ISSUES THAT THE SEC CONFRONTS IN THE LIQUIDATION OF HEDGE FUNDS

ALISTAIRE BAMBACH[*]

INTRODUCTION

Some of the obstacles and issues that the Securities & Exchange Commission ("SEC" or "Commission") confronts arise when the SEC has to liquidate hedge funds when they are in bankruptcy proceedings or insolvent. Fund managers, who are sued by the SEC for fraud or most breaches of fiduciary duty under the Advisers Act[1] or the '33/'34 Act,[2] are subject to bars from managing funds. Many of the funds sued by the SEC were initially legitimate operations that morphed into Ponzi schemes and some are legitimate funds that are tainted by their management's illegal conduct. As a result, the SEC must figure out how best to clean up the mess. The tools that the Commission uses include monitors, equity receivers, the bankruptcy process, and occasionally, the SEC encourages new management to come in and do wind downs. Very rarely does the SEC allow those who have been charged with violations of the fiduciary provisions in the Advisers Act or fraud to remain in position. However, there are some exceptions.

I. CARVE OUTS FROM INVESTOR ADVISER BARS FOR FUND MANAGERS CHARGED WITH VIOLATIONS OF FEDERAL SECURITIES LAW

Recently, there were two cases involving carve outs from Investor Adviser bars that allowed fund managers to liquidate their own funds. The most prominent case is *SEC v. Harbinger Capital Partners*.[3] This case is important because it is the first time that the Commission's new policy of requiring respondents to admit wrongful conduct in more cases has been embodied in an administrative order. Here, the principal obtained undisclosed loans from a fund that he was managing at a lower than market rate and limited redemption rights of some key investors in another fund.[4] The settlement that was ultimately negotiated with the principal was a five

[*] Assistant Regional Director and Chief Bankruptcy Counsel to the United States Securities and Exchange Commission. A previous version of this article was originally presented at the *ABI Law Review* Symposium on "Hedge Funds in Bankruptcy" on October 4, 2013. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or the author's colleagues upon the staff of the Commission.

[1] Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1–80b-21 (2012).

[2] Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2012); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78nn (2012).

[3] Complaint, SEC v. Harbinger Capital Partners, No. 12 Civ 5028 (S.D.N.Y. June 27, 2012), *available at* http://www.sec.gov/litigation/complaints/2012/comp-pr2012-122.pdf.

[4] Litigation Release No. 22403, SEC, SEC Charges Philip A. Falcone and Harbinger Charged with Securities Fraud, SEC v. Harbinger Capital Partners, (June 28, 2012), *available at* http://www.sec.gov/litigation/litreleases/2012/lr22403.htm (explaining SEC's allegations).

year bar from acting as an investment Adviser, substantial financial penalties, and disgorgement of prejudgment interest.[5]

The most important provision of the settlement was the carve out for the principal to restructure or sell LightSquared, an entity that is currently in chapter 11.[6] It is understandably highly contentious to allow a person accused of a substantial fiduciary breach to remain as an officer of a public company. Here, in a highly negotiated settlement, because of the principal's expertise he was allowed to continue administering the fund's interest in LightSquared under the jurisdiction of a corporate monitor.[7] Further, in addition to the principal admitting wrongful conduct, the fund also had to consent to express findings of misconduct that were exceedingly detailed.[8]

VICIS Capital, on the other hand, provides a contrast to the *Harbinger* case. In *VICIS*, the principal of the fund manager was charged with entering into an undisclosed principal transaction.[9] The principal owned a position in the fund and failed to disclose the sale of his position to the Adviser and to the fund itself.[10] Notwithstanding that there was no profit on that transaction, the principal was barred from being an investment Adviser for eighteen months and from running the firm.[11] However, in the settlement, the Commission authorized a very limited carve out to enable the principal, who had knowledge of the fund's portfolio, to wind down the fund pursuant to a monitor's oversight.[12] The monitor in this case was not supposed to be a substitute for the business judgment of the liquidating Adviser, but to be the eyes and the ears of the SEC and the investors. These two cases are recent and highly unusual.

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[5] *See* Consent of Defendants Philip A. Falcone; Harbinger Capital Partners LLC; Harbinger Capital Partners Offshore Manager, L.L.C.; and Harbinger Capital Partners Special Situations GP, L.L.C. at 2, SEC v. Harbinger Capital Partners LLC, No. 12 Civ 5027 (S.D.N.Y. Aug. 16, 2013), *available at* http://www.sec.gov/litigation/litreleases/2013/consent-pr2013-159.pdf (denoting agreed upon consequences).

[6] Final Consent Judgment as to Defendants Philip A. Falcone; Harbinger Capital Partners LLC; Harbinger Capital Partners Offshore Manager, L.L.C.; and Harbinger Capital Partners Special Situations GP, L.L.C. at 15, SEC v Harbinger Capital Partners LLC, No. 12 Civ 5028 (S.D.N.Y. 2013) *available at* http://www.sec.gov/litigation/litreleases/2013/proposedjudgment-pr2013-159.pdf.

[7] *Id.* The Monitor has the authority to review the distribution of the Fund's receipt of proceeds from the Lightsquared bankruptcy.

[8] *See* Press Release No. 2013-159, SEC, Philip Falcone and Harbinger Capital Agree to Settlement (Aug. 19, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539780222.

[9] *See* Press Release No. 2013-183, SEC, SEC Charges N.Y.-Based Hedge Fund Adviser With Breaching Fiduciary Duty By Participating in Conflicted Principal Transaction (Sept. 18, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539811779.

[10] *See id.*

[11] *See id.*

[12] *See id.*

II. FORUM SELECTION

Another significant issue that arises in SEC liquidations of funds is forum selection. Is bankruptcy appropriate or is it appropriate to do a liquidation in an equity receivership? From the SEC's perspective, one is not necessarily better than the other, as there are advantages and disadvantages to both. The benefit of bankruptcy is established case law that governs the liquidation of an entity, an experienced judge whose primary responsibility is to oversee liquidations and reorganizations, and the participation of the United States Trustee and other key constituents. The benefit of an equity receivership is that from the perspective of the victims of a Ponzi scheme, there is no absolute priority rule. Therefore, distribution plans can be proposed and distributions can be made to fund investors based on principles of equity, with input from the parties in interest. Additionally, expenses in the receivership can generally be more easily controlled because the SEC has the primary responsibility of monitoring fees and there are fewer constituencies being paid from the corpus of the fund. Further, equity receivers have a mandatory duty to cooperate with law enforcement and because many communications are privileged, it is easier for the staff to oversee such cases.

Two recent cases illustrate the benefits and burdens of liquidating in either forum. The first case, *SEC v. Landberg* (aka West End Financial),[13] demonstrates that, at times, failure to remove a case from bankruptcy court to district court can hinder the liquidation of insolvent hedge funds.[14] Here, the principal looted hedge funds that had been marketed exclusively to psycho-analysts.[15] In short, West End was a psycho-analyst affinity fraud. As a result of the principal's fraudulent behavior, Mr. Landberg went to jail for securities fraud.[16] When the principal was removed from fund management, alleged "new" management, the funds' general counsel, seized control of the Adviser and tried to liquidate the funds. Because of this alleged new management, the SEC did not initially seek control of the funds. However, from the perspective of the investors, the alleged new management was no better than the old management. Because of the new management's failure to timely liquidate the funds and the enormous fees and expenses that the new principal was charging, the SEC sought to seize control of the Adviser and the funds through an equity receivership. To avoid litigation, the new management

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[13] 836 F. Supp. 2d 148 (S.D.N.Y. 2011).

[14] *See* Complaint, SEC v. William Landberg et al., No. 11 Civ 0404 (S.D.N.Y. Apr. 4, 2006), *available at* http://www.sec.gov/litigation/complaints/2011/comp-pr2011-17.pdf.

[15] *See Landberg*, 836 F. Supp. 2d at 151 (explaining Landberg's misuse of funds).

[16] *See* Press Release, The Federal Bureau of Investigation, Former Chairman and CEO of West End Financial Advisors Sentenced in Manhattan Federal Court to 42 Months in Prison for Securities Fraud (Mar. 18, 2013) (on file with the FBI New York Field office), *available at* http://www.fbi.gov/newyork/press-releases/2013/former-chairman-and-ceo-of-west-end-financial-advisors-sentenced-in-manhattan-federal-court-to-42-months-in-prison-for-securities-fraud.

agreed to the appointment of a corporate monitor, who also reported continued waste and mismanagement.[17]

On the eve of the SEC staff's attempt to convert the corporate monitorship into an equity receivership, the new management filed a chapter 11 case.[18] Instead of seeking to remove the case to District Court, the SEC elected to seek the appointment of a trustee.[19] In hindsight, there were disadvantages to this approach. Extensive and expensive litigation ensued over professional fees, the scope of the wind down, and the extent of misconduct.[20] After many months, a chapter 11 plan was proposed that contained a time table for the wind down and a limitation on expenses. Had the case stayed in the District Court, it would have been easier for that court to throw out the "new" management, put in a receiver, and staunch the rampant expenses.

On the other hand, in *Geneva Capital Partners*, the bankruptcy court was the appropriate forum to select. Geneva Capital Partners, a certificate company under the Investment Advisers Act of 1940, issued fixed income debt certificates primarily to elderly people.[21] At least 7 years ago, the Commission entered into a consent decree with Mr. Westbury, the manager, requiring extreme limitation on operations and expenditures, obtained asset freezes, and appointed an independent consultant.[22] The defendant breached the consent decree when he, among other things, cashed checks for at least $150,000 from the investors' capital accounts at a liquor store. Following the violation of the consent decree, proceedings in district court resumed, including extensive evidentiary hearings and a contempt citation.[23] On the eve of the appointment of a receiver, the defendant sought to place the entity into bankruptcy to stay the receivership proceedings. The staff went to bankruptcy court and successfully argued for the appointment of a trustee the same day, a result that was more desirable than years of continued litigation.

III. EXTRATERRITORIALITY AND TAXATION ISSUES

Other very important issues confronting the SEC are extraterritoriality and taxation. In the recent *Morrison* decision, the Supreme Court made it clear that

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[17] *See* Amended Stipulation and Order, *Landberg*, 836 F. Supp.2d 148 (S.D.N.Y. 2011) (No. 11 Civ. 0404).

[18] *See* Voluntary Petition, *In re* West End Financial Advisors, LLC, No. 1:11-BK-11152 (Bankr. S.D.N.Y. 2011) (filing chapter 11 on March 15, 2011).

[19] *See In re* W. End Fin. Advisors, LLC, No. 11-11152, 2012 WL 2590613, at *2 (Bankr. S.D.N.Y. July 3, 2012) (explaining SEC joined in Trustee Motion).

[20] *See id*. at *1 (stating case involved many disputes, including fee applications).

[21] Geneva Capital Partners was registered with the Commission as a face-amount certificate company under the Investment Company Act. Face Amount Certificate companies were more common in past decades—indeed, only a few exist today. Under the structure in Geneva Capital Partners, the fund was operated as a hedge fund, and the note holders had no authority over the manager.

[22] *See* Memorandum Opinion at 2–3, S.E.C. v. SBM Inv. Certificates, Inc., No. 06-866 (D. Md. Mar. 2, 2012) (describing terms of consent decree).

[23] *See id.* at 35–36 (discussing violations of consent decree).

section 10(b) of the Securities Exchange Act of 1934 only applies to transactions that occurred domestically.[24] The question becomes, what happens if the Commission has frozen the assets of a fund that contains investments that may have occurred outside the jurisdiction of U.S. courts? What kind of standing do the principals and others have to argue that receivers should not be appointed over the assets or that criminal restitution should not be permitted?

In addressing those issues in the *Amerindo* case, the staff requested the District Court to exercise equitable jurisdiction to return property to its rightful owners, who included foreign investors.[25] The staff argued that the court had jurisdiction to do a distribution since these investors had also been victims of violations of the Advisers Act,[26] which does not have an extraterritoriality provision.

In addition to the extraterritoriality issue, there is also the substantial issue of taxation in receiverships as opposed to the treatment of taxes in bankruptcy. With respect to equity receiverships, there is no provision in federal law similar to the Bankruptcy Code provision that enables tax claims to be determined by bankruptcy judges.[27] Consequently, equity receivers have personal liability for unpaid receivership taxes of the entities or the persons whose assets they take over. The IRS can determine the liability of the entity, which can go back almost ten years, until three years after the receivership has closed. As a result, investors could be subject to clawbacks or a substantial hold back.

The Department of Justice, which represents the IRS, has a policy that favors defrauded investors over unpaid tax claims "[w]hen both the tax claim and the claim of the investor or victim arise from the same transaction and the investor or victim can trace its property to the fund in issue[.]"[28] Although the Department of Justice represents the IRS, the IRS in some cases has refused to concede that the federal court has authority to order it to appear to resolve federal tax claims. As a result, there is tension between the SEC, the equity receiver in the district court, the IRS, and the Department of Justice. In a recent case in Pennsylvania, local IRS officials took the position that funds that had been paid to defrauded investors from a hedge fund liquidation were subject to clawback since the estate did not have enough money to pay income taxes.[29] This issue should be resolved so that there is no delay in paying investors in equity receiverships.

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[24] Morrison v. Nat'l Australia Bank Ltd., 130 S. Ct. 2869, 2873–74 (2010) (noting § 10(b) contains nothing to imply it applies abroad).

[25] *See* S.E.C. v. Amerindo Inv. Advisors, Inc., 05 CIV. 5231, 2013 WL 1385013 at *11, *13 (S.D.N.Y. Mar. 11, 2013) (discussing equitable remedy of disgorgement).

[26] *See id.* at *9 n.10 (emphasizing lack of domestic requirement for liability under Investment Advisers Act).

[27] *See* 11 U.S.C. § 505(a)(1) (2012) (providing bankruptcy court "may determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax . . . .").

[28] Department of Justice Tax Division Directive 137, Tax Claims against Embezzlers, Swindlers, etc. v. Recovery by Investors, Dupes & Victims.

[29] *See* Complaint, SEC v. Young, 2011 WL 1376045 (E.D.P.A. Apr. 17, 2009) (No. 09-cv-01634), *available at* http://www.sec.gov/litigation/complaints/2009/comp21006.pdf.

IV. CLAWBACKS

Another issue that the SEC faces in liquidation and bankruptcy cases are so-called clawbacks of fraudulent transfers. The clawback issue illustrates the pressure points where trustees and receivers of insolvent hedge funds seek to recover prior distributions from investors. One example is *Absolute Fund*, which is a chapter 7 case in the Southern District.[30] Here, the Trustee determined that it was in the estate's interest to clawback principal payments that investors had received regardless of the fact that none of them had received a return of their principal investment.

In another case, *SEC v. Forte*, the District Court, in an equity receivership, reached the conclusion that every penny that investors had received during the term of the investment had to go back into a pool and be redistributed.[31] The SEC staff has significant policy concerns over such actions and has articulated a policy of not bringing fraudulent transfer actions against investors for recovering principal unless the investors themselves were participants in the fraud.[32] The SEC staff also has a different view than that of some judges and receivers as to how "red" flags must be to an investor before an investor cannot assert a good faith defense to an avoidance action. For example, in the *Forte* case, the idea was expressed that a high rate of promised return on a technology contract should be sufficient to put an investor on notice that the investment was fraudulent. This raises substantial concerns, especially since many of the investments at issue were made during the tech boom when high rates of return were commonplace.

V. SAFE HARBORS FOR SECURITIES CONTRACTS IN BANKRUPTCY

The final issue confronting the SEC staff is the impact of the safe harbor in bankruptcy cases. There is a safe harbor in the Bankruptcy Code from avoidance actions for margin and settlement payments and transfers made in connection with a securities contract.[33] In the past, the SEC has taken the position that the safe harbor is to be broadly construed to protect the smooth operation of capital markets.[34] The Second Circuit will soon have to address whether or not the safe harbors would also apply to actions brought post-bankruptcy by creditor liquidation trusts and individual investors in state or federal court and the extent to which there is federal

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[30] *See* Complaint, SEC v. Konior, No. 12-Civ-4145 (S.D.N.Y. May 24, 2012), *available at* http://www.sec.gov/litigation/complaints/2012/comp-pr2012-103.pdf.

[31] *See* Complaint, SEC v. Forte, 2012 WL 1719145 (E. D. Pa. May 16, 2012) (No. 09- Civ-0063), *available at* http://www.sec.gov/litigation/complaints/2009/comp20847.pdf (requesting disgorgement).

[32] *See* Brief of Securities and Exchange Commission, Amicus Curiae, in support of Appellees, Janvey v. Adams, 588 F.3d 831 (5th Cir. 2009) (No. 09-10761).

[33] 11 U.S.C. § 546(e) (2012) (providing trustee may not avoid transfer that is margin payment made before commencement of case).

[34] *See In re* Enron Creditors Recovery Corp., 422 B.R. 423, 434 (S.D.N.Y. 2009), *aff'd*, 651 F.3d 329 (2d Cir. 2011) (applying safe harbor to payments to redeem commercial paper prior to maturity).

preemption.[35]

These issues present some of the substantial challenges that the SEC faces in the liquidation of funds.

[35] *See* Whyte v. Barclays Bank PLC, 494 B.R. 196, 199 (S.D.N.Y. 2013) (finding preemption); *see also In re* Tribune Co. Fraudulent Conveyance Litig., 291 F.R.D. 38, 41 (S.D.N.Y. 2013). Since the presentation of this paper, the Commission filed a brief in the Second Circuit in the *White v. Barclays* case supporting the application of the safe harbor to preempt fraudulent conveyance claims brought by the trustee of the litigation trust to avoid certain swap transactions. *See* Brief for Amicus Curiae Securities and Exchange Commission in Support of Defendants-Appellees and of Affirmance, Whyte v. Barclays Bank PLC, No. 13-2653-cv (2d Cir. Oct. 31, 2013). In addition, the Commission filed a brief in the *Tribune* case supporting the application of the safe harbor to preempt fraudulent conveyance claims brought by creditors against the recipients of LBO payments. *See* Brief of the Securities and Exchange Commission, Amicus Curiae, in Support of Cross-Appellants' Implied Preemption Argument, *In re* Tribune Company Fraudulent Conveyance Litigation, No. 13-3992-cv(L); 13-3875-cv; 13-4172-cv; 13-4196-cv (March 2014).