



Business Divorces

Loose Corporate Formalities of Former Hedge Fund Management Partners Result in a Messy Business Divorce

Aug. 4, 2011

By Alisa Greenstein, *Hedge Fund Law Report*

On July 8, 2011, the U.S. District Court for the District of Connecticut issued an **opinion** that partially ruled on summary judgment motions involving a highly “unusual set of circumstances” in a contentious dissolution involving former hedge fund partners Scott Stagg and Gary Katcher. The action, part of three separate lawsuits that arose out of Stagg’s creation of a new hedge fund and Katcher’s sale of a company for a sizeable personal fortune, involved allegedly fraudulent and otherwise improper transfers by and among two families of hedge funds, their investment adviser and broker. The plaintiffs, 3V Capital Master Fund, Ltd. (3V), and its purported successor-in-interest, SV Special Situations Master Fund, Ltd. (SV), which Stagg formed independently of Katcher, filed a complaint against his former partner Katcher and Katcher’s brokerage firms, Libertas Holdings, LLC and Libertas Partners, LLC, as well as a subsequent purchaser of the Libertas entities, in order to recover millions in allegedly improper financial transfers to those firms. These defendants, in turn, filed a third-party complaint against Stagg, the Chief Operating Officer (COO) Mark Focht they had hired, and 3V Capital Management, LLC (3V Management), their investment adviser, in order to obtain, among other things, indemnification for the third-party defendants’ part in the alleged wrongdoing.

At issue before the court were multiple atypical summary judgment motions. In its motion papers, SV admitted that it possessed over \$4 million due to Katcher without a claim of right and the Libertas entities (and, thus, their owner Katcher) admitted that they wrongly obtained and possessed almost \$9 million due to 3V without a claim of right. Yet, the Court, in the face of the funds’ loose corporate formalities and the parties’ inability to identify whether the law of Connecticut or of a foreign jurisdiction should govern, could not determine whether SV had standing to recover as a successor-in-interest to 3V, which defendants received or benefited from possession of the sums due to 3V, and whether Katcher had unclean hands affecting his recovery of the sums owed to him. As a result, it denied the claims or took them “under advisement,” ordered the outstanding sums placed in interest-bearing escrow accounts, and assigned a financial expert. We detail the background of the action and the Court’s legal analysis.

Background of the Action

In 2002, Katcher, an experienced distressed debt trader, founded, as Chief Executive Officer and majority owner, brokerage firms Libertas Holdings, LLC and its subsidiary, Libertas Partners,

LLC, to specialize in the sales, trading and research of high-yield / distressed debt instruments. Katcher brought in Stagg and, later, Mark Focht as Chief Operations Officer.

In February 2004, Katcher and Stagg started the 3V Capital Master Fund, Ltd. (3V), and feeder funds, 3V Capital Fund, Ltd., and 3V Capital Partners LP, the general partner of which was 3V Capital Advisors, in which Stagg and Katcher each held half-ownership interests. To effectuate their trades, they formed investment advisor 3V Capital Management, LLC (3V Management), and used Libertas Partners to broker their trades. The funds specialized in below-grade investments. Focht joined as 3V Management's COO, and his duties expanded to include managing the relationship and expenses of both Libertas and the 3V family of funds. Operations, offices and employees of the Libertas and 3V entities extensively overlapped.

From October 2005 through April 2007, Focht prepared and executed, with Stagg's alleged authorization, a series of multi-million dollar financial transfers from 3V (and certain affiliated funds which had since assigned their interests to 3V), to the Libertas entities in order to purchase shares in certain companies, which in some cases 3V never received and, allegedly, to assist Libertas Holdings to pay its payroll. Libertas undisputedly had no legitimate claim to \$8.9 million worth of these transfers, which were used primarily to pay off Libertas' debts.

In March 2007, Stagg, without Katcher, formed SV Special Situations Master Fund, Ltd. (SV), and feeder funds SV Special Situations Fund, LP and SV Special Situations Fund, Ltd. Then, allegedly without Katcher's knowledge, Stagg shuttered the 3V funds to new investors, moved their offices, and absorbed the assets of 3V into SV.

In 2008, Knight Capital Group, Inc. (Knight) purchased the Libertas entities. In August 2009, Focht pled guilty in New York state court grand larceny for misappropriating funds from 3V.

Litigation ensued. Plaintiffs, SV, as self-proclaimed successor-in-interest to 3V, and 3V, sued defendants Knight Libertas, LLC, Libertas Holdings, LLC, Libertas Partners, LLC, and Katcher to recover an estimated \$13 million in financial transfers from 3V to the defendants. They brought claims of breach of contract, unjust enrichment, a "claim for money," breach of fiduciary duty against Katcher, conversion, statutory theft under Connecticut law, statutory theft against Katcher, breach of fiduciary duty against Libertas, aiding and abetting a breach of fiduciary duty, conspiracy to commit theft, and a violation of the Connecticut Unfair Trade Practices Act (CUTPA).

The defendants, conceding that they had \$8.9 million wrongfully obtained from 3V in their possession without a claim of right, challenged the plaintiffs' standing to recover those funds and disputed the legitimacy of the remaining transfers. They filed a third-party complaint as third-party plaintiffs against Stagg, Focht, and 3V Management for fraud, breach of fiduciary duty, negligent supervision of Focht, CUTPA violations, and statutory and common law indemnification. In support, they alleged certain fund transfers by these third-party defendants to Libertas were done without the knowledge of Libertas or Katcher and, in one instance, without their involvement. Katcher, individually, filed a cross-complaint against SV to recover over \$4 million due him from the sale of 3V Capital Advisors.

Defendants moved and plaintiffs cross-moved for summary judgment on the complaint, and the third-party defendants moved for partial summary judgment on the third-party complaint.

Legal Analysis

Defendants' motion for summary judgment rested on two main grounds. First, they disputed SV's status as a successor-in-interest with standing to bring claims on 3V's behalf, which had undisputedly suffered the injuries at issue, and argued that any sums due 3V "abated during the asset transfer process" between them. Second, defendants claimed Katcher cannot be held personally liable.

SV countered that it had acquired 3V's assets, and thus its right to recover the sums wrongfully in defendant's possession, through a back-to-back stock redemption, in which the redeeming investors in 3V and 3V feeder funds reinvested their assets into SV feeder funds, which then transferred to SV. It added that, through the transfer, it suffered injury because it received the fraudulently inflated positions of the bonds associated with the transfers which never happened, and which SV wrote down.

Defendants replied that SV and 3V have separate legal identities, independently incorporated in the British Virgin Islands (BVI), that the SV feeder funds were marketed to investors as new, distinct funds with different strategies and subscription agreements than 3V funds, and that "not all of the 3V feeder funds' investors chose to re-invest in the SV feeder funds," meaning SV could not have acquired all of 3V's assets. In other words, defendants argued the method chosen by SV to obtain 3V's assets was legally insufficient to transfer 3V's rights.

The District Court, citing *Raines v. Byrd*, 521 U.S. 811 (1997), recognized that Article III of the United States Constitution requires the "plaintiff[] [to] establish [its] 'standing' as 'the proper part[y] to bring' suit." Thus, it looked to Rule 25(c) of the Federal Rules of Civil Procedure (FRCP), to determine if SV had standing. Rule 25(c) states:

Transfer of Interest. In case of any transfer of interest, the action may be continued by or against the original party, unless the court upon motion directs the person to whom the interest is transferred to be substituted in the action or joined with the original party.

The problem for the District Court arose from its determination as to "whether an entity [here, SV] is a transferee of interest," pursuant to this Rule, because that analysis "is a matter of state law," and neither parties had identified the jurisdictional law, BVI or Connecticut, that controlled the transfer of assets at issue. And, without that information, the Court could not decide whether to recognize the transfer as sufficient to create a successor-in-interest. The Court also rejected 3V's ratification, pursuant to FRCP Rule 17, of SV as the party authorized to pursue its claim, saying that, "under these circumstances," ratification is not enough without knowing, under state law, whether 3V continued to have the right to prosecute its claim, and whether SV succeeded to it. The Court also could not determine, on the record provided, whether 3V's right to pursue the claim independently abated during the transfer process. Accordingly, it took the issues "under advisement" and ordered further briefing.

The District Court denied Katcher's motion for summary judgment. He asserted that SV could not "pierce the corporate veil" to hold him directly liable, and testified to having no knowledge of the wrongful transfers. Nonetheless, the Court noted that a claim under Connecticut law of unjust enrichment (where a defendant receives a benefit, unjustly, fails to pay for the benefit, and the payment is to a plaintiff's detriment), a "claim for money" (where defendant received and benefited from money belonging to plaintiff), and a claim of conversion (where a defendant participated in an unauthorized act that deprived the plaintiff of property) against Katcher need not pierce the veil. Since the record contained evidence that Katcher personally received over \$100,000 from the 3V payroll transfer to Libertas, a jury could find he "personally benefited," thus giving rise to personal liability under these theories.

Next, the District Court took under advisement the plaintiffs' motion for summary judgment because, with it unable to determine the issue of standing, it could not rule in their favor notwithstanding the defendants' admission to possession of their property. It added that assuming standing for SV or 3V did exist, it also could not decide an unjust enrichment claim because, due to the loose corporate formalities of the defendants, it could not determine who held or benefited from the funds at issue. To that end, the Court found that the "exceedingly adversarial relationship of the parties," insufficient record, and protracted history of litigation, called for the appointment of an expert, pursuant to Rule 706 of the Federal Rules of Evidence, to conduct a forensic accounting of defendant's books and records in order to assist it, or a jury, as the trier of fact on this issue. Finally, the Court ordered the defendants to place almost \$9 million into an escrow account to the benefit of SV.

The District Court also granted the motion by third-party defendants, Stagg, Focht and 3V Management, for summary judgment on the defendants' claims of negligence, common law indemnification and contractual indemnification against them. The complaint accused 3V Management and Focht of initiating the multi-million dollar transfers from 3V to the defendants and Focht of carrying out the transactions associated with the transfers. It also alleged that the defendants were unaware of their receipt of those transfers.

Addressing the common law indemnification claim, the Court explained that, in Connecticut, the defendant-third-party-plaintiff must establish: (1) a third-party-defendant was negligent; (2) the negligence was the direct and immediate cause of the injury; (3) the third-party-defendant had control over the events leading to the plaintiff's injury; and (4) the defendant-third-party-plaintiff did not know of the wrongful conduct, had no reason to anticipate the wrongful conduct, and reasonably relied on the third-party defendant not to engage in the wrongful conduct. *Ferryman v. City of Groton*, 212 Conn. 138, 142 (1989). The defendants, the Court noted, must also prove by a preponderance of the evidence that the third-party defendant was the active or primary tortfeasor. The Court found the facts in the third-party complaint failed to identify how the third-party defendant's negligence amounts to anything more than a contributing factor to the financial transfers, rather than the primary cause as required to establish its claims of negligence and common-law indemnification in a third-party context. Accordingly, the Court dismissed these claims without prejudice to refile.

The District Court also rejected Katcher's attempt to seek contractual indemnification, in his role as a manager for the 3V entities, because the terms of the Operating Agreement did not authorize it. Instead, the indemnification provision allowed for payment of expenses incurred while the manager acted in good faith and in the best interests of the company. The liability Katcher faced dealt with his wrongful retention of funds through *Libertas*, or his breach of a fiduciary duty for "loot[ing]" 3V. Either way, the contract would not indemnify him.

Finally, the District Court declined to grant Katcher's counterclaim against SV to redeem his partnership interest in 3V Capital Partners, notwithstanding SV's admission to holding over \$4.1 million, without claim of right, from Katcher's interest. The Court found genuine issues of material fact exist concerning whether Katcher had "unclean hands" relating to his part in the financial transfers, thus allowing SV to offset its losses against Katcher's interest. The Court explained that under Connecticut law, "The party seeking to invoke the clean hands doctrine to bar equitable relief must show that his opponent engaged in willful misconduct with regard to the matter in litigation." SV offered evidence from which a jury could infer that Katcher was aware of the transfers from 3V to the *Libertas* entities and personally benefited from the sale of *Libertas* due to the artificial increase in value it obtained as a result of the transfers. As a result of this genuine issue of material fact, it found Katcher's motion could not be granted.

Nonetheless, the Court ordered SV to place the \$4.1 million into an escrow account for the benefit of Katcher until such time as a trier of fact resolved the issue.

IMPORTANT: This article contains information protected by copyright which can only be used in accordance with the terms of your Hedge Fund Law Report subscription agreement. You must not therefore copy or forward this article, its contents, or any contents on the password-protected Hedge Fund Law Report website. (Your subscription agreement explains how you can use contents for reports and presentations.) UNAUTHORISED USE OR DISCLOSURE IS UNLAWFUL.

© 2019 Mergermarket Limited. All rights reserved.