in Chicago, Illinois. (*Id.* at 3.) Specifically, the Limited Partners are: (i) Plaintiffs Policemen's Annuity and Benefit Fund of Chicago, Illinois ("Policemen's Fund"); (ii) Municipal Employees' Annuity and Benefit Fund of Chicago ("Municipal Fund"); (iii) Laborers' and Retirement Board Employees' Annuity and Benefit Fund of Chicago

("Laborers' Fund"); (iv) Retirement Plan for Chicago Transit Authority Employees' Trust ("CTA Fund"); and (v) Public School Teachers' Pension and Retirement Fund of Chicago ("Teachers' Fund"). (*Id.*) Collectively, the Limited Partners own the 95.1% of Limited Partnership Interests not owned by DV Realty. (*Id.*)

Each of the Limited Partners has a board of trustees which directs its business and affairs. (*Id.*) Each of the Limited Partners also has an executive director who reports to its board of trustees and is responsible for directing and overseeing its investments. (*Id.*) John Gallagher ("Gallagher") is the Executive Director of the Policemen's Fund. James Mohler ("Mohler") is the Executive Director of the Municipal Fund. James Capasso ("Capasso") is the Executive Director of the Laborers' Fund. John Kallianis ("Kallianis") is the Executive Director of the CTA Fund. Kevin Huber ("Huber") is the Executive Director of the Teachers' Fund. (*Id.* at 3-4.)

B. <u>The Removal Provision of the LPA</u>

The Limited Partners purported to remove DV Realty as the General Partner of the Limited Partnership pursuant to Section 3.10(a)(ii) of the LPA, which states:

> Both General Partners (and only both, not either General Partner individually) may be removed without Cause by an affirmative vote or consent of the Limited Partners holding in excess of 75% of the Partnership Interests then held by all Limited Partners; provided that consenting Limited Partners <u>in good faith</u> determine that such removal is <u>necessary for the best interest of the [Limited] Partnership</u>.

(A251-52 (emphasis added)).[1] Thus, the LPA does not afford the Limited Partners discretion to remove DV Realty whenever they would prefer to do so, or when they feel that removal would be in their individual or collective self-interest. Rather, they have the power to remove DV Realty only if they determine, in good faith, that such removal is necessary for the best interests of the Limited Partnership.

C. The Limited Partners' Purported Reasons for Removing DV Realty.

In their complaint, the Limited Partners raised several issues with DV Realty's performance that purportedly permitted them to remove DV Realty without cause under the LPA. However, as the case progressed, the Limited Partners' alleged good faith bases for removal shifted. They abandoned some of their initial bases and raised new ones. Ultimately, the Limited Partners argued that their decision to remove DV Realty was based primarily on DV Realty's inability to deliver annual audited financial statements by the deadline set forth in the LPA. In addition to the audit delivery issue, the Limited Partners identified several so-called "red flag" issues that purportedly served as additional grounds for their removal decision.

In the Opinion, the Court of Chancery rejected several of the red flag issues because the Limited Partners raised them for the first time after they had already voted to remove DV Realty. (Op. at 38-39, n.109.) DV Realty agrees with the Court of Chancery's exclusion of

[1] There is no dispute over the "Both . . . and only both" provision because, as previously explained, DV Realty was the only General Partner. (*See* Op. at 28 n.35.)

those issues from its decision and, accordingly, DV Realty does not discuss those issues here.[2]

The removal reasons actually considered by the Court of Chancery were as follows: (1) the "dysfunction" of the Limited Partnership's "Advisory Committee"; (2) DV Realty's late delivery of audited financial statements to the Limited Partners; (3) Vanecko's resignation; (4) a "finder's fee" lawsuit filed by Michael Dudek ("Dudek") against DV Realty, the Limited Partnership and the Limited Partners; and (5) DV Realty's use of recourse debt. (*Id*. at 38.) The Court of Chancery held (correctly) that DV Realty's alleged use of recourse debt "does not provide any support for the removal decisions" of the Limited Partners. (*Id*. at 51.) Because DV Realty agrees with that finding, which was not appealed by the Limited Partners, DV Realty's statement of facts and argument are limited to the first four removal reasons identified above.

1. The Advisory Committee Reason

Section 6.1 of the LPA provides for the formation of an Advisory Committee to "assist the General Partners in identifying and resolving potential conflicts of interest and other matters." (A266.) The Advisory Committee was to be "composed of three individuals nominated by the General Partners and approved by a Majority Vote of the Limited Partners." (*Id*.) The General Partners were given complete discretion to determine how to fill any vacancies on the Advisory Committee. (*Id*.)

[2] The Limited Partners have not appealed that part, or any other part, of the Opinion.

Initially, the Advisory Committee consisted of Blake Eagle, Tariq Malhance and Steven Rogers. (Op. at 7.) On July 26, 2007, Rogers resigned as a member of the Advisory Committee. (*Id*.) Later, Eagle also resigned. Those vacancies were not filled.

The Limited Partners were well aware that the Advisory Committee had since 2007 not functioned as envisioned back in 2006. (*Id*. at 49.) Several of the Limited Partners' Executive Directors attended many, if not most, of the Advisory Committee meetings and thus knew that, after July 2007, the Advisory Committee had vacancies. (*Id*.) Moreover, the Advisory Committee never provided much real benefit, which is why the Limited Partners did not complain for years about the makeup of the Advisory Committee. (*Id*.) Accordingly, the Court of Chancery gave "little weight" to the Limited Partners' argument that they viewed the Advisory Committee and its eventual demise as serious issues necessitating the removal of DV Realty.

2. The 2008 Audit Reason

Section 11.5 of the LPA sets forth DV Realty's reporting obligations to the Limited Partners. In relevant part, that section states:

> For each Fiscal Year, the Managing Partner shall cause to be prepared and furnished to each Limited Partner an annual report containing . . . audited financial statements for such Fiscal Year . . . .
>
> The audited financial statements for the Fiscal Year shall be furnished to each Limited Partner within 120 days after the end of each Fiscal Year.

(A273-74.)

Pursuant to Section 11.5 of the LPA, DV Realty was to deliver the 2008 audited financial statements to the Limited Partners by April 30,

2009. However, for a reason beyond its control (which is discussed below): (a) DV Realty could not deliver a final, "clean" audit opinion by April 30, 2009; and (b) therefore, DV Realty delivered a draft audit opinion in June 2009. (A283.)

On June 5, 2009, Mohler (Municipal Fund) sent DV Realty an email inquiring about the status of the 2008 audit. (Op. at 8.) DV Realty explained to Mohler -- and the other Executive Directors and/or their consultants -- that issuance of the final audit was delayed because the Limited Partnership's auditor, Deloitte & Touche LLP ("Deloitte"), would not issue an audit opinion without a "going concern" qualification until every loan that was to mature within twelve months of the audit report's date of issuance was renewed or replaced. (A136 at 348:22-349:16; A137 at 353:6-12; A138 at 355:17-357:18 (Mohler); A47 at 129:3-130:20 (Huber); A127 at 312:20-23 (Gallagher); A146 at 387:5-11 (Capasso); A154 at 420:23-421:3 (Kallianis); *see also* A283.)[3] The Limited Partners admit that they knew and understood that issuance of an audit with a "going concern" qualification would be bad for the Limited Partnership because, among other things, it would make it more difficult for the Limited Partnership to obtain new financing or extend existing financing. (A128 at 314:17-22 (Gallagher); A146 at 387:21-388:3 (Capasso); A154 at 421:4-17 (Kallianis); A160 at 442:23-443:9 (Kochis).)

[3] This Court may take judicial notice of the fact that, in 2009, the nation's financial and real estate markets were still in a state of unprecedented turmoil. *See Bank of N.Y. Mellon Trust Co. v. Liberty Media Corp.*, 29 A.3d 225, 235 (Del. 2011) (referring to the "ongoing financial crisis" in 2009). Huber admitted that this was the worst real estate market in 20 years. (A54 at 159:3-5 (Huber).)

The Limited Partners did not doubt the truth of DV Realty's explanation for the audit delay. (A47 at 129-130 (Huber); A146 at 387:5-388:7 (Capasso); A154-55 at 421:15-422:3 (Kallianis); A589-90 at 27:21-28:9 (Mohler Dep.); A160 at 442:23-443:15 (Kochis).) Not surprisingly, since the Limited Partners understood that a "going concern" qualification in the audit would be bad for the Limited Partnership, the Limited Partners did not ask DV Realty to cause the audit to be issued with a "going concern" qualification. (A47 at 130:21-131:7 (Huber); A154 at 421:19-23 (Kallianis); A127-28 at 313:21-314:10 (Gallagher).) Rather, they deferred to DV Realty's business judgment on the matter.

The Limited Partners also admitted that, after 2007, it became more difficult for DV Realty (and everyone else) to obtain loan extensions because of unprecedented problems in the real estate market. (A138 at 355:23-356:5 (Mohler); A146 at 388:4-7 (Capasso); A154 at 421:7-10 (Kallianis); A161 at 449:14-20 (Kochis).) The Limited Partners did not produce any evidence that DV Realty could have done something more (or different) to speed up the loan extension process, which was the root cause of the "going concern" issue. In fact, Mohler admitted that he had no reason to believe that DV Realty did not do everything possible to alleviate the "going concern" issue. (A139 at 360:13-17 (Mohler).)

On August 25, 2009, the Limited Partners sent Allison a letter stating that they were concerned that they had not yet received audited financial statements for 2008 (the "August 25 Letter"). (A286.) On September 9, 2009, Allison responded and again explained

the "going concern" issue, and gave an update on the Limited Partnership's efforts to obtain loan extensions to eliminate that issue:

> First, the issue of the 2008 audit has been a frustrating matter for both of us. Previously on June 22, 2009 we provided you with the relevant numbers which will be contained in the final 2008 audit. We believe these numbers are accurate and reflect the operations of 2008.
>
> The issue which has held up the issuance of the 2008 audit is the 'going concern' issue which has stemmed from the near term expiration of two loans – a Bank of America loan for the Pulaski development and a First National Bank of Highland Park (FNBHP) which is secured by the 217 Jefferson property.
>
> The Deloitte auditors' position has been that unless these loans were extended, our audit would have a 'going concern' note <u>which is not desirable</u>.
>
> In the interim we have obtained and closed on a one year extension on the Bank of America Pulaski loan, and we have a firm commitment for a two year commitment for a loan extension from FNBHP for the 217 [Jefferson] loan . . . . In these turbulent financial times I am sure you are cognizant that obtaining a loan or a loan extension for real estate is very difficult.

(A288-89 (emphasis added)) (the "September 9 E-mail").

On October 20, 2009, DV Realty delivered the final 2008 audited financial statements to the Limited Partners. (A291.) The 2008 audited financial statements did not contain a going concern qualification. (*See* A292-314 (2008 audited financials).)

Although delivery of the 2008 audit was delayed, DV Realty continued to have a good working relationship with each of the Limited Partners. (A47 at 132:8-12 (Huber).) DV Realty's employees were always respectful and responsive to Huber and the other executive directors. (A47 at 132:13-15; A57 at 171:22-172:19 (Huber).) During Advisory Committee meetings, the executive directors could (and did)

ask questions, and Allison and Jared did a good job relating all there was to know about the Limited Partnership's investments. (A52 at 151:6-9; A63 at 196:3-12 (Huber).) Indeed, in March 2011, the Policemen Fund's CIO, Samuel Kunz, reported to his board of trustees that DV Realty was "very collaborative . . . very open" and that they answered "very tough questions." (A322.) Furthermore, DV Realty provided the Limited Partners with quarterly and annual unaudited financial statements. (A146-47 at 388:8-390:12 (Capasso).)

3. The Vanecko Resignation Reason

From 2007 until at least the summer of 2009, the Chicago Sun Times published stories speculating that Vanecko improperly used his relationship with his uncle, Richard M. Daley ("Daley"), the former Chicago mayor, to influence the Limited Partners to invest in the Limited Partnership. (Op. at 7-8.) The Limited Partners became concerned about how their pension fund constituents (i.e., retirees) would react to the publicity. (*E.g.*, A326; A328; A330-31.)

The publicity led Vanecko (OCCAM) to withdraw as general partner in July 2009. One month before Vanecko resigned, he and the Davises sent a letter to the Limited Partners explaining that in the wake of the negative (albeit untrue) newspaper articles, Vanecko was resigning in order to "minimize unwarranted distractions from [the Limited Partnership's] core purpose." (A335.) Each of the Limited Partners sent a representative to the Advisory Committee meeting at which Vanecko's resignation was discussed and approved. (A141 at 366:11-21 (Mohler); A147 at 391:4-7 (Capasso); *see* A337.)

In the (previously discussed) August 25 Letter, the Limited Partners asked DV Realty for more details about Vanecko's resignation. (A286.) Two days later, the CTA's consultant, Sara Cachat ("Cachat"), reported to Kallianis and the CTA's board of trustees that she had been having "ongoing conversations with members of the DV team, primarily Allison and Jared Davis" about, *inter alia*, Vanecko's resignation and the status of the 2008 audit. (A372 at 133:22-134:4.)

Cachat reported that the Davises told her that they could not provide the specific details of Vanecko's buyout package because of a confidentiality agreement, but they had explained the broad parameters of the deal to her. Allison and Jared explained that Vanecko would benefit from the majority of his buyout package only if the Limited Partners benefited from their investment. (A155 at 425:2-6; A156 at 427:17-23 (Kallianis); A372 at 134-37.) None of the trustees asked Cachat any questions or raised any concerns in response to her report. (*Id.*) In addition, the trustees of the CTA never concluded that Vanecko's withdrawal rendered DV Realty unable to administer the Limited Partnership. (A156-57 at 429:21-430:1.)

In the September 9 Email, Allison told the Limited Partners that "not one penny" of the Limited Partners' money would be used to pay Vanecko. (A289.) DV Realty also explained how it planned to fill Vanecko's role following his departure. (A162 at 451:7-11 (Kochis).) After receiving that explanation, the Limited Partners raised no objection. They decided to just "wait and see" how it played out. (A162 at 451:7-15 (Kochis).) Over time, Vanecko's departure became less of an issue to the Limited Partners. (A163 at 454:2-4 (Kochis).)

In fact, Mohler admitted that the Limited Partnership "moved forward" without Vanecko. (A141 at 366:7-10 (Mohler).)

The Court of Chancery questioned how much significance Vanecko's resignation really could have had, asking: "If the Limited Partners were really that worried about Vanecko's withdrawal, why did they wait as long as they did [more than one year] to even begin the removal process?" (Op. at 48.) Nonetheless, the Court of Chancery held that OCCAM's resignation as co-general partner was a factor that the Policemen's Fund, the Teacher's Fund, the Laborer's Fund and the Municipal Fund could have viewed in good faith as "slightly" favoring the removal of DV Realty. (*Id.*)

4. The Dudek Lawsuit Reason

In or around February 2005 -- that is, prior to any Limited Partner's investment -- Dudek entered into a written "Consulting Agreement" with DV Realty, which purported to entitle Dudek to 2% of the capital raised from certain "Target Investors," including the pension funds which later became Limited Partners. (A426 ¶ 1.) When the Limited Partners invested in the Limited Partnership in 2006, they insisted on including a provision in the LPA that prohibited anyone, including DV Realty, from paying any "finder's fees" in connection with their investment. (A254; A49 at 138:5-140:2 (Huber).) Ultimately, any potential conflict between Dudek's Consulting Agreement and the LPA became moot because Dudek was not the procuring cause of the Limited Partners' investment in the Limited Partnership. Indeed, Dudek never even spoke to four of the five Executive Directors

about the Limited Partnership. (A48 at 133:10-134:4 (Huber); A139 at 358:20-23 (Mohler); A147 at 392:16-393:1 (Capasso)).

Nonetheless, in April 2010, Dudek filed a seven count complaint (the "Dudek Lawsuit") against the Limited Partnership, the General Partners, and all of the Limited Partners, alleging that he is entitled to a finder's fee because of the Limited Partners' investment in the Limited Partnership. (Op. at 11.) (The Limited Partners have been dismissed from the Dudek Lawsuit. (*Id*. at 12.)) As shown by the executive directors' testimony that they did not even talk to Dudek about investing in the Limited Partnership, Dudek's lawsuit has no merit. Moreover, while Kallianis recalls discussing the investment opportunity with Dudek, he does not know if Dudek's lawsuit has any merit. (A157 at 430:5-7 (Kallianis).)

In the Court of Chancery, the Limited Partners argued that the Dudek Lawsuit concerned them because Section 4.1 of the LPA prohibits DV Realty from paying a finder's fee. (A254.) However, the Limited Partners admit that they have no reason to think that DV Realty actually paid Dudek a finder's fee. (A48 at 134:5-8 (Huber); A147 at 393:2-20 (Capasso); A157 at 430:2-4 (Kallianis).) To the contrary, the fact that Dudek filed a lawsuit seeking payment of a finder's fee demonstrates that he was not paid a fee. Moreover, Jared and Allison told Huber that they did not pay Dudek a finder's fee. (A48 at 135:7-9 (Huber).)

Despite the fact that the Consulting Agreement was entered into before the Limited Partners insisted on the inclusion of Section 4.1 in the LPA, the Court of Chancery found that the Limited Partners

could in good faith have viewed the Dudek Lawsuit as evidence that DV Realty either breached the LPA or "came very close to breaching" it. (Op. at 50.) Thus, the Court of Chancery concluded that the Dudek Lawsuit provided "some support" for the Limited Partners' removal decision. (*Id.*)

5. The 2009 Audit Reason

Pursuant to Section 11.5 of the LPA, the 2009 audit was to be delivered to the Limited Partners by April 30, 2010. However, due to the same "going concern" issue that had delayed delivery of the 2008 audit -- *i.e.*, the loan renewal issue -- completion and delivery of the 2009 audit was delayed. DV Realty repeatedly explained to the Limited Partners that delivery of the 2009 audit was delayed as a result of that "going concern" issue.

For example, on May 26, 2010, the Limited Partners sent a letter to DV Realty asking that the 2009 audit be delivered by June 14, 2010. (A453.) On June 9, 2010, DV Realty responded, in part, as follows:

> In November of 2009 we commenced preparation of the 2009 Audit. We met with senior representatives from [Deloitte] and RSM McGladry. We established dates for Audit materials to be transferred to them as well as dates for the Audit file work to be commenced and completed. The objective was to deliver the 2009 Audit to you on or before April 30, 2010.
>
> This work has proceeded on schedule and we have offered each of you copies of the "draft financial statements."
>
> Our goal is to have a "clean" audit issued which does not impair our relationship with you, our lenders, creditors or third parties.
>
> As each of you know the last several years have been difficult for real estate and the renewal and extension of loans has been very difficult . . . unless we renew certain loans for a term acceptable to Deloitte, they will raise a "going concern" issue. The "going concern" note would

> raise red flags with all of our lenders and creditors . . . .
>
> One going concern consideration is debt maturities, and our auditors have interpreted the [Financial Accounting] Standards (similar to interpretations made by other auditors) to mean that any project debt maturing within one year of the report's issuance (vs. within one year of the end of the report period) would require disclosure of doubt regarding the entity's ability to continue as a going concern.
>
> We have three loans which are impacted by the Standards . . . .

(A456-57.)

DV Realty concluded its response to the Limited Partners by estimating that it would have the 2009 audit completed and submitted by August 1, 2010. (A458.) However, for reasons beyond its control (in particular, the troubled real estate market and lending environment), DV Realty could not secure loan extensions for all three loans before August 1, 2010. DV Realty kept the Limited Partners apprised of the situation. For example, Jared explained to the Limited Partners that:

> Unfortunately, it has been difficult to get the banks we are dealing with to focus on renewing loans substantially before their actual maturities and equally difficult to get our auditor to re-focus on this matter in a timely fashion . . . . I will update you once we speak with Deloitte in the next day or two.

(A461.) When Jared gave Mohler this explanation, Mohler's response was "thanks." (A460.)

Also, on September 14, 2010, Allison notified the Limited Partners that the Limited Partnership's bookkeeper, RSM McGladrey ("RSM"), was preparing a memorandum which DV Realty would share with the Limited Partners, regarding the status of the audit and why it was

important to have a "clean" opinion -- that is, one with no "going concern" issue. (*Id.*)[4] On September 16, 2010, DV Realty delivered the "RSM Memorandum" to the Limited Partners. (A463.) In part, the RSM memorandum informed the Limited Partners that:

> [The Limited Partnership's] management team and [RSM] have completed all audit requests that have been brought forth by the auditors except for the "going concern" documentation which is still in process waiting on certain of the properties' loan extensions . . . . Based on conversations with Deloitte, it appears that the only issue outstanding at this point is to obtain the information related to the loan extensions.
>
> . . .
>
> We have encountered similar delays on other of our 2009 calendar year clients that are trying to get a "clean" opinion with loans maturing in 2010. This is impacting the entire real estate industry as everyone is trying to make sure loans are extended before the audit is released . . . . A "going concern" opinion will make it more difficult and expensive to extend and/or refinance its current debt. Currently, the audit process has been held up in anticipation of obtaining final executed loan extension documents on a number of the properties.

(A465, 466.)

After delivering the RSM Memorandum, DV Realty continued to apprise the Limited Partners of the status of the 2009 audit. For example, on November 15, 2010, DV Realty gave the Limited Partners a status report, which reiterated the debt maturity/going-concern issue. (A468.) Based on information then available, DV Realty projected a December 1, 2010 delivery date for the 2009 audit. (*Id.*)

When the 2009 audit could not be delivered by December 1, 2010, DV Realty continued to provide updates. For example, on February 3,

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[4] The memo came from RSM (not Deloitte) because, for independence reasons, Deloitte would not communicate with the Limited Partners directly. (*See* A460.)

2011, Allison forwarded to Mohler a Deloitte email demonstrating that the delay in delivery of the audit was due to circumstances out of DV Realty's control. (A472-72.) In that email, Deloitte explained that its auditors were "working 70+ hrs per week on engagements in addition to DV Urban." (*Id*.) Allison further reported to Mohler that DV Realty was continuing to respond to Deloitte's requests for information. (*Id*.)

On March 9, 2011, Deloitte completed the 2009 audited financial statements with no "going concern" qualification. (*See* A474-98.)

D. <u>The Removal of DV Realty</u>

Several of the Limited Partners employ outside consultants to provide services relating to the Limited Partners' real estate investments. Both the Teacher's Fund and the CTA Fund have been using the Townsend Group ("Townsend") for that service since before they decided to invest in the Limited Partnership. (Op. at 19.) During the relevant time, the primary representative from Townsend for the Teacher's Fund was Rob Kochis ("Kochis"). (*Id*.)

In approximately September 2010, the Teacher's Fund (Huber) asked Kochis to recommend the removal of DV Realty. (*Id*. at 17.) On September 24, 2010, Kochis prepared a letter to Huber with the subject line "DV Urban Realty Partners Fund I: recommended manager change." (A500.) Kochis began the letter by stating, "[p]er our recent discussion, Townsend recommends that investors in the DV Urban Realty Partners consider terminating and replacing the General Partner (Davis Group)." (*Id*.) In the remainder of the letter, Kochis described several purported grounds for removing DV. (*See* A500-02.)

Three days later, on September 27, 2010, Kochis discussed his recommendation to remove DV with the other members of Townsend's advisory investment committee. (A505.) Specifically, Kochis reported to the committee that he was "recommending to remove [DV] and identify a new manager." (*Id*.) One of the committee members asked Kochis if there would be any political ramifications from the recommendation. He responded that "the client [Teachers (Huber)] had requested this recommendation," so he did not foresee any ramifications. (*Id*.)

A few days after that meeting, on October 1, 2010, Kochis delivered a final version of the September 24, 2010 letter to Huber. (A507.) Huber then organized a meeting on November 10, 2010, which was attended by all of the executive directors and Townsend. (A512; A514; A517; A519.) At that meeting, Townsend presented the executive directors with its opinion that grounds existed to remove DV Realty. (*See* A524; A527-31.) Shortly thereafter, having already confirmed that Townsend would support their desire to remove DV Realty, the Limited Partners hired Townsend to perform a "review" of the Limited Partnership and to give an opinion on the removal issue. (A533-36; A539-42.)

As pre-determined, on May 26, 2011, Townsend delivered to the Teacher's Fund the removal recommendation that it wanted. (*See* A544.) Townsend's May 26th letter stated that removing DV "<u>may</u> be in the best interests of the <u>Limited Partners</u>." (A544 (emphasis added).) It did not say that removing DV Realty was "necessary for the best interests of the Partnership." Huber gave the Teacher's Fund's board of trustees a copy of Townsend's May 26 letter. (A44-45 at 120-22

(Huber).) On June 9, 2011, the Teacher's Fund's board of trustees authorized Huber to execute Townsend's removal recommendation. (*Id*.)

That same day, June 9, 2011, Townsend delivered a nearly identical removal recommendation to the other Limited Partners' executive directors. (*See* A550; A555; A560.) In its June 9, 2011 letter, Townsend recommended removing DV Realty for, *inter alia*, the following reasons: (1) untimely financial reporting; (2) Vanecko's resignation; (3) the dysfunction of the Advisory Committee; and (4) the Dudek Lawsuit. (A550.)[5] Gallagher, Capasso, Mohler and Kallianis testified that their respective boards of trustees authorized removal of DV Realty based on Townsend's conclusions and recommendations. (Op. at 20.)

Several months after that decision was made, on January 30, 2012, the Limited Partners delivered the Written Consent to DV Realty purporting to remove DV Realty as the Limited Partnership's Managing General Partner. (A565-67.) On February 1, 2012 the Limited Partners filed their Complaint, alleging that they properly removed DV Realty without cause pursuant to section 3.10(a)(ii) of the LPA. DV Realty disputes that the Limited Partners determined, in good faith, that removing DV Realty was necessary for the best interests of the Limited Partnership.

[5] The other bases in the letter that are not mentioned here were either abandoned by the Limited Partners during trial or rejected by the Court of Chancery.

ARGUMENT

I. THE DECISION OF THE COURT OF CHANCERY SHOULD BE REVERSED BECAUSE DV REALTY'S FAILURE TO DELIVER AUDITED FINANCIAL STATEMENTS ON A TIMELY BASIS DID NOT PROVIDE THE LIMITED PARTNERS WITH A GOOD FAITH BASIS TO BELIEVE THAT REMOVING DV REALTY WAS NECESSARY FOR THE BEST INTERESTS OF THE PARTNERSHIP.

A. Question Presented

The Court of Chancery held that "the principal basis for the Limited Partners' decision to remove [DV Realty] was [DV Realty's] consistent failure to have the Limited Partnership's annual audited financial statements completed on time." (Op. at 46.) Indeed, although the Court of Chancery held that three of the "red flag" issues provided only slight support for the Limited Partners' removal decision, it is clear that without the late audit issue, the red flag issues are not enough to support the removal decision. Thus, the principal issue on appeal is whether the Court of Chancery's ruling on the late audit issue was correct.

Interpreting Section 3.10(a)(ii) of the LPA, the Court of Chancery correctly concluded that whether or not the Limited Partners determined in "good faith" that removing DV Realty was "necessary in the best interests of the Partnership" is reviewed both subjectively (did each of the Limited Partners honestly hold that belief?) and objectively (was that belief reasonable?). (*Id*. at 32-34). However, DV Realty respectfully submits that the Court of Chancery misapplied that legal standard when it ruled that the Limited Partners acted in good faith when they determined that DV Realty's late delivery of audited financial statements made removal of DV Realty necessary for the best interests of the Limited Partnership. (*Id*. at 39-41.)

Specifically, the question presented here is: was it objectively reasonable for the Limited Partners to conclude that it was necessary for the best interests of the Limited Partnership to have the annual audits completed by the deadline set by the LPA even though the audits would not be "clean" and would contain a "going concern" qualification, which would make it more difficult for the Limited Partnership to extend existing loans and obtain replacement loans?

B. <u>Scope of Review</u>

The relevant facts are not in dispute. The issue in dispute is the Court of Chancery's legal conclusion that the Limited Partners acted in good faith. That decision is reviewed *de novo*. *Bank of N.Y. Mellon*, 29 A.3d at 236 ("Once the historical facts are established, the issue becomes whether the trial court properly concluded that a rule of law is or is not violated. Appellate courts review a trial court's legal conclusions de novo.")

C. <u>Merits of the Argument</u>

In reaching its decision, the Court of Chancery first determined what the parties intended the term "good faith" to mean when they included it in Section 3.10(a)(ii) of the LPA. Because the LPA did not define that term, the Court of Chancery ruled that "the parties intended to adopt Delaware's common law definition of good faith as applied to contracts." (Op. at 33.) Then, citing Section 1-201(b)(20) of Delaware's UCC, 6 *Del. C*. § 1-201, the Court of Chancery held that good faith has both a subjective component, meaning "honesty in fact," and an objective component, meaning "the observance of reasonable commercial standards of fair dealing." (*Id*.)

Not surprisingly, since this case does not involve the sale of goods, DV Realty could not find any cases applying the UCC's definition of "good faith" to facts analogous to the instant facts.[6] Moreover, as the Court of Chancery correctly noted, when determining whether conduct has been taken in good faith, "[c]ontext matters." (Op. at 34.)

The decision in *Me. Family Fed. Cred. Union v. Sun Life Assur. Co. of Canada*, 727 A.2d 335 (Me. 1999), provides some helpful instruction on the UCC definition of good faith. In that case, the court interpreted a UCC definition of good faith that is identical to that found in Section 1-201(b)(20) of the Delaware UCC. The court held that under the objective component of good faith, one cannot act with "a pure heart and an empty head." *Id.* at 342. The court explained that the objective component requires: (1) conduct that comports with industry or commercial standards, and (2) those standards must be objectively reasonably intended to result in fair dealing. *Id*. at 343.

The Court of Chancery's decision in *Wilmington Leasing, Inc. v. Parrish Leasing Co., L.P.*, 1996 WL 560190 (Del. Ch. Sept. 25, 1996), also sheds light on the meaning of good faith in this context. In that case, the Court was called upon to apply a provision in a limited partnership agreement permitting limited partners to remove a general partner only if they determined that the general partner had failed to perform satisfactorily, but which did not specify the level of

[6] None of the parties urged the UCC definition of good faith in briefing in the Court of Chancery.

discretion given to the limited partners in making that determination. *Id*. at *1. The Court implied a requirement that the determination be made reasonably and in good faith because otherwise the removal condition would be "marginalized" so as to allow "the limited partners to remove, maliciously or unreasonably, a general partner who was performing satisfactorily." *Id*. at *2. Read together, *Maine Family* and *Wilmington Leasing* demonstrate that good faith requires conduct designed to promote fair dealing and carry out the intention of the parties' bargain.

Here, the Court of Chancery held that the Limited Partners acted reasonably (and thus met the objective part of the good faith test) in concluding that the removal of the General Partner was necessary for the best interest of the Limited Partnership because audited financial statements were not delivered on time. (Op. at 46.) But that ruling misapplied the good faith standard. The question of whether the Limited Partners acted in good faith is not whether it was reasonable for them to believe that audits are important to them or to the Limited Partnership, or whether they thought it might be preferable to have the audits completed on time. In the abstract, those questions are not in dispute. However, those were not the questions being asked here. As previously stated, "context matters" (Op. at 34), and the dilemma confronted by DV Realty in 2009 was whether to: (a) deliver the audit on time, but with a "going concern" note that would have been catastrophic for the Limited Partnership's financing efforts; or (b) deliver a "clean" audit without adverse consequences for the Limited Partnership, albeit after the deadline in the LPA. In other

words, could the Limited Partners reasonably have concluded that it was necessary for the best interests of the Limited Partnership to remove DV Realty because it selected the latter option?

Under the undisputed facts, removing DV Realty was not objectively necessary. Specifically, it is undisputed that:

1. DV Realty repeatedly explained the debt maturity/going concern issue that was delaying the audit to the Limited Partners;
2. The Limited Partners did not doubt the truth of that explanation;
3. The Limited Partners understood that receiving a "going concern" note in the audit would be bad for the Limited Partnership;
4. The Limited Partners understood that as a result of the recession and unprecedented problems in the real estate market, it had become increasingly difficult for DV Realty (and other real estate developers) to obtain and extend loans;
5. The Limited Partners never produced any evidence that DV Realty failed to do everything it could to obtain the necessary loan extensions as soon as possible;
6. The Limited Partners never asked DV Realty to cause the audits to be issued with a going concern note; and,
7. DV Realty provided the Limited Partners with unaudited financial statements on a quarterly basis; and

8. DV Realty was open and responsive to the Limited Partners, provided updates on the status of the Limited Partnership's projects and answered the Limited Partners' questions, even when those questions were "tough."

Given these undisputed facts, the Limited Partners' could not have reasonably concluded (and did not reasonably conclude) that receiving a timely audit with a "going concern" note was better for the Limited Partnership than receiving an untimely audit without a "going concern" note –- let alone that it was necessary. Indeed, the Limited Partners' own complaint reveals that they wanted the audits sooner -- regardless of the negative impact on the Limited Partnership -- so that they could meet their own internal reporting requirements: "[t]he General Partner's lack of routine financial reporting impeded the Limited Partner Pension Fund's ability to report to their own respective beneficiaries." (A581 ¶ 19(vi).) Furthermore, Townsend's removal recommendation stated that removing DV Realty may be best for the Limited Partners, it did not say removal was necessary for the best interests of the Limited Partnership. The removal standard under the LPA looks at what was necessary for the best interests of the Limited Partnership, not what was best (or preferable) for the Limited Partners.

By delaying issuance of the audits until the "going concern" condition was satisfied, DV Realty did what was best for the Limited Partnership. The Limited Partners did not object to that business decision. The Court of Chancery held that the Executive Directors disagreed with that business decision, but did not cite any testimony

or evidence for that finding. In fact, although there is evidence that the Limited Partners were anxious to receive the audits (e.g., their letters and emails to DV Realty discussed above) there is no evidence that the Limited Partners ever concluded that receiving a timely audit with a going concern condition was better for the Limited Partnership than receiving the audit late, but without the "going concern" condition.

Moreover, neither the Limited Partners nor the Court of Chancery ever explained why the audit delays made it necessary for the best interests of the Limited Partnership to remove DV Realty. The word "necessary" imposes a high burden for removal on the Limited Partners. It means that they must show that they believed, in good faith, that if they did not remove DV Realty, the Limited Partnership would suffer an otherwise avoidable injury. We understand the Limited Partners' argument and the Court of Chancery's ruling as to why it was preferable for the Limited Partners to receive the audits within the LPA's 120-day deadline, but the audit delays did not make it necessary to remove DV Realty. Indeed, in Townsend's removal recommendation, which was the basis for the Limited Partners' removal decision, Townsend never opined –- or ever suggested -- that removing DV Realty was necessary for the best interests of the Limited Partnership.

Furthermore, if removing DV Realty was really "necessary," then what took the Limited Partners so long to do it? Most of the issues that the Limited Partners complain about -- including the audit issue -- first took place before 2010, yet the Limited Partners did not vote to remove DV Realty until June 2011. The Limited Partners then waited

another seven months (until January 30, 2012) before executing the Written Consent and notifying DV Realty of the purported removal. If removing DV Realty was truly “necessary,” the Limited Partners would have acted with more urgency in doing so. Moreover, if removing DV Realty had been “necessary” based on things that happened before 2010, there would have been evidence of adverse consequences in the ensuing two years -– but there were none.

Because an objectively reasonable person would not have concluded (and could not have concluded) that DV Realty’s business decision to delay issuance of the audits until the “going concern” condition was resolved made it necessary for the best interests of the Limited Partnership to remove DV Realty, the Court of Chancery’s removal decision should be reversed.

II. IF THE COURT OF CHANCERY'S DECISION ON THE AUDIT ISSUE IS REVERSED, THE ENTIRE OPINION SHOULD BE REVERSED BECAUSE THE SLIGHT WEIGHT GIVEN TO THE RED FLAG ISSUES IS NOT SUFFICIENT TO SUPPORT THE REMOVAL DECISION AND, IN ANY EVENT, THE COURT OF CHANCERY ERRED IN GIVING THE RED FLAG ISSUES ANY WEIGHT AT ALL.

A. Question Presented

The Court of Chancery afforded the dysfunction of the Advisory Committee, Vanecko's resignation and the Dudek lawsuit slight weight in its determination that the Limited Partners' without cause removal met the requirements of Section 3.10(a)(ii) of the LPA. However, the Court of Chancery did not state whether these red flag issues alone, i.e., without the audit issue, are sufficient to support the Limited Partners' removal decision. Based on the Court of Chancery's discussion of those issues and the "slight" weight it accorded them, without the audit issue, the red flag issues are insufficient to support the removal.

Nevertheless, the Court of Chancery erred when it afforded the red flag issues any weight for the Limited Partners' removal decision (Op. at 48, 49, 50), because the undisputed facts establish that the Limited Partners could not have held a good faith belief that the red flag issues necessitated removing DV Realty for the best interests of the Limited Partnership.

B. Scope of Review

The facts regarding the red flag issues are not in dispute. DV Realty is challenging the Court of Chancery's application of the good faith standard to the undisputed facts. Therefore, the standard of review is *de novo*. *Bank of N.Y. Mellon*, 29 A.3d at 236.

C. Merits of Argument

First, although the Court of Chancery gave just "little weight" to the alleged "dysfunction" of the Advisory Committee as a good faith basis for the Limited Partner's decision to remove DV Realty, that issue should not have been given any weight at all. It is undisputed that practically from its inception, the Advisory Committee was not constituted as envisioned in the LPA, yet none of the Limited Partners ever complained about that fact. There is not one single piece of evidence from any of the Limited Partners to DV Realty raising an issue about the functioning of the Advisory Committee.

The Limited Partners' lack of complaint about the Advisory Committee until Townsend raised it as an issue in its removal recommendation shows that the Limited Partners did not subjectively believe that the functioning of the Advisory Committee necessitated removal of DV Realty. Moreover, as with most of the Limited Partners' arguments, there is a timing issue. If the Limited Partners really believed in good faith that the structure and functioning of the Advisory Committee necessitated removal of DV Realty for the best interests of the Limited Partnership, they would have removed DV Realty much sooner than they did. The purported dysfunction of the Advisory Committee did not provide the Limited Partners with an objectively good faith basis to believe that removing DV Realty was necessary for the best interests of the Limited Partnership.

Second, the Court of Chancery afforded Vanecko's July 2009 resignation "slight" weight as support for the Limited Partners' June 2011 decision to remove DV Realty. Respectfully, that issue should

not have been given any weight. As the Court of Chancery correctly pointed out, there is a serious timing issue with the Limited Partners' argument. If they truly viewed Vanecko's resignation in 2009 as a concern that was so serious that it necessitated removing DV Realty as the general partner, they would have done something about it sooner. But, instead, when Vanecko withdrew, the Limited Partners decided to "wait and see" how DV Realty did without Vanecko. The Limited Partners' consultant, Kochis, admitted that Vanecko's resignation became less of an issue over time,[7] so how could it possibly provide any support for their June 2011 decision to remove DV Realty? If anything, the Limited Partners' reliance on Vanecko's resignation for their removal decision shows that they are not acting in good faith.

Finally, the Court of Chancery held that the Dudek Lawsuit could have provided the Limited Partners with "some support" for their removal decision because the existence of the consulting agreement suggests that DV Realty may have breached the LPA. The Dudek Lawsuit did not provide the Limited Partners with any support for their removal decision. They all understood that DV Realty entered into the Consulting Agreement before they decided to invest in the Limited Partnership and before they insisted on the finder's fee prohibition. Moreover, the Executive Directors' own testimony demonstrates that Dudek is not entitled to a fee because he did not procure the Limited Partners' investments. Moreover, DV Realty never paid Dudek a fee and none of the Limited Partners have any reason to believe DV Realty paid

[7] None of the Limited Partners testified to the contrary.

Dudek a fee. Simply, the Dudek Lawsuit could not cause a reasonable person to believe that it was necessary to remove DV Realty for the best interests of the Limited Partnership. Thus, that issue should not have been given any weight.

CONCLUSION

For all of the foregoing reasons, DV Realty respectfully requests that this Court reverse the Court of Chancery's determination that the Limited Partners validly removed DV Realty without cause and enter an order reinstating DV Realty as the managing general partner of the Limited Partnership.

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Dated: November 26, 2012