Handling Mass Redemptions: A Primer

Contributed by:
Jennifer A. Spiegel, Paul, Weiss, Rifkind, Wharton & Garrison LLP

The hedge fund industry is facing an unprecedented volume of redemption requests—an estimated outflow of over $100 billion in December 2008 alone—at a time of intense market volatility and at a time when many hedge funds have strayed from highly liquid long-short strategies to far less liquid strategies. Hedge funds are straining to satisfy these requests while still complying with their fund documents and their fiduciary duties and salvaging enough of their business to remain a viable presence in the industry. Below we explore some questions that have arisen in connection with hedge funds' struggles to satisfy overwhelming demands for redemptions.

Gates and Suspensions

What is the difference between a gate and a suspension provision? A gate, typically measured as a percentage of the net asset value of a fund, provides the sponsor with the option to defer or limit the amount of the fund's capital redeemed at one time to the relevant percentage. For example, if a fund has a 20 percent gate and it has received redemption requests exceeding in the aggregate 20 percent of the net asset value of the fund, then the fund may either (a) satisfy all such redemption requests, even those exceeding the gate or (b) satisfy a pro rata portion of each request so that in aggregate no more than 20 percent of the net asset value of the fund is redeemed. Some gates are drafted as mandatory gates, such that redemptions must be limited as in (b). Some funds may impose investor-level gates, precluding each investor from redeeming more than 10-15 percent of its interest in the fund upon any redemption date. Although historically only a relatively small portion of funds imposed individual investor-level gates—primarily because this approach is seen as more restrictive than a fund-wide gate—investors have accepted such investor-level gates as part of recent fund restructurings.

A suspension provision enables a fund to suspend redemptions altogether (rather than just limit them). The authority to suspend may be triggered by certain events of market disruption (e.g., the closure of an exchange on which the fund's assets are traded) or may be more discretionary and permit the sponsor to determine that satisfying redemptions would not be in the best interests of the fund. Historically, implementing a suspension provision was perceived as a more drastic measure than gating and often signaled a fund's imminent collapse. Given market volatility and resulting valuation difficulties, however, suspensions have become common in the last several months. As a result, funds that suspend may not be facing the same stigma.

Why do funds impose gates or suspend redemptions? A reason commonly cited is to prevent a sudden outflow of capital, which could itself have many adverse consequences, including: (a) the forced sale of assets at inopportune prices; (b) a resulting portfolio for non-redeeming investors that is deeply concentrated in illiquid assets; and (c) a resulting portfolio that may be too small for the intended strategy of the fund.

When and how often can a gate or suspension be implemented? The exact timing of the implementation of the gate will depend on the language of the fund documents. Some fund documents are drafted in order to give a sponsor full flexibility such that the sponsor could impose the gate before the notice period for redemption expires or after the actual redemption date. A fund sponsor may seek to delay its decision to suspend or gate so that it has the maximum amount of information with respect to market conditions, the volume of redemption requests and cash reserves before deciding. Typically there is no limit to the number of times a fund can impose its gate. However, some fund documents provide that if an investor's redemption request has been subject to a gate for more than a certain number of times (anywhere from two to four times), then the investor must receive its redemption proceeds in full upon the next succeeding redemption date.

Similarly, the timing of any suspension will depend on the exact drafting of the fund documents. Some fund documents may permit a fund to suspend even after the redemption date has passed. However, a fund sponsor that suspends after the actual redemption date and that may eventually face bankruptcy should consider whether investors having submitted redemption requests have become creditors as of the redemption date, a change in bankruptcy status that may be avoidable if the fund suspends prior to the redemption date. The highest court in the Cayman Islands recently addressed this question in *In re Strategic Turnaround Master P'ship Ltd.*[1] There is no limit to the number of times a fund can suspend redemptions. However, depending on how the suspension provision is drafted, a fund may be authorized to suspend only during the continued circumstances giving rise to the suspension. Thus, a sponsor that suspends on the theory that extreme market volatility is an event of market disruption may eventually face challenges to its determination to suspend if market volatility continues for a prolonged period such that rather than constituting an event of disruption, such volatility has become the new norm.

Payments in Kind (PIKs)

Can a fund satisfy redemptions through PIKs? It depends. Some fund documents expressly permit PIKs while others may prohibit or limit them.[2] A fund faced with significant redemptions may not be able to liquidate enough of its positions to satisfy redemption requests in cash. Similarly, a fund may feel constrained to make a PIK if it believes it could only liquidate assets at prices well below their market values or if satisfying redemptions in cash would leave its non-redeeming investors overly concentrated in illiquid or difficult to value assets.

If a fund makes PIKs, which investors get cash and which get PIKs? Fund documents sometimes obligate a fund to treat all redeeming investors ratably such that if one investor's request is paid 50 percent in cash and 50 percent in kind, then all redeeming investors at such redemption date must receive the same ratio of cash to PIKs. This avoids the inequity that could result if one investor receives his redemption proceeds exclusively in cash and another receives its proceeds exclusively in securities which it must then liquidate on its own. If non-pro rata PIKs are effected in a manner that explicitly disadvantages some investors, a fund should be mindful of the prohibitions of Rule 206(4)-8 under the Investment Advisers Act of 1940 (Advisers Act) antifraud provisions, which prohibits fraudulent, deceptive or manipulative conduct.

What should a fund be concerned with when satisfying redemptions in kind?

- *Compliance with Fund Documents.* A fund must first confirm that the intended PIK complies with the redemption provisions of the fund documents, which may impose limitations on the distribution of non-marketable securities.
- *Valuation.* If a fund is uncertain of the value of an asset distributed, the fund risks either underpaying redeeming investors or providing a windfall distribution to redeeming investors at the expense of the non-redeeming investors.
- *Transferability of Securities.* Depending on the fund's strategy and the composition of its portfolio, it may not be able to transfer title to the securities it holds because of investor eligibility and transfer restrictions.
- *Ability of Investor to Liquidate PIK.* If the fund does not face obstacles in respect of the transferability of the securities it wishes to distribute, it may still face investor relations issues. Not all investors are well positioned to accept PIKs because of the relative difficulty of disposing of such assets efficiently, which may require continued management prior to disposal or a negotiated disposal.
- *Fiduciary Duties.* A fund sponsor may face a variety of fiduciary issues when making PIKs. For example, the sponsor must be sure that it does not cherry pick assets in a manner that intentionally disadvantages its non-redeeming investors, by, for

example, leaving the non-redeeming investors with the least liquid assets in the fund's portfolio. Following the *Goldstein* decision,[3] which overturned the hedge fund adviser registration rule in 2006, an adviser is said to owe fiduciary duties to its client—the fund—rather than to each of the fund's investors. However, when a portion of a fund's portfolio is being liquidated in satisfaction of redemptions, a sponsor may have effectively created a separate client—the portion of the portfolio allocable to redeeming investors—that it is managing differently. In addition, Rule 206(4)-8 could preclude an adviser from discriminating against non-redeeming investors for the benefit of redeeming investors.

What is a liquidating SPV? A liquidating SPV is a special purpose vehicle used to isolate and manage down assets to be liquidated in connection with satisfying redemptions of redeeming investors. In recent months a number of funds have implemented SPVs as a form of PIKs to redeeming investors.

How does a fund implement a liquidating SPV? There are several ways in which a liquidating SPV can be used. A common use is as follows: A fund holding assets that cannot be liquidated within the time frame required to satisfy redemptions transfers the redeeming investors' allocable portion of such assets to the liquidating SPV and distributes interests in the SPV to the redeeming investors. The interests in the SPV entitle them to the proceeds of the investments as and when they are liquidated by the SPV.

Is a liquidating SPV a separate "client" for purposes of the Advisers Act? Probably. Even if the liquidating SPV does not bear management fees, it should be considered a client and an adviser should assume it owes fiduciary duties to the SPV.

What are some advantages and disadvantages of using a liquidating SPV?

Potential Advantages:

- *Flexibility of Timing*. A liquidating SPV provides the sponsor with the flexibility of managing down the assets over time in order to avoid being forced into a fire sale of assets.
- *Separate Tracking of Assets and Liabilities.* With an SPV, a fund may be able to more effectively "ring fence" the assets and liabilities of securities being liquidated in connection with redemptions and allocate any related liabilities solely to the redeeming investors. Placing the securities in an SPV may also facilitate tracking the costs associated with liquidation separately.
- *Separate Management.* The SPV may also enable a sponsor to manage these securities separately from the rest of the fund's portfolio, which can provide a significant advantage as the SPV and the fund may have divergent goals, with one seeking to liquidate to cash while the other may seek to maximize value over a much longer term.

Potential Disadvantages:

- *An Untested Model.* The liquidating SPV is not a tried and true technique for satisfying redemptions. Litigation surrounding the use of SPVs is just now surfacing in the Cayman Islands, Bermuda and the United States in the form of breach of contract, breach of fiduciary duties and claims under Rule 10b-5 under the Securities Exchange Act of 1934.[4] If a fund sponsor exceeds its authority in implementing an SPV or mismanages the implementation through, for example, cherry picking of investments transferred to the SPV, a fund sponsor may face liability both from its redeeming and non-redeeming investors. The challenge of determining how to allocate the costs of any investor litigation between the redeeming and non-redeeming investors may add salt to the wound.

- *Admission of Redeeming Investors to the SPV.* Like any other collective investment vehicle, the SPV will need to find appropriate exemptions from the Securities Act of 1933 (Securities Act) and the Investment Company Act of 1940 (Investment Company Act). Depending on the provisions of the original fund to which a redeeming investor was admitted, a fund sponsor may be able to admit the investor to the SPV without any need for the investor to complete documentation and the investor may be deemed to repeat its eligibility representations. However, one needs to consider the power of attorney and other provisions in the original fund documentation.
- *Conflicts of Interest.* At least at the outset of its existence, the SPV may hold a portfolio of assets substantially similar to that held by the fund from which investors have redeemed. The fund sponsor may face attractive opportunities with respect to the aggregate of such assets that may not be practical to effect with only a portion of such assets. The divergent goals of the SPV and the fund may create other conflicts as well.
- *Fees and Expenses.* Managing the assets of an SPV toward liquidation may require significant time and effort while redeeming investors will likely pressure the fund sponsor to manage the SPV for either no fee or a reduced fee. Similarly, the fund sponsor may face pressure to minimize the expenses associated with such management so that the proceeds ultimately received by the redeeming investors are not diminished.
- *Consents.* Some fund documents do not by their terms permit the use of an SPV and a fund sponsor may be forced to seek investor consent first before implementing an SPV. The consent process can divert time and attention away from the management of assets at a time when fund sponsors are already facing extraordinary demands as a result of market volatility.
- *Valuation Issues.* Depending on the language of the fund's redemption provisions, the value of the SPV interest itself may become relevant to determining whether the distribution of the SPV interest contractually satisfies the redemption.

What sort of disclosure should be made upon implementing an SPV? Assessing the appropriate disclosure may be a function of how the SPV is implemented. For example, if a fund has broad authority to make a distribution of kind, including by distributing interests in an SPV, then additional disclosure of the SPV's risks at the time the SPV is created may be of limited relevance—if these risks were not disclosed at the time fund interests were originally acquired. This is because the implementation of the SPV and any related risks may be seen as an aspect of, and risk associated with, the original interest acquired. However, if a fund sponsor offers redeeming investors the ability to make an affirmative election to receive either a redemption in kind of assets held by the fund or the continued management of such assets through an SPV, then there is an argument that the investor's election to participate in the SPV represents the acceptance of the offer of a new investment, with any right of rescission relating back not to the original acquisition of the fund interest but instead to the acquisition of the interest in the SPV. In this case, it may be advisable to craft disclosure specifically tailored to the risks of such SPV. As a practical matter, even if a liquidating SPV is well within a fund sponsor's authority, if a fund has not historically implemented such a mechanism, a fund sponsor may wish to provide advance notice to investors, whether verbally or in writing, so that investors are not surprised when they do not receive cash.

What sort of documentation is required to implement a liquidating SPV? The SPV will have a constituent document, such as a partnership agreement or articles of association. The SPV may also enter into a management agreement with the fund sponsor. The fund sponsor may also wish for the investors receiving SPV interests to confirm certain representations made in their original fund subscription documentation to ensure that the SPV may rely on the same exemptions from the Securities Act and Investment Company Act as the fund itself does. If the fund originally relied on the Section 3(c)(7) exemption from the Investment Company Act, it will need to ascertain whether investors that were previously "qualified purchasers" still meet this standard. The transfer of the SPV interests to fund investors in exchange for fund interests may constitute a new investment for purposes of the Investment Company Act, requiring an investor to meet the "qualified purchaser" standard at the time of such exchange.

What sort of reporting do liquidating SPVs provide? Because the use of liquidating SPVs has not historically been widespread, there is no clear market standard for the reporting or level of transparency to be provided. An investor could argue for complete transparency into the portfolio of the SPV under the theory that had it received a PIK of the securities held by the fund, it would know exactly which securities it held. However, a fund sponsor may find that offering such transparency undermines its ability to manage the SPV and may also be inconsistent with any obligations with respect to material non-public information. As a practical matter, investors will want to know, at the very least, anticipated liquidation and distribution dates.

Is a limited partner (LP) holding an interest in a liquidating SPV treated the same as an LP of the fund? Typically not. A redeeming investor holding an interest in an SPV is typically no longer treated as an LP of the fund entitled to vote on amendments or exercise any other rights of an LP. Such LP may have voting rights in respect of the SPV, but such rights are likely to be more limited.

Which of the fund's assets are transferred to the liquidating SPV? Some funds transfer the redeeming investors' ratable portion of each and every asset of the fund to the SPV. By doing so, the fund may be more certain it is transferring the appropriate amount to the SPV even if it is not certain of the exact dollar value of each asset. However, transferring a portion of every asset may not be feasible for certain portfolios and selecting assets may give rise to conflicts of interest.

Who bears the costs of the liquidating SPV? Most fund documents provide that the costs associated with a redemption (typically brokerage costs) may be allocated to the redeeming investors. Similarly, one would expect that the costs of organizing and managing a liquidating SPV should be allocable to the redeeming investors holding interests in such SPV. However, because the SPV may also benefit the non-redeeming investors (by ensuring that no more than the redemption amount is transferred to redeeming investors), a fund sponsor may be justified in allocating a portion of the costs to the non-redeeming investors.

Jennifer A. Spiegel is a counsel in the Investment Funds Group in the New York office of Paul, Weiss, Rifkind, Wharton & Garrison LLP. She advises hedge funds, private equity funds and hybrid funds and their respective management companies on a wide range of fund formation and regulatory issues as well as acquisitions of investment managers and seeding arrangements for emerging funds and emerging managers. Ms. Spiegel's clients include both large institutional clients, as well as smaller investment management boutiques. Ms. Spiegel may be reached at tel. (212) 373-3748 or e-mail: jspiegel@paulweiss.com.

[1] *In re Strategic Turnaround Master P'ship Ltd.* (Cayman Is. C.A. Dec. 12, 2008).

[2] Note that the Delaware Chancery Court recently confirmed the ability of a general partner of a Delaware limited partnership to override Section 17-605 of the Delaware Revised Uniform Limited Partnership Act, which precludes a limited partner from receiving more than its partnership percentage of any asset distributed in kind. See *Schuss v. Penfield Partners, L.P.*, No. 07-CV-3132, 2008 BL 129014 (Del. Ch. Jun. 13, 2008).

[3] *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

[4] *In re Stewardship Credit Arbitrage Fund* (Berm. Sup. Ct. Nov. 27, 2008); *Bank of America N.A. v. Steel Partners II (Offshore) Ltd.*, No. 09-CV-4284 (Del. Ch. filed Jan. 13, 2009); and *In re Strategic Turnaround Master P'ship Ltd.* (Cayman Is. C.A. Dec. 12, 2008).