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Fund Documents

When Are the Personal Legal Disputes of a Hedge Fund Manager Principal "Material" and Therefore Required to Be Disclosed in Fund Offering Documents?

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By Alessia Bell, *Hedge Fund Law Report*

Massachusetts' highest court, the Supreme Judicial Court (Court), recently handed down a ruling in a case in which Jack Welch, the legendary former CEO of GE, sued the founder of a hedge fund manager after suffering nearly $7 million in losses in one of the manager's funds. Welch claimed that the principal failed to disclose his involvement in housing-related litigation that occurred several years before Welch invested in the fund. Welch claimed he made his investment, nearly all of which he subsequently lost, based in large part on the principal's character. Had he known that the principal "had made threats to people and their property, I would have run so far from a character like this, and I would not put a dollar in there."

The case raises an interesting question recently explored by academics and financial commentators: How relevant are an executive's personal legal disputes to issues like securities fraud, or, in legal terms, are such personal disputes material to an investor's consideration of a fund investment? The Court's decision sheds some light on this question, which in turn is relevant to investors in hedge funds. Accordingly, this article summarizes the Court's decision as well as a New York Times article describing the results of an academic study on whether executives who are willing to violate non-securities laws in their day-to-day lives are more likely to violate securities laws. For a discussion of materiality in a different but related context, see "Are Hedge Fund Managers Required to Disclose the Existence or Outcome of Regulatory Examinations to Current or Potential Investors?," Hedge Fund Law Report, Vol. 4, No. 32 (Sep. 16, 2011).

Background

In 1997, Daniel J. Barach founded hedge fund MLT Capital, L.P. (MLT Capital); MLT Management, LLC, the sole general partner of MLT Capital; and MLT Advisors Corp., the investment adviser of MLT Capital. MLT Capital's strategy was to invest in companies undergoing management-led rehabilitations, based on research relating to the companies' financials and meetings with the incoming CEOs. The fund enjoyed steady success from 1997 to 2003.

At a Harvard Business School class reunion in June 2003, a friend and classmate of Barach's introduced him to Welch, who had retired as CEO of the General Electric Company in 2001.

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Based on this introduction, Welch became impressed with MLT Capital and requested more information about the fund.

Fund Offering Documents and Prior Lawsuit against Barach

Barach provided investors in the fund with a private placement memorandum (PPM) dated November 24, 1997, that included a specific assurance that "[t]here have been no administrative, civil or criminal actions, whether pending, on appeal, or concluded, against the General Partner or Barach." In 1997, this statement was accurate.

In 1999, Barach's residential landlords sued in New York to evict Barach and his family from their leased house in Westchester County. The Barachs allegedly requested that the landlords allow them to extend their tenancy for a few weeks because they had recently closed on a home and wanted to avoid moving their children twice in a short period. The landlords refused, but the Barachs remained in the house. The day before the expiration of the tenancy, one of the landlords went to the house and attempted to repossess the premises. She alleged that Mr. Barach refused to vacate and made various threats to damage the property.

The landlords then sued to evict the Barachs and secured a temporary restraining order forbidding any harm by Mr. Barach to their property. The parties settled the lawsuit shortly after it was filed, and the terms allowed the Barachs to stay at the house for the requested additional three weeks at a reduced rate of rent.

Welch's Investments

Barach provided Welch a PPM in 2003, which included the same "no litigation" assurance that was contained in the 1997 version of the PPM. In late June 2003, Welch invested $2 million in MLT Capital. In 2004, Welch invested an additional $5 million. In his deposition testimony, Welch enumerated the factors motivating his investment decision: (1) Barach's strategy of selecting turnaround companies under new management whom he had directly evaluated; (2) MLT Capital's strong performance record since 1997; (3) its moderate fees; (4) Barach's personal qualities, including his business school achievement; and (5) the esteem of his former classmate. Welch noted that when investing with single investors like Barach, the "character of that [single investor] was critical to my investment decision."

Barach provided a new PPM to investors in 2005 that included certain amendments but did not change the "no litigation" statement.

Dissolution of MLT Capital

In 2007, MLT Capital's performance declined. Welch requested to withdraw his investment, but Barach convinced him to remain invested in the fund. In October 2008, Welch again requested to withdraw his investment to take effect on December 31, 2008. By early December 2008, however, MLT Capital had suffered additional severe losses and Barach informed investors that he was dissolving the fund on December 12, 2008.

Welch lost nearly all of his $7 million investment. He then learned of the 1999 New York litigation.

Procedural History

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Welch sued in May 2009 in Superior Court in Massachusetts, claiming that the absence of any reference to the New York litigation from the 2003 and 2005 PPMs constituted a material omission under the Massachusetts Securities Act and an unfair or deceptive act or practice within the state's Consumer Protection Act. Barach moved to dismiss the complaint for failure to state a claim entitled to relief. A judge denied the motion on the basis that "Barach was the sole person upon whom MLT's investment decisions rested, and that information concerning Barach's character and judgment was therefore material."

Following extensive discovery, the parties moved for summary judgment. A different judge concluded that the omission of any reference to the New York litigation lacked the materiality necessary for a Massachusetts Securities Act violation and or violation of the state Consumer Protection Act. The judge concluded: "no reasonable investor in Welch's position would have viewed the brief housing dispute against Barach . . . as material to the decision whether to purchase interests in MLT Capital."

Analysis

Liability under the Massachusetts Securities Act

Because the Massachusetts Securities Act directs the state's courts to coordinate the interpretation of the Act with federal securities regulation, the Court applied federal case law under the federal Securities Act of 1933 to its analysis of the Massachusetts Securities Act.

The standard for a "material" misstatement or omission is the "substantial likelihood" that the omitted information would have "significantly altered the 'total mix' of information" available to an ordinary reasonable investor. The misstated or omitted fact must have been important, but need not have been causally or decisively important.

Applying this standard, the Court concluded that the record did not support a conclusion that the disclosure of Barach's litigation would have significantly altered the mix of information considered by a reasonable investor. The Court acknowledged that, with respect to a solo operation like MLT Capital, the character of the hedge fund's founder and sole decision-maker was important. However, the Court reasoned that the landlord-tenant dispute was a single episode, which was resolved quickly and voluntarily in Barach's favor. It was removed in time from the investment decision, and was equally remote in substance because it was a personal or family matter unrelated to business integrity. Meanwhile, Welch himself had acknowledged the numerous positive factors favoring investment. The Court concluded, "In the eyes of a reasonably prudent investor, the unreferenced litigation would constitute an insignificant ingredient in the resulting mix."

Liability under the Consumer Protection Act

The Court upheld the motion judge's determination that the omission did not constitute an "unfair or deceptive" practice within the meaning of the Massachusetts Consumer Protection Act, finding that "[o]ur analysis of the immateriality or unimportance of the undisclosed litigation nullifies the claim of actionable deception." Further, the omission was not otherwise unfair under common law, nor was it immoral, nor did it cause a substantial injury to consumers, competitors or other businesses.

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Is a Manager's Principal More Likely to Commit Securities Law Violations if He or She Commits Personal Legal Violations?

The Court's ruling in the Welch lawsuit, however, only represents one data point in the analysis of whether the legal disputes of principals of a hedge fund manager are material to investors and should therefore be disclosed. Robert Davidson, who teaches accounting at Georgetown University, along with Aiyesha Day of the University of Minnesota and Abbie Smith of the University of Chicago, recently examined how executives' behavior outside the workplace, as measured by factors including prior legal infractions, correlates with financial reporting risk. As described by Floyd Norris of the New York Times, the academics found evidence that executives who are willing to violate other rules are also more willing to violate securities laws.

The academics examined a set of 109 companies where the SEC detected fraud and 109 similar ones where it did not for the period 1992 to 2004. Then the researchers hired private investigators to look at the criminal records, including traffic violations, of the companies' CEOs, as well as public records of what cars, homes and boats the executives owned.

From the criminal records, the study revealed that among the 109 companies accused of committing fraud, executives faced eight felony drug charges, four domestic violence charges, four "reckless endangerment" traffic violations and 16 ordinary traffic tickets. Of the CEOs at companies not accused of committing fraud, records showed only five ordinary traffic violations.

While the evidence was preliminary, the three researchers concluded that people who are willing to violate one set of norms may be more likely to violate far more serious ones, even considering only minor infractions like speeding tickets. Based upon the academic study, the Times reporter, Norris, concluded, "the evidence may indicate that boards should routinely run background checks on top officers and on those being considered for such positions."

Further research may support the notion that hedge funds – particularly funds like MLT Capital that are managed by a single principal – should be required to disclose executives' personal legal disputes because such disputes are material to an investor's investment decision. Even if the research does not support this notion or is not done, investors in "one man show" hedge funds should consider requesting information on all litigation involving the principal – not just material or securities litigation – because "character evidence" in such circumstances is particularly important. Moreover, the insight is not limited to small managers. Non-securities litigation against a principal at an institutional management company may also adversely affect investment returns inasmuch as such litigation indicates shortcomings in the judgment or decision-making capacities of that principal.

For a copy of the Supreme Judicial Court's opinion, click here.

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