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November 27, 2013

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Re: *Policemen's Annuity and Benefit Fund of Chicago, Illinois v. DV Realty Advisors LLC*
C.A. No. 7204-VCN
Date Submitted: August 26, 2013

Dear Counsel:

The Plaintiffs, five Chicago public employee pension plans and the limited partners of Nominal Defendant DV Urban Realty Partners I L.P. (the “Partnership”), removed Defendant DV Realty Advisors LLC (“DV Realty”) as General Partner of the Partnership and then obtained the Court’s confirmation of

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the validity and effectiveness of their action.¹ The Court reserved jurisdiction to address follow-on matters. The first of those issues is whether DV Realty's interest in the Partnership, as a general partnership interest, converted into a limited partnership interest on its removal or, as the Plaintiffs call it, "a mere economic interest." The second issue involves valuation of DV Realty's interest in the Partnership or, to use the concepts of the limited partnership agreement, a determination of its capital account.

A. *DV Realty's Status*

Under the Delaware Revised Uniform Limited Partnership Act ("DRULPA"), unless the partnership agreement provides otherwise, a person may be admitted to the partnership as a limited partner only upon the consent of all of the limited partners. By Section 17-301(b)(1) of the DRULPA:

(b) After the formation of a limited partnership, a person is admitted as a limited partner of the limited partnership:

(1) In the case of a person who is not an assignee of a partnership interest, including a person acquiring a partnership interest directly from the limited partnership and a person to be admitted as a limited partner of the limited partnership without acquiring a partnership interest in the limited partnership, at the time provided in

¹ *Policemen's Annuity and Benefit Fund v. DV Realty Advisors LLC*, 2012 WL 3548206 (Del. Ch. Aug. 16, 2012), aff'd, 75 A.3d 101 (Del. 2013).

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and upon compliance with the partnership agreement or, if the partnership agreement does not so provide, upon the consent of all partners and when the person's admission is reflected in the records of the limited partnership;²

Because none of the existing limited partners consented to DV Realty's becoming a limited partner, it has no specific statutory claim to that status. Moreover, nothing in DRULPA supports the claim that a removed general partner's interest somehow automatically converts into a limited partnership interest.³ Thus, consideration of the Partnership's limited partnership agreement is necessary.⁴

Partnership law generally embraces freedom of contract, and, through the partnership agreement, the partners may provide different procedures for becoming a limited partner. The LPA allows for the transfer of a limited partnership interest to a "substitute Limited Partner."⁵ Any such transfer of an interest in the partnership requires approval of the General Partner, and that has not been

² 6 Del. C. § 17-301(b)(1). Section 17-101(8) defines a "limited partner" as "a person who is admitted to a limited partnership as a limited partner as provided in § 17-301"

³ See, e.g., *Hillman v. Hillman*, 910 A.2d 262 (Del. Ch. 2006).

⁴ DV Urban Realty Partners I L.P. Third Amended and Restated Agreement of Limited Partnership (the "LPA") appears as Exhibit A to Def. DV Realty Advisors LLC's Combined Resp. Br. Regarding its Status as a Limited Partner and Opening Br. in Supp. of its Mot. for a Determination of its Capital Account.

⁵ LPA § 9.2.

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obtained.⁶ Thus, no provision of the LPA expressly establishes a process—automatic or otherwise—by which DV Realty may claim to have achieved limited partnership status.

The LPA addresses the rights of a removed General Partner:

In the event of the removal of a General Partner . . . such General Partner . . . shall retain 100% of its Capital Account . . . with 50% of such Capital Account . . . being maintained on the same basis as any other Limited Partner's Capital Account, while the other 50% of such Capital Account . . . shall be distributed to such General Partner in cash within 30 days of the date of removal.⁷

This paragraph confirms that the removed General Partner retains its Capital Account (subject to the buy-back of half of it). DV Realty seeks solace in two aspects of this provision. First, its Capital Account is to be “maintained on the same basis as any other Limited Partner's Capital Account.” The language requiring the treatment of a person on the same basis as any other limited partner may be read to suggest that the person would also be a limited partner. Second, “Capital Account” is defined as “an account maintained for each Partner.”⁸

⁶ LPA § 9.1(a).

⁷ LPA § 3.10(a)(iii)(B)(1).

⁸ LPA § 1.1, at 3.

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“Partner,” in turn, means “a Limited Partner or a General Partner.”⁹ If DV Realty has a Capital Account—which it does—then, based on the definitions in the LPA, one can conclude that it is either a general partner or a limited partner. Because DV Realty is no longer a General Partner, then through the very simple process of elimination, it must now be a limited partner. The logic of these arguments is appealing but, ultimately, unavailing.

First, it is unlikely that such a major issue in partnership governance would be handled through a maze of financial valuation or definitional provisions, especially when the LPA has specific provisions addressing how one becomes a limited partner. Second, the provisions upon which DV Realty relies generally deal with economic rights. Third, the removed General Partner still carries the title, even if its status has been modified, of General Partner. If the removed General Partner had become a limited partner, then one would have expected that the LPA would have acknowledged that. Fourth, the removed General Partner is no longer obligated to honor capital calls. Nothing in the LPA supports the notion that there are two types of limited partners: some who must make additional capital

⁹ LPA § 1.1, at 7.

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contributions and some who bear no such burden. Finally, there is a reasonable drafting explanation. Someone who holds an interest (not yet liquidated) as a former partner, under the revenue laws, must be treated the same as a partner for tax purposes. Perhaps “any other” was an infelicitous choice of words, but those words do not change the clear intent of the LPA or introduce that type of ambiguity that may be resolved by reference to extrinsic evidence.

Representatives or advisors to the Plaintiffs have made statements reflecting their understanding that a deposed general partner would become a limited partner. Maybe that is a common understanding or expectation, but it is not what either the law or the LPA provides. The Plaintiffs are not bound by such speculative mistakes because (1) they are questions of law which are for the Court to resolve and (2) DV Realty did not rely upon any of the statements.

Accordingly, DV Realty is not a limited partner of the Partnership. Whether it holds an “economic interest” or a “mere economic interest” is a question that the Court does not need to address.

B. *The Capital Account*

The Plaintiffs invested approximately \$66.5 million for a 95.1% interest in the Partnership while DV Realty invested approximately \$3.4 million for a 4.9% interest in the Partnership, which is now worth approximately \$294,000. The Partnership's assets are now worth approximately \$6 million. Under the LPA, the Partnership must buy back half of DV Realty's interest (*i.e.*, 50% of its Capital Account). Thus, if that interest is to be purchased at current fair market value, DV Realty would receive approximately \$150,000, a number that does not compare favorably with \$1.087 million, which is half of its tax basis capital account based on its 2011 Schedule K-1. In contrast, if DV Realty were paid half of its initial investment, or half of its tax basis capital account, in consideration of a 2.45% interest (half of its interest), an outcome would result that would not please the Plaintiffs.

The Partnership looks to the LPA to find a way to use a current fair market valuation. By Section 5.14(b) of the LPA, “[t]he Managing Partner may make, or refrain from making, any elections relating to or affecting the Partnership under the

[Internal Revenue] Code [of 1986, as amended].”¹⁰ Treasury Regulations allow an increase or decrease in the partners’ capital accounts based on the fair market value of the Partnership’s assets when a distribution is being made to a partner: “[a] partnership agreement may, upon the occurrence of certain events, increase or decrease the capital accounts of the partners to reflect a revaluation of the partnership property (including tangible assets such as goodwill) on the partnership’s books.”¹¹ In order to adjust capital accounts in compliance with the Treasury Regulations, five criteria must be satisfied:

1. Adjustments must be based “on the fair market value of the Partnership property.”
2. The adjustments must reflect how “unrealized income, gain, loss, or deduction” is allocated among the partners.
3. Each Capital Account must be adjusted in accordance with Treasury Regulation § 1.704-1(b)(2)(iv)(g) with respect to allocations of depreciation, depletion, amortization, and gain or loss.
4. The partners’ distributive shares of depreciation, depletion, amortization, and gain or loss for revalued property must account for the variations between the adjusted tax bases and the book value of the property following the directions of § 704(c).

¹⁰ Through this provision, the parties accorded substantial discretion to the General Partner. The General Partner is “the Managing Partner or the Co-General Partner.” LPA § 1.1, at 5.

¹¹ Treasury Regulations § 1.704-1(b)(2)(iv)(f).

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5. The adjustments must be made principally for a non-tax business purpose.¹²

These requirements have been satisfied.¹³ With that, the LPA allows the General Partner to make elections under the Code, and the Code, as elaborated in the Treasury Regulations, authorizes the Partnership to value Capital Accounts based on the fair market value of the Partnership property in connection with the distribution.

The LPA offers another means by which fair market value calculations may be performed by the Managing Partner. Section 5.11 of the LPA provides:

For purposes of calculating Partnership Percentages, Capital Account balances, calculating and allocating Partner Guaranteed Payments, the allocation of income and loss and distributions, and for all other purposes, all timely Capital Contributions shall be deemed to have been made on the same day and the Managing Partner shall be permitted to adopt reasonable conventions for such purposes and any such determination by the Managing Partner shall be final and binding

¹² See generally Treasury Regulations § 1.704-1(b)(2)(iv)(f)(1)-(5).

¹³ The current General Partner, TCB Urban LLC ("TCB"), took the following steps: It based its adjustments on the fair market value of the Partnership's property. It based its allocation upon each partner's proportionate share. The third requirement was satisfied by using the LPA's definitions of depreciation and of net profits and net losses. As for the fourth requirement, the LPA, in Section 5.15, requires that the revaluation take into account any variations between the property's adjusted tax basis and its book value. Finally, the adjustments were taken for a non-tax business purpose, more specifically, for the distribution to a former partner in payment for part of its partnership interest.

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on the Partners. Capital Accounts will not be adjusted by *de minimis* contributions or distributions of cash or other property.

Adjusting values to fair market value constitutes a reasonable convention. In light of the steep drop in value of the Partnership assets, such a revaluation is especially appropriate.

The date for valuing the Capital Account is yet another source of disagreement. The Partnership looks to December 31, 2012, as the first valuation following DV Realty's removal.¹⁴ DV Realty, instead, wants to use the 2011 Capital Account balance appearing on its Schedule K-1. The debate, in practical effect, is about whether the assets should be valued contemporaneously or historically. One wonders if the positions would be different if the value had escalated as dramatically as it has declined.

The removal process took some time. Although the Plaintiffs may have started considering DV Realty's removal earlier, they formally gave notice on January 30, 2012. Litigation commenced in this Court on February 1, 2012, and was resolved in the Supreme Court in August 2013. DV Realty remained as a General Partner until September 20, 2012, when TCB was designated as the new

¹⁴ DV Realty has not challenged the 2012 valuation numbers.

General Partner. The LPA provides no helpful, express guidance on the timing of the valuation. The valuation should be near the date of termination. This reasonable observation leads to other abstract considerations. If the General Partner had left when the termination notice was given, then the proper date would be more apparent. Here, however, DV Realty did not go upon receiving notice. Instead, the Plaintiffs concluded that this litigation should be commenced.

Thus, in these circumstances, with no clear basis for setting the date, the focus must be on reasonableness. The end of tax (calendar) year 2012 date is the better choice because it more accurately reflects the economic realities of the Partnership. DV Realty seeks a partial cash-out from the Partnership at a value that is much larger than its 2.45% of the Partnership's current fair market valuation.¹⁵ That outcome finds no support in either the text or the logic of the LPA.

DV Realty wants to add to its Capital Account \$2 million for a loan on which it was a co-borrower and \$985,000 for a guarantee provided by one of DV Realty's principals for a portion of a Partnership loan. The LPA provides an

¹⁵ The LPA does not prescribe a date that leads to an unreasonable valuation. Thus, it is not necessary to avoid the parties' agreement.

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explanation for why DV Realty is not entitled to what it seeks. A partner's Capital Account will be increased by "the amount of any Partnership liabilities . . . assumed by such partner . . ."¹⁶ DV Realty is a co-borrower on the loans, but DV Realty is not "ultimately liable"¹⁷ because it is entitled to contribution from the Partnership.¹⁸ As for the guarantee, it was not made by DV Realty; instead, it was provided by one of DV Realty's principals. As such, the guarantee does not operate under the LPA to increase DV Realty's Capital Account through its principal's personal and individual guarantee.

It should also be noted that DV Realty, while it was General Partner, made no changes to its Capital Account for either of these reasons.

A somewhat technical argument by the Plaintiffs—one upon which the Court need not rely—also supports this outcome. The LPA, in Section 6.1(f), requires the Advisory Committee to approve any transaction involving the General Partner. The Advisory Committee did not approve either of these transactions (assuming that DV Realty's principal somehow qualifies as a general partner for

¹⁶ LPA § 1.1, at 3.

¹⁷ See Treasury Regulations § 1.704-1(b)(2)(iv)(c).

¹⁸ This also applies to the \$985,000 loan guaranteed by one of DV Realty's principals.

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these purposes). Thus, no advantage may be gained by DV Realty for either the \$2 million as a co-borrower or for the guarantee of payment of \$985,000 for purposes of calculating its Capital Account.

Finally, there is debate about when the Partnership should have paid (or should pay) DV Realty for 50% of its Capital Account. Until August 2013, DV Realty was appealing this Court's order confirming its removal as General Partner and sought to be reinstated as a General Partner. The LPA provides that payment should be made within thirty days of removal of the General Partner, but as long as the General Partner contests its removal on appeal, there is no reason why the duty to pay should not have been stayed in an effort to avoid the complications that would ensue if the General Partner's interests were, in part, paid and then it was reinstated. Payment of half of its Capital Account was due DV Realty within thirty days of the Supreme Court's decision; interest will accrue on sums due DV Realty thereafter.

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Counsel are requested to confer and to submit an implementing form of order.

Very truly yours,

/s/ John W. Noble

JWN/cap
cc: Register in Chancery-K