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Corporate Restructuring & Bankruptcy

Hedge Fund Liquidations

Deciding what to do when investors ask for their money back.

BY MATTHEW A. FELDMAN AND JENNIFER L. DUDANOWICZ

IN TODAY'S market, many hedge fund investors want their money back. At the end of 2008, it was estimated that during the year hedge funds had paid out approximately $399 billion in total redemptions.[1] Coupled with an average loss of value estimated at between 18.3 percent[2] and 21.44 percent[3] of funds' total assets over the course of 2008, total hedge fund assets shrunk from an estimated peak of $1.92[4] trillion during 2007 to somewhere in the range of $1.2[5] to $1.4[6] trillion at the end of 2008.

In the process of counseling a battered and beaten hedge fund client who is seeking advice on whether to try to continue to operate or undertake a liquidation, two threshold issues must be addressed. First, it is critical for the fund to evaluate with the fund manager whether the fund is capable of meeting current and projected redemptions while still fulfilling its investment mandate for the non-redeeming investors. If the answer to the first question is no, then the second issue for the client is determining whether the fund's liquidation can be managed under applicable state or foreign law or whether Chapter 11 protection offers a safer and fairer environment in which to liquidate the fund's assets.

MATTHEW A. FELDMAN *is a business reorganization and restructuring partner at Willkie Farr & Gallagher.* JENNIFER L. DUDANOWICZ *is an associate at the firm.*

Whether to Liquidate

To determine a fund's long-term viability, a fund manager facing a slew of redemptions must determine whether redemptions will drain the liquid assets of the fund. If the pending redemptions would adversely affect what the manager believes is a prudent balance between liquid and illiquid assets, or if the amount of the redemptions in fact exceeds the amount of liquid assets available in the fund, a manager has several choices.

> A critical issue faced by liquidating hedge funds is how to treat early redeeming investors as compared to later redeeming investors as compared to non-redeeming investors.

Most hedge fund governing documents allow the manager to suspend or limit[7] redemptions or to delay the payment of redemption proceeds under certain circumstances. Where permitted and assuming prevailing market conditions allow, such actions may provide the manager additional time to liquidate illiquid assets at market prices and not be forced to sell assets at "fire sale" prices.

Another option that may exist in the hedge fund investment agreement permits the manager to pay a portion of redemption proceeds in kind with illiquid assets, either by transferring the assets directly to the redeeming investors or by transferring the assets indirectly by means of a "synthetic side pocket." A "synthetic side pocket" is accomplished by sequestering illiquid assets in a newly created subsidiary and granting an ownership interest in the subsidiary to the redeeming investor with a value equivalent to the investor's share in the fund as of the redemption date.[8] Over time, the manager will liquidate the illiquid assets in the synthetic side pocket for the benefit of redeemed investors, but it is the investor who accepts market risk in that scenario. The fund is protected from a run on its cash by the placement of illiquid assets into the synthetic side pocket as it allows redemption claims to be satisfied with illiquid assets.

Each of these techniques is intended to create time and space for the fund manager to weather unexpected market conditions and avoid a proverbial "run on the fund" by redeeming investors. Notwithstanding these techniques, there is no guarantee that a fund manager can ultimately control the volume of redemptions (which in many cases are driven by the need of the investor rather than the performance of the fund) where a broad swath of investors want to exit the investment. In these circumstances, the fund manager must act prudently and consistently with the fund documents in determining a path reasonably calculated to maximize value of the fund's assets for the benefit of the fund's investors.[9]

Liquidating the Fund

In circumstances in which a fund's assets are sufficient to meet its liabilities and there are no disputes between earlier and later redeeming investors, it is usually simpler and less costly to liquidate and dissolve the fund under applicable state or foreign law.[10] A critical issue faced by liquidating hedge funds is how to treat early redeeming investors as compared to later redeeming investors as compared to non-redeeming investors. It is common, even for funds that have received an unacceptably high volume of redemptions preventing them from continuing to operate in the ordinary course, for some investors not to have given notice of redemption. Typically, these non-redeeming investors have determined that they would rather continue owning the "equity" of the fund on the theory that asset values will recover quickly, permitting them a greater recovery than if they redeemed.

Notwithstanding the desire not to redeem, many hedge fund governing documents have a provision that allows for the fund manager to declare a mandatory redemption. Because most fund managers receive the bulk of their compensation as a percentage of fund profits after the recovery of all prior losses, fund managers may be more motivated to liquidate than to continue operations where the asset values have diminished significantly and the prospects for near-term recovery are dim. To the extent that the manager determines that it is best to liquidate the fund, utilizing the mandatory redemption option will facilitate the dissolution.[11] In circumstances where all of the investors have voluntarily and involuntarily redeemed, the fund can distribute all of its assets based on the values attributable to the redeeming investors as of the date of their redemption, permitting an efficient and orderly liquidation.

Priority of Redemption

Even when the fund manager has either voluntarily or involuntarily redeemed all of the fund's investors, it is not always simple to determine the exact mechanics for paying redeeming investors. The priority in which the former equity holders are paid is often a point of contention among redeeming investors.[12] Equity holders who have redeemed their stakes in the hedge fund earliest are likely to argue that their earlier redemption date gives them priority over other redeemers. Several recent lawsuits have involved hedge fund investors suing over the priority of their redemption rights, both domestically and in foreign jurisdictions.[13]

For instance, consider a scenario wherein a hedge fund has $100 in illiquid assets and no liquid assets. Prior to any redemptions, Investor 1 in the fund holds 20 percent, Investor 2 holds 10 percent and Investor 3 holds 70 percent of the fund. On Jan. 1, Investor 1 redeems, seeking his share of 20 percent of the fund's assets, or $20. On Feb. 1, the fund's assets have dropped to $50 and Investor 2 redeems his share of 10 percent, seeking $5. Finally, on March 1, the fund, whose illiquid assets have dropped to a value of $20, declares a mandatory redemption of Investor 3, forcing its remaining 70 percent interest in the fund to be redeemed.

During this period, the fund manager determined it was not prudent to attempt to liquidate any of the assets given rapidly deteriorating market conditions. As a result, as of March 2, all of the investors remain unpaid. Investor 1, who redeemed on Jan. 1, will likely claim that he has priority over both Investor 2 and Investor 3. From Investor 1's perspective, it redeemed first and is now owed $20. In fact, it is likely that Investor 1 would assert it is a creditor for $20 and not subject to pari passu treatment with the other redeeming investors. For Investor 1, claiming status as a creditor might help it obtain a priority under state partnership law and certainly would help it obtain a priority under the Bankruptcy Code. See 11 USC §507. In contrast, given the facts of this hypothetical, Investor 2 should pursue a decidedly different tack.

Investor 2 faces a conundrum. If Investor 2 supported Investor 1's argument that once an investor redeems it is a creditor entitled to be paid in full before later-redeeming investors, then all of the value in the fund as of March 1, which equaled $20, would belong to Investor 1 and Investor 2 would receive nothing. In contrast, it is likely that Investor 2 will argue that each of the redeeming investors should share the remaining $20 of asset value on a pari passu basis calculated based upon their allocable percentage of equity; then Investor 2 would be entitled to 10 percent of $20 or $2.[14] Under this rationale, Investor 1 would be entitled to 20 percent of $20 or $4 and the balance of $14 would be paid to the compulsorily redeemed Investor 3. This position undermines Investor 2's right to argue that it should have received $5 (10 percent of $50, the value as of Feb. 1), but given the actual value remaining, if Investor 2 were to adopt this position, all of the remaining $20 of value would have gone to Investor 1.

In the current environment, hedge fund investors who have previously issued notices of redemption and then stood by as asset values have fallen have increasingly been asserting Investor 1's argument, claiming that when their redemption requests are not paid on time, they then become creditors. The argument that former limited partners could become creditors was recognized in *Schuss v. Penfield Partners, L.P.*, where the Chancery Court found that under Delaware law, once a limited partner withdrew from a hedge fund, the partner became a contract claimant holding fixed rights who can sue in contract for failure to pay the value of its share at the withdrawal date. The court held that "…logically and consistent with the plain meaning of the Delaware Revised Uniform Partnership Act §17-606(a), it is the partnership that owes the distribution to the creditor (i.e., the withdrawn limited partner)."[15]

Another recent example was the involuntary Chapter 11 bankruptcy action filed against the domestic feeder fund of the Ritchie Multi-Strategy Fund. The fund's investors, who had redeemed 16 months earlier, but had not been paid, claimed that their redemption rights converted into debt obligations of the fund and as creditors, they had standing to commence an involuntary bankruptcy proceeding against the fund. See 11 USC §303(b)(1) (an involuntary case may be commenced "by three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute as to liability…").

The Ritchie Multi-Strategy Fund filed a motion with the Bankruptcy Court to dismiss the involuntary proceeding on the basis that the redeeming investors were equity holders, not creditors holding fixed, non-contingent claims, and therefore ineligible under the statute to commence an involuntary bankruptcy action. The fund also argued that it was solvent since it was paying its third-party debts as they came due, and that the financially sophisticated investors in the fund were not creditors since they had not been guaranteed a return on their investment.[16] The Bankruptcy Court in the *Ritchie* case granted the motion to dismiss.[17]

An interesting example of a hedge fund filing for bankruptcy protection involved the Bayou Group, which filed for protection in the Bankruptcy Court for the Southern District of New York. *Bayou* involved a fund manager that had fraudulently misrepresented the fund's financial performance. *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P.* (*In re Bayou*), 396 B.R. 810, 832 (Bankr. SDNY 2008). In *Bayou*, the court found that the creditors of Bayou's estates were "the defrauded investors who did not redeem their investments, augmented post-petition by those investors who redeemed pre-petition, settled fraudulent conveyance claims asserted against them by the plaintiffs and thereby became creditors to the extent of their redemptions…." Id. at 832.

Bayou provides an example of equity holders, albeit as victims of fraud, who were elevated to the status of creditors by the Bankruptcy Court. This case might be viewed attractively by a fund manager who seeks to overlay an "equitable" result in distributing assets to redeeming investors and who does not simply want to distribute the fund's assets pursuant to its fund documents as defined by state or foreign law. *Bayou* arguably supports the proposition that as a court of equity the Bankruptcy Court can overlay a fairness standard in determining the appropriate mechanism to distribute available assets to investors who have redeemed at different points in time.

On the other hand, in *In re: Revco, D.S. Inc.*, the Bankruptcy Court for the Northern District of Ohio held that holders of mandatory redeemable preferred stock of a corporation do not become creditors in a Chapter 11 case. The court noted that "[g]enerally, the rights of shareholders to redeem stock are not guaranteed but are dependent on the financial solvency of the corporation. Accordingly, the mandatory redemption provision of convertible preferred stock is an interest and not a claim…" 118 B.R. 468, 474 (Bankr. N.D. Ohio 1990). The holding in this case is seemingly contradictory to the court's view in *Bayou*.

Conclusion

Hedge fund liquidations and dissolutions form an evolving area of law with limited precedent. As hedge funds face rapidly declining asset values combined with historically high redemptions, fund managers are being forced to evaluate whether to continue operating.

Once the specter of liquidation is raised, the manager should promptly provide the fund more time and control by taking advantage of options that may exist under its fund documents, such as suspending redemptions or creating synthetic side pockets. If these options do not exist, the fund manager should focus his attention on the timing of redemptions to try to ensure the most equitable outcome among investors—if for no other reason than that it will reduce the risk of costly litigation. As a less attractive option, the fund manager can avail itself of the bankruptcy process to create judicial oversight of the liquidation process.

1. Hennessee Group LLC, "Hedge Funds' Worst Historical Net Outflows of Capital in 2008: $782 Billion of Record Redemptions and Performance Losses" (Jan. 20, 2009), http://www.hennesseegroup.com/releases/release20090120.html.
2. Alistair Barr, "Investors Pull Record $152 Billion From Funds in Fourth Quarter," MarketWatch, Jan. 21, 2009, at News & Commentary citing Hedge Fund Research Global HF Industry Report: Year End 2008.
3. Barclay Hedge, "70% of Hedge Funds Lost Money in 2008; Average Fund Plunges 21.44% in 12 Months" (Jan. 21, 2009), http://www.barclayhedge.com/research/press_releases/PR_Jan_21_2009.html.
4. Barr, citing Hedge Fund Research Global HF Industry Report: Year End 2008, supra note 2.
5. Hennessee Group LLC, supra note 1.
6. Barr, citing Hedge Fund Research Global HF Industry Report: Year End 2008, supra note 2.
7. Many hedge fund governing documents permit the hedge fund to limit redemptions for a given redemption date to a specified percentage of fund assets (usually 10 percent to 25 percent). Investors seeking a redemption as of that date would normally have their redemption claims reduced pro rata until aggregate redemptions are within the allowable percentage. The portion of the redemption claim that is barred by this feature, commonly known as a "redemption gate," remains as non-redeemed equity until the next available redemption date. Depending on the governing documents, investors that have been barred by a gate may not have priority over other investors at the next available redemption date should the gate be imposed yet again. A gate may be of limited usefulness where liquid assets slowly bleed out over a series of continuous monthly redemptions, never rising to a level that would trigger the gate but which in aggregate irreparably impair the fund's liquidity.
8. Where a synthetic side pocket is employed, often a redeeming investor will receive a portion of its redemption proceeds in cash and a portion in the form of an interest in the synthetic side pocket, each portion respectively representing the fund's mix of liquid and illiquid assets as of the redemption date.
9. Most issues surrounding distributions of assets revolve around redeeming investors, because it is rare for a hedge fund to have insufficient assets to pay creditors in full. When a fund's assets are insufficient to pay third-party creditors, a filing under 11 USC §101 et seq. is generally best.
10. Most domestic funds are limited partnerships, governed by detailed provisions regarding liquidation and dissolution found in a particular state's Uniform Limited Partnership Act. With respect to foreign funds, each jurisdiction under whose laws the fund has been created also have statutory schemes governing liquidation and dissolution.
11. Notably, under most fund documents the redemption of all shareholders would have the effect of terminating the fees payable to the manager, which a manager should be aware of when determining the timing of any compulsory redemption.
12. Although not discussed in this article, friction between redeeming investors and the fund manager can arise when a portion of the fund manager's compensation has been deferred as equity in the fund. The timing and amount of these payments can cause disagreement between the redeeming investors and the fund manager, who may attempt to claim priority for its fees as a creditor.
13. See *Schuss v. Penfield Partners, L.P.*, 2008 Del. Ch. LEXIS 73 (Del. Ch. June 13, 2008); *Umbach v. Mercator Market Fund, L.P.*, Case No. 07-6861 (D.C.D. Cal. filed Oct. 23, 2007). See also Maples and Calder, "Cayman Islands Corporate Funds: New Case Law Concerning Redemptions and Suspensions" (Dec. 17, 2008), http://www.maplesandcalder.com/viewlibraryitem.aspx?lib_id=129; Bermuda Supreme Court, Commercial Court matter 2008/266: *BNY AIS Nominees Ltd. v. Stewardship Credit Arbitrage Fund, Ltd.*, (decided Nov. 27, 2008).
14. If measured as of Investor 2's redemption date, Investor 2's equity ownership would be 12.5 percent and Investor 2 would have a fixed redemption claim of 12.5 percent of $30 (i.e., $50 less Investor 1's prior claim of $20). This latter treatment is typical under normal circumstances outside the context of a contentious liquidation.
15. Supra at 13-14.
16. See Motion to Dismiss Case by Summary Judgment, *In re Ritchie Multi-Strategy Global*, Case No. 07-24236 (Bankr. N.D. Ill. Jan. 14, 2008).
17. See Order Granting Motion to Dismiss Case, *In re Ritchie Multi-Strategy Global*, Case No. 07-24236 (Bankr. N.D. Ill. April 16, 2008).