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Fund Liquidations

Practical Tips for Fund Managers to Mitigate Litigation Risk From Regulators, Investors and Vendors When Winding Down Funds

Oct. 27, 2016

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As private funds wind down – typically because of poor performance, investor attrition or fallout from regulatory enforcement actions – it is critically important for fund principals to approach the closure thoughtfully and methodically in order to minimize any potential issues. This includes understanding and honoring the requirements in fund documentation and other contracts; carefully managing communications with investors; promptly notifying investors when the fund liquidation commences; assessing liquidity in preparation for pending redemptions; and identifying which employees can and should be incentivized to remain with the fund through its wind-down.

These points were made in a session entitled "Steps for Winding Down a Fund: Determining When It's Time and What to Do" during the second day of the Tenth Annual Hedge Fund General Counsel and Compliance Summit, hosted by Corporate Counsel and ALM, on September 29, 2016.

The panel featured Patricia Arciero-Craig, general counsel and secretary of Gleacher & Company, Inc.; Cynthia A. Marian, head of legal and compliance of Marto Capital LP; Finbarr O'Connor, managing director and private funds advisory practice leader of Berkeley Research Group, LLC; and Michael R. Schwenk, general counsel and chief compliance officer of NWI Management LP. This article presents key takeaways from the panel discussion. For coverage of the opening session of the conference, see "How Hedge Fund Managers Can Accommodate Heightened Investor Demands for Bespoke Negative Consent, Liquidity, MFN and Other Provisions in Side Letters" (Oct. 13, 2016).

Circumstances Precipitating Wind-Downs

Marian identified a tendency that began with the global financial crisis of funds winding down because of poor performance. A run on assets by limited partners can occur somewhat prematurely, she explained, when a fund is not doing too badly but investors are driven by the prospect of getting their money back as quickly as possible.

Funds typically wind down due to performance-related issues, O'Connor concurred. However, he acknowledged that this is not always the reason why funds wind down.

One wind-down situation occurs when a fund experiences a decline in assets under management (AUM). This occurred with a fund that O'Connor's firm is managing that never suffered steep

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financial losses but had several lackluster years where it failed to make much money for investors. This caused limited partners who made money in the fund's early years to lose interest, while also making it hard to justify the managers' fees. This led to the principals' decision to wind down the fund.

A fund may also wind down when it transitions to another manager. For example, a group of limited partners contacted O'Connor out of concern over the SEC's investigation of their fund's manager. Liquidation would have been premature at that stage, so the limited partners decided to find a replacement manager for their highly specialized private equity portfolio. O'Connor described this sort of transition planning as highly popular at the moment, especially considering recent SEC proposals for manager-business continuity and transition plans.

Finally, sometimes funds shut down after an SEC investigation or when confronted by the enhanced regulatory landscape, Marian explained, choosing instead to operate as a family office. She described a large number of conversations she had with fund managers concerning whether to continue operating in the existing environment, possible ways to do so going forward and whether to convert to a family office instead. See "Benefits and Burdens for Hedge Fund Managers in Establishing or Converting to a Family Office" (Jun. 6, 2014).

Impact of Deciding to Wind Down

It is possible for a fund to wind down in orderly fashion, with plenty of time to work with ample resources to address and resolve issues concerning shareholders. However, it is even more likely that a firm's AUM is below the break-even point, fund personnel are operating with negative cash flow, there is little time to carry out critical tasks and there are scant financial resources to dissuade employees from walking out.

In either event, there are far-reaching ramifications once the fund principals commit to closing up shop. Effecting a wind-down plan has a big impact on resources, Schwenk noted, including time, financial resources and human capital. "If you're the general counsel or the chief compliance officer," he warned, "you'll probably have little or no input into the type of situation you're dealing with."

It is important to continue to conduct business in an orderly fashion in either scenario, Marian added, paying close attention to matters such as optics, selective disclosures, vendor relationships, negotiation of contracts and employee departures.

Considerations When Winding Down

Understand How Asset Liquidity Impacts Timing

A portfolio's liquidity dictates the planning and timing of a wind-down, O'Connor noted, adding, "Obviously, the more liquid, the more quickly you can get the cash." For example, if the fund principals were trading stocks on electronic markets, then they would probably have flexibility when it comes to exiting positions.

Conversely, a manager with wide-scale operations and many assets to liquidate – including illiquid assets – should anticipate a potentially drawn-out timeline. For instance, if the fund holds private equity investments, then a whole book of items may have to go into a liquidating trust. In such case, it may take many years to complete the wind-down.

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"In either event, the focus will be on getting cash and working through your portfolio monetization strategy as quickly as possible," O'Connor explained. Consequently, the fund manager should carefully analyze the fund's liquidity in order to prepare to meet pending redemptions.

Review Fund Documents and Policies

Regardless of time constraints, O'Connor said, the first step in any wind-down is to examine the fund's documents and understand what they actually allow, including whether there are any prescribed methods for performing the wind-down. For example, it is important to review the offering documents to determine if they permit the suspension of redemptions, impose any investor-level gates or – among other things – otherwise promise or make commitments to investors. Likewise, the manager should determine whether investor consent is necessary for any steps or actions.

Further, it is prudent for the fund principals to review their insurance policies to determine what they do and do not cover. Thereafter, they should open discussions with their insurance providers about the wind-down, including to negotiate an extended coverage period for their policies. This will help ensure that if litigation over the fund's collapse exists years later, the fund principals will have all the documents they need on hand.

Marian echoed these sentiments, pointing out that fund principals may not even have copies of the contracts or other documents that need to be reviewed at this time, which can be highly problematic. If the principals have to request copies from vendors, she explained, it may fuel outside speculation and scrutiny at precisely a time when the fund principals do not want word of a potential wind-down to get out. "Being in a position to collect a lot of that information so you can do things in an orderly manner can be tricky but is important," she stressed.

Identify and Retain Essential Employees

"In terms of planning, we typically undertake a functional review of all operations – both front and back office – to assess what is needed and who should be retained to perform the wind-down," O'Connor stated. Front-office professionals tend to be some of the first people out the door when a fund is going under, he added, although those are precisely the personnel needed to monetize the book.

Managers should address these essential employees and their inevitable questions about the wind-down in a sensitive manner, Arciero-Craig emphasized. "You need, within that context, to consider your employees, be able to identify those who are essential and reach out to them to negotiate retention arrangements and stay incentives," she explained, stressing the many creative ways to negotiate packages for employees.

Limit Markdowns of Illiquid Assets

Funds often hold assets that are illiquid by nature, such as private equity investments. There are also inherently liquid assets that hedge funds make effectively illiquid through the use of leverage, Schwenk explained. This leverage may take the form of explicit financing, borrowing, repurchase agreements, margin loans or OTC derivatives in a principal market where dependence on counterparties comes into play.

It is a "reality of Wall Street," argued Schwenk, that counterparties in these situations will be happy to make money off a fund when acquiring these illiquid assets, regardless of whether it

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harms the fund in the midst of winding down. "If they know you are in trouble, they are going to push as hard as they can to make you lose as much money as you can," he explained. Schwenk specifically warned about the possibility of a fund being taken advantage of when it is dependent on a relatively small number of counterparties – *e.g.*, explicit or implicit financing – in its pre-wind-down operations.

In response to this risk, Schwenk recommended that managers monetize those illiquid assets before anyone on the market knows about the impending wind-down. This is a tricky scenario, he added, because once you make the decision to wind down, then the clock is ticking for when the manager must notify investors. "It's in the investors' best interests for us to liquidate before the street knows about the wind-down, since they will try to take advantage of the fund's situation," he explained.

For more on illiquid assets, see "Investor Suit Against Hedge Fund Manager Illustrates the Perils of Valuing Illiquid Securities" (Oct. 8, 2015); and "DLA Piper Hedge Fund Valuation Webinar Covers Fair Value Methodologies, Valuation Services, Valuing Illiquid Positions and Handling Valuation Inquiries During SEC Examinations" (Aug. 7, 2013).

Communicating With Investors

Schwenk said that the period of time fraught with the most peril, from a legal and compliance standpoint, is the period between the decision to shut down the firm and the communication of that decision to investors.

Sounding a strong cautionary note, Schwenk pointed to the case of Ralph Cioffi and Matthew Tannin, two portfolio managers for Bear Stearns Asset Management who were charged with (but ultimately found not guilty of) lying to investors about the state of the funds they managed, which wound down in 2007. See "U.S. District Court Approves SEC's Settlement with Bear Stearns Fund Managers Cioffi and Tannin" (Jun. 28, 2012); and "As Criminal Trial Looms, Small Victory for Bear Stearns Hedge Fund Manager Matthew Tannin" (Nov. 5, 2009).

"If you read the SEC's complaint in that case, it's a laundry list of things that you don't want to be doing," Schwenk added. A key takeaway from the Cioffi and Tannen case is the need to avoid painting a rosy view for investors of the state of a fund's health while, on the other hand, speaking behind closed doors about the need to shut the fund down. Once a fund's principals make the decision to wind down, there needs to be as small a gap of time as possible before that decision is communicated to investors, he recommended.

Dealing With Disgruntled Investors

If investors receive dishonest or misleading answers, Schwenk warned, they may resort to litigation. This will greatly exacerbate an already troubled situation, since the fund principals do not have millions of dollars to answer subpoenas and handle regulatory investigations. "You're shutting the firm down because you don't have those financial resources," he reasoned, "so the last thing you want is to also have to combat litigation during the wind-down."

Marian agreed with these sentiments and emphasized the importance of anticipating that investors will be angry, since they may not know when they will get their money back or how much they will recover. In the interest of preventing damage and avoiding lawsuits, it is imperative to communicate consistently, and ideally simultaneously, to all investors. Marian drew a parallel with the medical industry, where, she pointed out, the doctors who are sued for

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malpractice are those who spend, on average, three or four minutes less with their patients, fail to answer questions promptly and fail to show that they care.

The person on the investor side with whom the fund principals are communicating may be in trouble with his or her boss for making an allocation that has gone bad, Schwenk observed. Fund principals should expect that, given the seriousness of the situation, a senior employee at the investor may not be satisfied with speaking to a junior investor relations associate at the fund and may demand to speak directly to a fund principal.

There could be an ongoing series of discussions with investors, O'Connor explained, since it may take a while for the fund manager to liquidate a fund's illiquid portfolio. In light of that, he recommended that managers proceed with utmost caution when fielding investor questions.

Avoid Selective Disclosures

Fund managers should generally avoid selective disclosure, Marian advised, but that should particularly be true during a wind-down. "You don't want certain investors to feel that they didn't have a chance that some other investors had, but you want also to think about the decision strategically," she noted.

Even when the fund has lost significant amounts of money and is shutting down, Marian explained, the task of communicating with investors is not a rote one that should be left to whomever may be available to do it. There may be a right person and a wrong person to make calls to investors, and it is useful to anticipate questions that will come up in the course of the calls and think through the answers with care.

Use the Audit Holdback to Create Goodwill

While communicating with investors is the best way to keep them calm, there are other methods by which managers can create goodwill with them. An example Marian provided was in the treatment of the audit holdback. If the fund's documents permit a 5 percent holdback, she suggested that a fund's principals may find it prudent only to hold back 2 percent to smooth investor sentiments towards the wind-down.

Extending this example further, Marian explained that funds could further engender this goodwill by retroactively reducing the hold back for investors that redeemed earlier in the year and had a full 5 percent held back for the same audit. This would involve returning the delta amount of 3 percent to those already-redeemed investors. This approach could make investors more willing to acquiesce to the wind-down, believing that the fund managers are looking out for their best interests.

For more on holdbacks, see our two-part series: "How Hedge Fund Contingency Reserves Can Lead to Inequitable Investor Treatment" (May 12, 2016); and "How an Alternative to Hedge Fund Contingency Reserves May Offer More Equitable Investor Treatment" (May 19, 2016).

It's Not Over Until It's Over

An important overarching fact for managers to remember is that, even in their drastically changed circumstances, they are still in business as a fund manager during the wind-down, according to Schwenk. This requires managers to conduct extra planning and be mindful of their ongoing commitments and compliance obligations during the wind-down process. Further, fund

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managers must honor all side letter provisions with remaining investors, including any requiring a manager to waive part or all of a fee in the event of any suspension of redemptions.

Fund managers should keep in mind that, until they have stopped providing investment advice – and until they have made a de-registration filing and that filing is in effect – they are still registrants from the point of view of regulators, urged Schwenk. Fund managers are answerable to regulators about their pools of funds until the regulators – not the fund managers – are fully satisfied that the pools have been wound down and investors have received all of what they were entitled to receive.

For insight on wind-downs in a Cayman context, see "Changes to Redeeming Investor Distribution Priority and Other Ramifications of the *Primeo* Appellate Decision for Cayman Islands Hedge Funds" (Sep. 15, 2016); and "Cayman Hedge Funds, Soft Wind-Downs and Disclosure" (Feb. 25, 2011).

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