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# Hedge Fund Governance and SEC Enforcement Proceedings



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Steve Cohen, Raj Rajaratnam, and numerous lesser known hedge fund managers have been charged or otherwise implicated in civil enforcement proceedings commenced by the Securities and Exchange Commission (the ''SEC'') over the past few years, alleging misuse of material, non-public, information, sometimes in addition to other wrongdoing. Some of these funds are almost immediately forced to commence liquidation while others like Steve Cohen's SAC Capital, struggle to survive while attempting to defend against the allegations and deal with the unfavorable attendant publicity.

Investment funds like those run by Cohen and Rajaratnam are usually structured as limited partnerships where the limited partners have invested to accomplish a specific investment objective based on the principals' reputation and where the general partner and its affiliated management company are typically owned and/or controlled by the principal.[1] With a limited partnership, limited partners are passive partners where investment and risk management considerations are entirely delegated to the general partner and a limited partner will lose the limitation of liability if it interferes with management.[2] Limited partners therefore have limited rights to challenge decisions, participate in day to day management or approve major transactions as board members of a corporation would do.[3] Often the investment fund itself, along with the interests of its limited partners, is not even represented by counsel, or at best is represented by counsel retained by the general partner. In either case the fund and its limited partners lack an independent voice in the absence of having one specifically appointed.

This article explores some of the conflicts and governance issues the limited partnership, its general partner and its management company can face during crises

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[1] *See* Martin Steindl, *The Alignment of Interests between the General and the Limited Partner in a Private Equity Fund—the Ultimate Governance Nut to Crack? HLS Forum on Corporate Governance and Financial Regulation* (Mar. 11, 2013), http://blogs.law.harvard.edu/corpgov/files/2013/02/The-Alignment-of-Interests-between-the-General-and-the-Limited-Partner-in-a-Private-Equity-Fund__Full-Article-1.pdf.

[2] Steindl, *supra* note 1.

[3] Steindl, *supra* note 1.

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where their principals confront allegations that can result in a bar or suspension from the industry and disgorgement of illegally obtained profits and penalties from and against the fund. These conflict and governance issues arise in part due to the unique nature of limited partnerships and the lack of control the limited partners have over actions taken by the general partner, particularly at a moment in time where the fund's principal, faced with allegations of wrongful conduct, nevertheless attempts to continue to manage the fund as an ongoing operation or during a liquidation, occasioned by the commencement of the SEC proceeding.

## Role of Fund's Principal After Commencement of SEC Proceeding

A significant decision that can confront the fund and its principal at the outset of a proceeding is whether the principal should continue to manage and control the general partner and/or management company while at the same time attempting to defend against the allegations. While the decision to remain with the general partner and/or management company does not necessarily belong solely to the principal, since the limited partners do have the power to remove the general partner, usually with a super majority vote, the reality is that the limited partners are unlikely to organize expeditiously to make such decisions and that the decision to stay or go will in practice be left to the principal. Limited partners are far more likely when faced with such allegations to vote with their feet and exercise their right of redemption rather than decide to exercise their right to become more involved in management and to attempt to remove the general partner.[4] Also, unlike a corporation where the board of directors can act quickly to suspend or terminate a chief executive officer where there have been allegations of wrongdoing, a limited partnership often has no equivalent mechanism to oversee and quickly remedy allegations of general partner or manager misconduct.

Since most funds have been built and exist solely based upon the principal's reputation, the principal may feel he must remain in control both for his own interests as well as survival of the fund—lest the investors begin to redeem *en masse*. Although this may be the best course in attempting to forestall investor redemptions and possible demise of the fund, the decision to remain poses complications with fund governance where decisions have to be made regarding various issues where the fund's interest may conflict with that of the principal's. This is true regardless of whether the fund is attempting to weather the crisis and survive as an ongoing operation or ultimately makes the decision to commence liquidation.

If the fund does decide to liquidate, under the limited partnership agreement the general partner often becomes the liquidator and continues to control the fund, absent resignation or removal.[5] Thus the general partner may continue to owe fiduciary and other duties to the limited partners, and the conflict and governance issues we discuss below will usually arise whether or not the fund liquidates or continues to operate.

[4] The typical hedge fund will have quarterly, semi-annual or annual withdrawals assuming the fund's investors are not otherwise restricted from withdrawing under a lock-up provision.

[5] Steindl, *supra* note 1.

## Retention of the Management Company

An initial issue a general partner may face if the fund decides to liquidate is whether to terminate the management agreement between the fund and the management entity and if so whether to enter into a separate contract with the management company to provide services during the course of the liquidation. As the management company vehicle often has an ownership structure that closely mirrors that of the general partner, the general partner, due to its self interest in any transaction with the management company, must act with care that it does not cause the general partner to breach any fiduciary or other duty owed to limited partners.[6] And although provisions of the limited partnership agreement normally afford the general partner broad authority to run the fund's business, it does not necessarily eliminate the general partner's fiduciary duty owed to the limited partners.[7] The general partner therefore has the duty to exercise the utmost good faith, fairness and loyalty in the absence of those duties being

[6] Delaware law permits parties to a partnership agreement to ''greatly restrict[] or even eliminate[] fiduciary duties.'' *See Fisk Ventures, LLC v. Segal*, Civil Action No. 3017-CC, (Del. Ch. May 7, 2008); citing 6 Del. C. § 18-1101(c); *Abry Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1063 (Del. Ch. 2006) (''In the alternative entity context, where it is more likely that sophisticated parties have carefully negotiated the governing agreement, the General Assembly has authorized even broader exculpation, to the extent of eliminating fiduciary duties altogether.''); *In re K-Sea Transp. Partners L.P. Unitholders Litig.*, No. 6301-VCP (Del. Ch. Jun. 10, 2011) (a limited partnership agreement can ''establish a contractual standard of review that supplants fiduciary duty analysis.''). If a court were to determine that the partnership agreement eliminated the general partner's fiduciary duties, then, in order to state a claim against the general partner, a limited partner would be required to show that the general partner either (i) breached the implied covenant of good faith and fair dealing, or (ii) did not act in good faith reliance upon the partnership agreement. Essentially – the limited partner would have to show that the general partner acted in bad faith – which is construed to mean ''actions that do not advance a proper partnership purpose.'' *Gelfman v. Weeden Investors, L.P.*, 792 A.2d 977, 987 (Del. Ch. 2001).

[7] Specifically, Section 1101 of the Delaware Revised Uniform Limited Partnership Act (the ''DRULPA''), entitled ''Construction and application of chapter and partnership agreement,'' provides, in pertinent part, as follows: ''To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.'' Furthermore, ''A partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement; provided, that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.'' 6 Del. Ch. § 17-1101 (d)-(f).

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contracted away pursuant to the limited partnership agreement.[8]

Usually, under the terms of the limited partnership agreement, the general partner is permitted to make payments on the fund's behalf. However the authority to make such expenditures on the fund's behalf during the winding up period is restricted to the tasks set forth in the agreement of limited partnership and such expenditures must be reasonable.[9] Payment of amounts for fees and expenses, beyond those necessary for the winding up of the partnership, to a management company in which the general partner is interested, may amount to a breach of fiduciary or other duty, express or implied, owed to the limited partners under the terms of the partnership agreement.

## Indemnification and Advancement of Defense Costs

In the event the SEC brings a civil enforcement action against a hedge fund principal, the principal may choose to ultimately resolve such action via an offer of settlement. The SEC's acceptance of an offer of settlement is conditioned upon the principal's consent to entry of a final judgment, in which the SEC would state its allegations and findings.[10] The consent judgment will set forth the penalties to which the principals have agreed, which may include a permanent injunction from violations of federal securities laws, a suspension or temporary or permanent ban from acting as an investment advisor, an order to pay disgorgement of wrongfully obtained profits and prejudgment interest thereon, and imposition of a civil penalty.[11]

In the event a principal enters into a settlement with the SEC on a non-admit/non-deny basis, which admittedly is no longer a certainty based on the SEC's recent policy change, the principal may have a right to indemnification for attorneys' fees and other costs incurred during the SEC investigation and subsequent enforcement action.[12] This is in contrast to situations where the principal has either been found liable or has admitted liability in which case the principal will not have a right to indemnity.

Federal courts disfavor indemnity for federal securities violations, calling into question the enforceability of these obligations. Courts have rejected indemnity for a variety of securities violations because indemnity contravened the public policy enunciated by federal securities laws.[13] Courts have reasoned that it would be against public policy embodied in the federal securities legislation to permit the principal to enforce an indemnification agreement if indemnification would reduce the deterrent effect of the securities laws.[14]

Since indemnity is generally precluded for ''reckless, willful or criminal conduct'', if fund principals are found liable or admit to violations of Section 10(b) and Rule 10b-5 or Section 14(e) and Rule 14e-3, they will not be entitled to indemnification. [15] Federal courts have also held that those held liable for violations of certain provisions of the federal securities laws, including the antifraud provisions of the 1934 Act, may not recover indemnification. [16]

In the event a fund principal reaches a settlement with the SEC and agrees to entry of a consent judgment calling for the imposition of monetary sanctions, the proceeding does not constitute an adjudication of whether the defendant violated securities laws.[17] It is only against public policy to allow a party who has been adjudicated to have been engaged in reckless, willful or criminal conduct to shift his liability to others.[18] Accordingly, the entry of a consent order — which does not constitute an adjudication — does not preclude eligibility for indemnification.[19] The SEC can also require that the consent judgment preclude indemnification for all payments made pursuant to the judgment—including disgorgement.[20]

Conflicts can arise where a principal makes a request for indemnity, along with possible requests for advancement to cover defense costs. Although less likely with well-heeled managers like Cohen and Rajaratnam, newer managers may have no choice but to make these requests of the fund since they may be unable to personally bear the costs of defense by themselves.

Assuming the fund believes it has an obligation to advance defense costs, the fund will have an interest in securing the obligation of the fund manager to repay such costs in the event the principal is not entitled to the in-

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[8] *See Twin Bridges, LP v. Draper*, Civil Action No. 2351-VCP., 2007 BL 102734 (Del. Ch. Sept. 14, 2007). In contrast to the DRULPA, the Delaware Revised Uniform Partnership Law expressly provides that a partner owes the duties of loyalty and care to the partnership and to the other partners. 6 Del. Ch. § 15-404(a)-(b). As made clear by the DRULPA, regardless of the terms of the partnership agreement, all general partners owe to the partnership and to the limited partners the duty of ''good faith and fair dealing.'' *See Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 442 (Del. 2005) (implied covenant of good faith and fair dealing ''attaches to every contract'').

[9] *See Active Asset Recovery, Inc. v. Real Estate Asset Recovery Servs., Inc.*, Civil Action No. 15478 (Del. Ch. Sept. 10, 1999).

[10] *See* Robert Khuzami, *Testimony on ''Examining the Settlement Practices of U.S. Financial Regulators,'' Before the Committee on Financial Services, U.S. House of Representatives*, SEC (May 17, 2012), http://www.sec.gov/News/Testimony/Detail/Testimony/1365171489454#.Ui9yf8akqDs.

[11] *See SEC, Release 2011-233, SEC Obtains Record $92.8 Million Penalty Against Raj Rajaratnam* (2011), http://www.sec.gov/news/press/2011/2011-233.htm.

[12] On June 18, 2013 the SEC announced that it would depart from its longstanding blanket policy of permitting defendants to settle enforcement actions without admitting or denying liability and that going forward the SEC would in certain cases require an admission of liability before settling an action. Molly White, *SEC Requires Admission of Liability in Settlement with Falcone and Harbinger Capital Partners*, SUBJECT TO INQUIRY (Aug. 21, 2013), http://www.subjecttoinquiry.com/securities-litigation/.

[13] *See First Golden Bancorp. v. Weiszmann*, 942 F.2d 726, 728-29 (10th Cir. 1991).

[14] *See Raychem Corp. v. Fed. Ins. Co.*, 853 F. Supp. 1170, 1177 (N.D. Cal. 1994).

[15] *See Globus v. Law Research Serv., Inc.,* 418 F.2d 1276, 1287-88 (2d Cir. 1969).

[16] *See Raychem Corp*., 853 F. Supp. at 1176; *Baker v. BP Amer., Inc.*, 749 F. Supp. 840, 846 (N.D. Ohio 1990).

[17] The final judgment, known as a ''consent judgment,'' ''does not result in an adjudication against the party consenting to it.'' *Cambridge Fund, Inc. v. Abella*, 501 F. Supp. 598, 617 (S.D.N.Y. 1980); citing *Lipsky v. Commonwealth United Corp.*, 551 F.2d 887, 893-94 (2d Cir. 1976) (noting that ''consent decrees and pleas of *nolo contendere* are not true adjudications of the underlying issues'').

[18] *See Cambridge Fund, Inc.*, 501 F. Supp. at 619.

[19] *See Cambridge Fund, Inc.*, 501 F. Supp. at 619.

[20] *SEC v. Scrushy*, CV-03-615 (N.D. Ala. Apr. 23, 2007).

demnity. This again poses a conflict in attempting to negotiate a satisfactory collateral package where the fund can feel comfortable advancing the fund and secure in the knowledge that the obligation will be repaid if the principal is not ultimately entitled to indemnity. For smaller funds these costs can result in a significant loss to limited partners if costs are forced to be absorbed by the fund.

Fund principals may also seek indemnity for disgorgement and penalty payments made pursuant to the settlement with the SEC. However this is more problematic as the SEC may, and frequently does, include in consent judgments a provision precluding the defendant from recovering through indemnification (or insurance) any part of the money owed under the final judgment.

Procedurally a right to indemnification may be asserted by the management company and/or its principals pursuant to the terms of the management agreement with the fund or by the general partner and/or its principals pursuant to the terms of the limited partnership agreement. The management agreement will typically have some variation of indemnity language stating that the fund shall indemnify the manager (along with others) and some agreements may also specifically state that the fund shall ''defend'' the manager which the principal may use to argue for advancement of legal costs and expenses. The agreement further usually contains an exculpatory clause which will prohibit indemnification in the event of willful misfeasance, bad faith or gross negligence in the performance of the manager's duties or by reason of the reckless disregard of the manager's duties and obligations under the management agreement. Where there is no management agreement but the general partner is performing management services pursuant to terms of the limited partnership agreement, similar indemnity language should be found in these agreements.

Assuming a principal decides to seek indemnification and/or advancement of legal costs from the fund, a conflict of interest may exist since the principal will be making the request of the fund's general partner, an entity which the principal may own or in which the principal have a sizable ownership stake. If the principal has not resigned and/or divested himself of his ownership stake, he should attempt to address the conflict either by referring the conflict issue to the limited partner advisory committee if one exists, or by appointing an independent committee, advised by independent counsel, to make the decision whether to indemnify and/or advance legal fees on behalf of the fund.[21] Otherwise the principal may be in breach of a fiduciary or other duty, express or implied, owed to the fund and its limited partners.

## Disgorgement of Profits—Who Should Pay?

If there is ultimately a settlement pursuant to which profits are disgorged, another issue which raises a potential conflict between the fund and its principal relates to funding the disgorgement. There may be a few choices of who can and should pay, namely, the principal, the general partner, the management company or the fund. The SEC may or may not be agnostic when it comes to this issue. It may simply want profits disgorged and not care if the source of funds is the principal or his fund. Or they may insist the principal pay the disgorgement especially where there is no question the principal has the wherewithal since the SEC's mission is, after all, investor protection. Where the principal does have the wherewithal he may also prefer to pay the disgorgement in order to maintain his present and future relationship with investors in the fund. However the issue can become more problematic where the principal has the ability to pay but wants the fund to pay instead, since the illegal profits were made by the fund, not by the principal.

Another issue arises if the fund, rather than the principal, pays. Do existing limited partners bear the expense or can the fund recoup the expense from those who were limited partners at the time of the wrongful trades, even those who have subsequently redeemed? Some of the existing limited partners may in fact be in a different category from others—having been admitted to the fund after the wrongful trading occurred. Each of the foregoing scenarios presents challenges and conflicts between the fund and its principal.

## Imposition of Disgorgement Upon Relief Defendants

A larger conflict can occur in negotiating with the SEC regarding whether the fund will be named a relief defendant in order to seek disgorgement of profit earned by the fund as a result of the insider trades. A relief defendant is not accused of wrongdoing but is joined in an action to aid the recovery of relief where it has no ownership interest in the property which is the subject of the litigation.[22]

A court may order disgorgement or other equitable relief against a relief defendant where that person or entity has received ill-gotten funds, and does not have a legitimate claim to those funds.[23] *SEC v. Skowron* and *SEC v. Scolaro* are two recent examples from the U.S. District Court for the Southern District of New York where the SEC named the funds as relief defendants and the funds were subsequently determined to lack legitimate claims to the ill-gotten gains. In *SEC v. Skowron* the SEC charged Joseph Skowron, a former hedge fund portfolio manager for six hedge funds, with insider trading, as a result of which the hedge funds avoided at least $30 million in losses.[24] The SEC also named the six hedge funds as relief defendants. For each of the six funds, Skowron served as a co-portfolio manager and as an executive officer of the fund's general partner, pursuant to which he had discretionary authority to select trades and determine the allocation of the fund's investments. He was also a limited partner and/or personally invested in three of the funds. The SEC asserted a claim for unjust enrichment against the relief defendants, seeking disgorgements of the ill-

[21] Most funds of size will have limited partner advisory committees which can act as decision making bodies with respect to conflicts that may arise between the interests of limited partners and the interests of the general partners throughout the life of the fund.

[22] *See SEC v. Cavanaugh*, 445 F.3d 105, 109 n.7 (2d Cir. 2006).

[23] *See SEC v. China Energy Svgs. Tech., Inc.*, 636 F. Supp. 2d 199, 204 (E.D.N.Y. 2009).

[24] *See SEC v. Skowron*, 10-CV-8266 (S.D.N.Y).

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gotten profits with prejudgment interest. The relief defendants ultimately agreed to settle and pay disgorgement of approximately $30 million plus prejudgment interest in the amount of approximately $4 million.

In *SEC v. Scolaro*, the SEC brought a civil enforcement action against defendant Anthony Scolaro, a former portfolio manager at Diamondback Capital Management, LLC , a hedge fund investment advisory firm, alleging that Scolaro, as a downstream tippee, used inside information to trade ahead of an acquisition announcement on behalf of Diamondback, earning profits of approximately $1.1 million for the fund. The SEC named Diamondback as a relief defendant. The SEC subsequently announced a settlement in which Scolaro agreed to pay disgorgement of $125,980 and Diamondback agreed to pay disgorgement of $962,486.[25]

Often the decision as to whether to name the fund as a relief defendant and seek disgorgement comes as a result of extended negotiation with the enforcement staff. It is important that the fund have independent counsel in these instances, especially if the fund is not liquidating and is attempting to survive as an ongoing entity. Just the naming of the fund as a relief defendant can cause a stampede to the exits by existing investors and make marketing the fund to new investors almost impossible, even if the fund has shown superior investment returns. It may be possible to avoid having the fund itself named as a relief defendant, even if ultimately the disgorgement will be paid in whole or in part by the fund. In these situations the continued involvement of the fund's principal may prove problematic especially if the principal is lobbying for the disgorgement to be paid by the fund or even if the principal just does not want to aggressively negotiate to keep the fund from being added as a relief defendant.

## Allocation of Disgorgement Among Limited Partners of Fund

Although the SEC may have great say in whether disgorgement is paid by the principal or by the fund, the SEC will not opine, assuming disgorgement is to be paid by the fund, as to how the fund should internally allocate the disgorgement losses among limited partners of the fund. These decisions will need to be made by the general partner with either the assistance of the limited partner advisory committee, if one exists, or with the consent of the requisite vote of the limited partners.

Limited partners may fall into four distinct categories:

- those who were limited partners at the time of the alleged wrongful acts and who remain in the fund;
- those who were limited partners at the time of the alleged wrongful acts and have fully redeemed;
- those who were limited partners at the time of the alleged wrongful acts and who have partially redeemed; and
- those who are limited partners at the present time but were not limited partners at the time of the wrongful acts.

Ultimately it may be impossible to strike a balance to satisfy the interests of all constituencies. Certainly a decision to recover disgorgement losses from limited partners who have already exited the fund can prove to be problematic. Although funds typically hold back 10 percent of the proceeds from redeeming investors pending completion of the annual audit, the SEC investigation and subsequent enforcement action may not have been initiated until after the some redeeming investors have received the holdback amount. And although some funds now include clawback provisions in their limited partnership agreements that allow them to pursue limited partners who have already redeemed in the event of subsequent losses, the practical realities and costs of collecting such amounts from redeemed partners may make it impractical to take this approach, notwithstanding the fact it may ultimately be the fairest way to allocate the disgorgement losses. In arriving at a decision the general partner will need to balance the interests of fairness in allocating disgorgement losses with the practical realities of collecting these amounts and also the very real possibility that if disgorgement losses are not allocated in a manner which the limited partners believe is fair, the general partner may face claims of breach of fiduciary and other duties from affected limited partners.

## Conclusion

Enforcement actions initiated against hedge fund managers for insider trading can pose significant governance issues for the continued operation of the business, especially if the principal decides to remain and manage the fund and whether or not the fund liquidates.

The general partner must carefully consider potential conflicts and possible breaches of its duties to the fund and its limited partners in (i) deciding whether to remain involved in management pending the proceedings, (ii) negotiating continuing service agreements with the management company, (iii) ruling upon its own request for indemnification and possible advancement of legal costs and expenses from the fund and (iv) negotiating with the SEC as to who should pay any disgorgement and subsequently, how to allocate any disgorgement losses internally among the fund's limited partners.

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[25] *See SEC v. Scolaro,* 11 Civ 6112 (S.D.N.Y. Sept. 1, 2011); *Ex-Portfolio Manager to Pay $203.3K to Settle Insider Trading Charges, SEC Says*, 43 BLOOMBERG BNA SEC. REG. & L. REP. 1829 (Sept. 5, 2011).