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MANAGING AND RESOLVING HEDGE FUND AND PRIVATE EQUITY FUND DISPUTES

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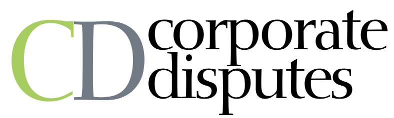

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HOT TOPIC

MANAGING AND RESOLVING HEDGE FUND AND PRIVATE EQUITY FUND DISPUTES

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David K. Momborquette focuses on complex commercial litigation and regulatory matters primarily for financial services industry clients, including hedge funds, funds of funds and private equity funds. Mr Momborquette has substantial experience in private securities litigation and securities regulatory matters, investigations by the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA), as well as investor disputes and class action litigation.

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Seth M. Schwartz is a partner in the New York office. Mr Schwartz has a wide-ranging trial and appellate litigation practice involving complex securities, commercial and corporate governance matters pending in federal and state courts throughout the country and before the SEC and FINRA.

CD: How would you characterise activity and performance in the hedge fund and private equity fund industries over the past 12 months or so?

Starr: From early to mid-2016, hedge funds struggled, with managers seeing flat to double-digit losses for their main funds. In particular, strategies that focused on macro trends and equity hedges were producing the worst returns. However, by the end of 2016, returns improved – a trend that has continued into 2017. In comparison, the private equity fund industry performed well throughout 2016 with continuously healthy appetites among investors, which helped to raise $589bn in capital globally. One notable trend has been a surge in megabuyout funds, defined as those that raise more than $5bn.

Schwartz: The environment for hedge funds has been challenging. Although returns improved in 2016 and the first quarter of 2017, the perception remains that performance has been disappointing relative to other investment alternatives and in light of the advisory fees levied by fund managers. Private equity funds have fared much better, undoubtedly because returns have significantly outpaced those of public equity markets.

Kish: Despite plenty of anecdotal evidence and press coverage about poor performance within the industry, we have seen a rise in the number of new offshore funds being formed – both hedge and private equity – in the last 12 months as compared to the previous 12 months. Market leaders continue to be able to attract large and rapid allocations from institutional and non-institutional money, which demonstrates that the alternative investment industry has not lost its appeal. However, with increased regulatory and compliance burdens, it remains a tough environment for start-up and emerging managers and those managers who are outside the genuine 'top tier' to maintain their competitive edge and continue to attract sizeable allocations.

CD: What are the key factors driving fund-related disputes in the current market?

Schwartz: Litigation against hedge fund managers has been driven principally by questions regarding valuation of fund assets, fund liquidity, inter-fund transactions, insider trading, Ponzi schemes and market-related 'blow-ups'. The principal issues in litigation against private equity fund managers include allegedly undisclosed fees, misallocated expenses and undisclosed conflicts of interest.

Kish: Fund disputes are almost always driven by a combination of uncertainty and distrust. Poor performance can be one trigger, of course, because no one is ever happy about losing money. That can result from a variety of factors, including commodity prices, strategy, timing and global macro events. But disputes only tend to escalate where the manager's response to losing money is not as quick or as clear as the investor would like it to be. Often, the reason a manager loses his investor's trust has nothing to do with the underlying losses but whether he appears to be acting in investors' best interests as opposed to covering any exposure he may think he has. The main two factors that contribute to this are not knowing what the fund's options are and a lack of communication with investors.

Momborquette: In the US, the single biggest factor driving fund-related disputes is regulatory risk, primarily involving the Securities and Exchange Commission (SEC). The SEC remains very focused on the investment management industry and this includes the SEC's enforcement programme. In the SEC's last fiscal year, which ended 30 September 2016, approximately 20 percent of all enforcement actions were against an investment adviser. Financial Industry Regulatory Authority (FINRA) and certain state-level regulatory agencies also have been very active over the last several years with respect to investment managers.

Starr: While hedge fund disputes are as unique as the hedge funds which generate them, there are several areas of regulatory and litigation focus, including valuation, insider trading, Foreign Corrupt Practices Act (FCPA) violations, trade allocation practices and fee allocations. What many of these disputes have in common is the emergence of disgorgement as the regulator's preferred remedy. Disgorgement often dwarfs fines and penalties. However, this trend will be reined in by the recent Supreme Court ruling in the Kokesh case that the same five year statute of limitations that applies to fines and penalties applies to disgorgement.

Johnson: In the last 12 months we have seen a number of post-acquisition disputes involving private equity funds. In each case, the fund made a business acquisition and, despite detailed analysis and due diligence, found that it did not get what it expected. There may be evidence suggesting that pre-acquisition financials had been misstated, for example, or that certain warranties in the sale and purchase agreement had been breached. These cases involve assessing the actual value of the acquired business and comparing that to the value of the business that the fund thought it was acquiring. We have seen more of these types of dispute in the last year, as more investment capital flows into and around Asia.

CD: Have any recent, high-profile fund disputes caught your attention? What lessons can fund managers learn from these cases?

Kish: *Rhone Holdings* was a well-received decision about 18 months ago, when the Cayman Court confirmed that non-petition language contained in a limited partnership agreement was enforceable and not contrary to public policy in the Cayman Islands. Managers are picking up on this now for both their corporate and partnership Cayman funds, but of course there is always a balancing exercise to be performed between protecting the fund through this kind of clause and being able to attract investment. That said, for some onshore firms the inclusion of a non-petition clause in the fund documents is fast becoming standard practice. Another well-known case here that was of reassurance to managers dealing with redemption disputes was the *Harbinger Class PE Holdings* decision.

Starr: Several recent high-profile fund disputes stand out. First, at the end of 2016, Platinum Partners' founder, former president and four others were accused of faking the firm's performance figures to collect a cut of all investment gains and to maintain a façade of financial stability. Similarly, in June 2016, valuation fraud was at the center of a case against fund managers at Visium Asset Management LP, where two former portfolio managers were accused of asking brokers to provide fraudulent quotes on securities that were better than the market price. All the individuals involved either pled guilty or were convicted by a jury. Second, an insider trading matter involving the CEO of Omega Advisors, Leon Cooperman, has received a lot of attention. Cooperman was accused of using his status as one of Atlas Pipeline Partners' largest shareholders to gain access to confidential information and trading on it, even though he made a commitment not to. Cooperman's settlement with the SEC is notable because both Cooperman and Omega avoided an industry bar. Instead, they

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>
> *Marc Kish, Harneys*

agreed to $2.2m in disgorgement and interest and a $1.7m penalty, and will hire an independent compliance consultant to review their trading and recommend improvements. Many experts expect that this unusual settlement will be used by defence attorneys to negotiate similar deals. These matters underline the need for robust compliance structures and increased levels of internal expertise so that funds can more effectively manage compliance risks.

Johnson: The Cayman Islands Grand Court has recently been considering several high-profile hedge fund disputes involving the value of shares in Chinese companies. In each case, a hedge fund held a shareholding in a US-listed Chinese company, the majority shareholders sought to privatise the company by buying out all minority shares and the fund challenged the consideration offered under Section 238 of the Cayman Islands Companies Law. In these disputes, the fair value of the fund's shares could be significantly more than the consideration actually offered. One lesson to take from this is a dispute can sometimes be a process through which funds earn their return. In this respect, disputes can be an opportunity rather than an inconvenience.

Momborquette: The SEC has focused a lot of attention in recent years on those who are charged with supervising individuals who violate insider trading laws. A good example of this is an administrative proceeding filed last year by the

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FTI Consulting

SEC against an investment adviser, Artis Capital Management, and one of its senior research analysts, for failure to supervise a junior analyst who improperly obtained material, non-public information. The junior analyst utilised that information to make trade recommendations that turned out to be very profitable. With the filing of this action, the SEC has made it clear that investment professionals play a key role with respect to preventing the misuse of confidential information, including investigating so-called red flags that may indicate that information has been obtained improperly. In recent years, the SEC also has been

very focused on conflicts of interest, in particular the failure of investment advisers to adequately disclose a conflict. Recent SEC actions involving Apollo and WL Ross, respectively, are good examples of the SEC's recent focus on this area.

Schwartz: The civil and criminal charges recently brought against Platinum Management and its principals are a standout because of the relatively large size and scope of the defendants' allegedly fraudulent scheme. The SEC's settlement of insider trading charges against Leon Cooperman and his firm Omega Advisors also was notable because of the high-profile defendants involved and the SEC's agreement to accept, as part of the settlement, Omega's retention of an independent compliance consultant, apparently in lieu of an industry bar. Another development worthy of note is that it appears that more lawsuits were commenced in the last 12 to 18 months by hedge fund managers, on behalf of their funds, than were initiated against them. Of particular significance recently has been litigation challenging the SEC's use of administrative proceedings in enforcement actions against hedge fund managers in lieu of suing them in federal district court. To date, the results of those suits have been mixed, setting the stage for potential resolution of the issue by the US Supreme Court. As for managers of private equity funds, the big story has been the significant uptick in SEC enforcement actions challenging the adequacy of fee-related disclosures.

CD: Could you outline some of the common types of fund disputes and the different strategies that can be deployed to resolve them? What are some of the specific challenges associated with fund disputes?

Johnson: The most common fund disputes that we see are post-acquisition disputes, involving allegations that warranties were breached or that misrepresentations were made. Arbitration is often used to resolve these disputes, especially if they are cross-border. Arbitration can be quicker than litigation, is often cheaper and the outcome is private. One of the challenges with any kind of fund dispute is that there is often, understandably, greater urgency and time pressure because of the overall strategies of the investment and the fund. For this reason, it is especially important for all aspects of the dispute process to be as efficient as possible.

Momborquette: The biggest challenge with respect to most regulatory or investor disputes is to minimise the risk that the dispute leads to a material amount of investor redemption requests. Investors' appetite to stick with a manager that is involved in a dispute with regulators, or even a material one involving other fund investors, is extremely low.

Accordingly, the same degree of care and attention that a manager gives the counterparty to a dispute often needs to be given to those investors not directly involved in that dispute. Some of the most interesting and challenging fund disputes often never make their way into the press or court docket. This is especially so with respect to disputes arising in the course of winding down a fund. Fund wind-downs are complicated affairs that require a well-planned and thoughtful approach with respect to investors, or problems will almost certainly arise, especially with respect to issues relating to the return of capital.

Schwartz: In the civil realm, litigated disputes typically fall within one of the two following categories: breach of fiduciary duty claims brought by fund investors against fund managers, for example, claims alleging style drift, or fraud claims asserted by investors against the managers and the funds, for example, allegations that a fund offering memorandum or periodic investor reports misrepresented or otherwise mischaracterised the fund's investment strategy or net asset value. Many such claims are subject to summary dismissal through the assertion of a variety of threshold defences that frequently arise in the hedge fund context. These include: the claims are barred by exculpation clauses in the governing fund documents; the breach of fiduciary duty claims belong to the hedge funds at issue, not the investors in the funds, consequently, the investors lack standing to maintain those claims; and the fraud claims are barred by disclaimers of reliance typically included in fund subscription agreements. As for challenges associated with fund disputes, the financial wherewithal of accredited or qualified investors to make hedge fund investments may compound those challenges. Multiple, unaffiliated high net worth individuals or institutions invested in a single hedge fund or group of feeder funds are better able to bring and control their own claims against managers and their funds. As a result, in the event of a fund 'blow-up' or other adverse development, hedge fund managers may find themselves defending overlapping, multiple individual actions in multiple jurisdictions, a dynamic that potentially and materially may increase the burdens, expenses and pressures on defendants.

Starr: In addition to trading and valuation problems, many funds have been caught up in regulatory and litigation disputes relating to 'cherry picking'. 'Cherry picking' involves allocating profitable trades to preferred accounts and less profitable or unprofitable accounts to non-preferred accounts. The SEC brought several actions challenging fund allocations, which resulted in fines and industry bars. These cases underline the importance of carefully scrutinising funds' accounting and allocation practices. Funds can be

sure that the regulators and their own investors will be asking pointed questions.

Kish: We still see a lot of disputes revolving around the use of side letters, in particular questions arising as to enforceability, inconsistencies between side letters and offering constitutional documents, and the use of nominees to enter into side letters on the investor's behalf. Another difficult question relates to the investor's ability to challenge audit holdbacks and when excessive use of holdbacks constitutes a red flag to investors. The timing of advice from offshore counsel is often critical in order to preserve the client's options in these scenarios, as well as knowing which points to focus on in correspondence and which not to. A well-informed letter or circular sends the right message and saves time and money by getting straight to the point. For investors, a lack of access to information can be a frustrating factor and so engaging in an effective way is important. For fund managers, keeping up to speed with legal and regulatory developments in the jurisdiction of the fund's formation is the only sure way to gain protection from angry investors and remain focused on matters at hand.

CD: How well are fund managers equipped to deal with the dispute process? What lessons can we draw from this?

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>
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Schwartz: The level of preparedness varies among advisers. The key is to work with fund counsel at the inception of each fund to craft fund documents that include fulsome risk disclosures and provisions exculpating managers from liability to the maximum extent permitted by law. In addition, managers should obtain the protections of professional liability insurance and seek to involve counsel at the earliest stages of actual or threatened disputes.

Starr: Hedge funds and private equity funds are often thinly staffed and do not have a significant number of legal and compliance personnel to

handle disputes, which can make managing litigation difficult. As a result, fund managers should ensure that they have robust policies and procedures in place to help spot potential problems quickly, allowing them to bring in outside experts as early as possible.

Momborquette: As a general matter, investment managers are not very well equipped to deal with the dispute process, whether it involves the regulators or investors. Understandably, most managers do not manage their business as though an enforcement action is imminent or that litigation will arise between the manager and investors. In addition, most investment managers that become involved in litigation or a regulatory investigation have an unrealistic perception of how quickly such disputes will be resolved. This can often lead a manager to make strategically unwise decisions at the outset of such disputes in an effort to make the dispute go away quickly, something that rarely happens. The lesson that should be drawn from this is that it is more important to make the right strategic decision, even if that leads to a longer resolution of the dispute.

Kish: We see a big difference between managers who dedicate resources to legal – for example, in-house general counsels or regular discussions with outside counsel – and those who tend to rely on intuition or advice they have received in the past. Understandably, most businesses shy away from taking external legal advice unless they absolutely have to, but invariably it costs more in the long run because it is always more work dealing with an emergency. Budgeting for strategy discussions with offshore counsel before taking any important step in the lifetime of the fund is a sensible way to approach things, combined with a healthy respect for the constitutional documents.

Johnson: Fund managers are often very comfortable understanding and discussing the most detailed aspects of damages and valuation work. This can make the process very efficient, in terms of framing the key issues and identifying the most important data and documentation. In general, I recommend to any party in a dispute that it identifies personnel who can help with the financial aspects of the case. It is likely that a damages expert will have information requests and may wish to ask questions about financial records, for example. Having someone available who can handle this will make the process more efficient and effective.

CD: If a dispute arises, how important is it to evaluate all the available options, including negotiation, mediation, arbitration or litigation?

Momborquette: It is very important to evaluate the options available. There really is no 'one-size-fits-

all' approach to these types of disputes. A strategy that may work in one context may not be effective in another. Accordingly, investment managers should explore and evaluate all available options and pursue the ones that make the most sense given the particulars of the dispute.

Starr: You should always evaluate all of the available options, particularly exploring early settlement through mediation or other methods. Some may consider settlement as a sign of weakness, but that is not the case. You should evaluate risks honestly and try to resolve disputes as quickly as possible while considering all of the economic factors. An early settlement is often more cost-effective and less disruptive than a lengthy inquiry, even if that inquiry ultimately leads nowhere.

Kish: The decision whether to refer disputes to formal mediation or arbitration as opposed to the courts will usually be made well in advance of any dispute occurring. Alternative dispute resolution (ADR) often sounds like a good idea but investors should be careful that they do not commit themselves to a process that leaves them unable to act quickly or unable to seek appropriate relief, potentially without notice to the fund. Because fund directors have duties to treat all investors fairly, disputes affecting an entire class of investors are less likely to be capable of settlement and payments to creditors will carry an additional risk if the fund is approaching the zone of insolvency.

"There are many variables that bear on the optimal strategy for addressing and resolving disputes. Prolonged, expensive litigation is not always inevitable."

Seth M. Schwartz,
Skadden, Arps, Slate, Meagher & Flom LLP

Johnson: It is always sensible to try to resolve a dispute through negotiation or mediation. This is likely to be the most efficient and cost-effective outcome. Even if such a resolution is not possible at the outset of the dispute, it could be an ongoing option as the parties' legal, factual and quantum positions become clearer.

Schwartz: There are many variables that bear on the optimal strategy for addressing and resolving disputes. Prolonged, expensive litigation is not always inevitable. For example, depending on the circumstances, a dispute may be resolved by means of a few meetings or telephone calls or through

arbitration or mediation with the assistance of a mutually respected investment professional. There often is no need to get dragged into major litigation prior to evaluating whether there are less expensive and more efficient alternatives for handling disputes and pursuing them, if available, without going to court.

CD: In your opinion, when should expert witnesses be introduced into the dispute resolution process? What benefits can they bring to the table, particularly in areas such as calculating damages, for example?

Starr: Expert witnesses can be very helpful when trying to persuade sceptical audiences, whether they are regulators or an opponent in a civil litigation, on technical issues, such as valuation. Expert witnesses can be more persuasive and may be more credible than internal advocates. As a result, they are often useful in the settlement process and can be worth looking into as an investment in a more favourable resolution.

Kish: Increasingly, particularly in valuation cases, we are seeing the use of two experts in different roles. First, the main 'clean' expert who will give testimony in court and who must remain independent at all times. Second, the so-called 'dirty' expert, who works closely with the party to the litigation to provide insight into the different possible methodologies for calculating loss and assisting the party in developing its case and stress-testing the arguments in a way which would be impossible with an independent expert.

Johnson: The sooner expert witnesses are brought into the dispute resolution process, the sooner they can contribute. If they are engaged at an early stage, they can help identify the key issues, give an initial idea of quantum and provide input into the disclosure process. This can give the party a head start in its pleadings, better prepare it for settlements negotiations, and save significant time and cost later in the process. However, if expert witnesses are only engaged a few weeks before the report deadline, then the benefit will be more limited.

Schwartz: In most litigation, the timing for formally identifying expert witnesses will be dictated by rules of court procedure. Nevertheless, it may be beneficial to retain experts early in the discovery process, well before they must be identified to your adversary. In addition to calculation of damages, there are numerous other areas where particular expertise is needed or useful in litigation, including, for example, issues pertaining to securities trading or valuation, or the standards of care applicable to investment advisers. Experts may not only provide important evidence needed to win a case, they also may be helpful in providing guidance in connection

with pretrial discovery of your adversary's documents and witnesses.

Momborquette: The no 'one-size-fits-all' approach to disputes also applies to the use of expert witnesses. As a general matter, I am somewhat cynical about the effectiveness of introducing expert witnesses into a dispute before one would normally do so in the context of an actual litigation. Too often, all that is accomplished by introducing experts early into the process is to give an adversary a preview of your arguments and they will adjust accordingly. However, if it appears that an expert can clarify, or at least narrow, the gap between the parties, particularly with respect to damages, then a manager should seriously consider surfacing an expert earlier rather than later. In addition, experts can educate the client regarding the strengths and weaknesses of its case, particularly with respect to the issue of damages.

CD: What final piece of advice can you offer to fund managers on resolving their disputes as quickly and efficiently as possible, with minimal financial and reputational impact?

Kish: It might be a cliché, but prevention is always better than cure and it is almost always the case that speaking to your lawyers early on – both onshore and offshore where relevant – will save you time and money. However, if things do go past the point of no return, it will also be important to have lawyers advising you who have seen similar issues before and ideally helped to shape the applicable law.

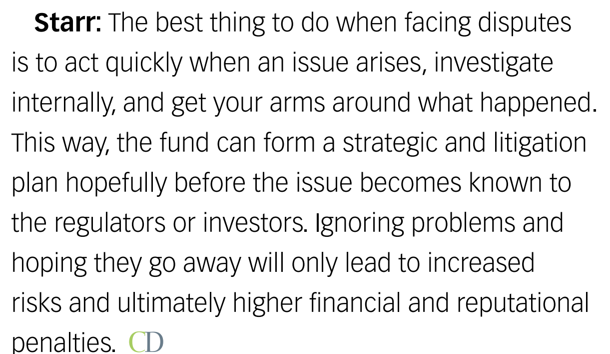
"Communication and transparency are typically the best ways for a manager to avoid disputes with its investors."

David K. Momborquette,
Schulte Roth & Zabel

Johnson: There is no one-size-fits-all approach to resolving disputes. We would advise any party that finds itself in a dispute to use all available resources to identify a cohesive legal, factual and quantum strategy at the outset. One of the biggest stumbling blocks in many disputes is a significant change being made to scope or approach later in the process, which requires work to be redone.

Schwartz: Rely on qualified fund counsel early and often to help anticipate and be prepared for potential disputes before they arise, and to help address and resolve actual disputes after they surface. In addition to securing exculpation against liability in the fund documents, managers should seek the advice of counsel as soon as potential disputes are identified. Counsel should remain involved pending resolution of any controversy that may emerge.

Momborquette: The best piece of advice I can offer is the old adage that 'an ounce of prevention is worth a pound of cure'. The best way to avoid an issue with regulators is to have a robust internal compliance programme. Communication and transparency are typically the best ways for a manager to avoid disputes with its investors. Once a dispute does arise, the manager's focus should be on making sound strategic decisions. Unfortunately, that approach can often clash with resolving the dispute quickly and cheaply and with a minimal-to-no reputational impact. However, managers should resist the urge to rush to 'sweep things under the rug' quickly. That approach too often creates more problems than it solves.



Starr: The best thing to do when facing disputes is to act quickly when an issue arises, investigate internally, and get your arms around what happened. This way, the fund can form a strategic and litigation plan hopefully before the issue becomes known to the regulators or investors. Ignoring problems and hoping they go away will only lead to increased risks and ultimately higher financial and reputational penalties. CD