US Outlook: Legal Limits on Hedge Fund Redemption Gates and Suspensions

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I. Introduction

Investors in hedge funds often face several restrictions on their ability to withdraw capital from the fund. These liquidity restrictions have definite benefits, allowing hedge funds to maintain long-term investment strategies, qualify for exemptions from regulatory requirements, and avoid the higher taxes associated with a publicly traded partnership.[1] Liquidity management tools assumed increased importance in the wake of the 2008 financial crisis, as hedge funds faced a flood of redemption requests and few new subscriptions.[2] The economic downturn that has accompanied the recent advent of the global COVID-19 pandemic is likely to bring liquidity issues to the forefront once again. At least one fund has already restricted redemption and begun dissolution, citing an unexpected wave of redemption requests and difficulty raising new capital.[3] Hedge fund managers and investors alike will need to be aware of liquidity management issues and the legal limits on the use of liquidity restrictions.

A fund's governing documents may provide for several restrictions on redemption, including: (1) periodic redemptions on a quarterly, semiannual, or annual basis; (2) initial lock-up periods during which redemption is prohibited; (3) temporary suspensions when certain criteria are met; (4) redemption in-kind of stock or shares in a special purpose vehicle instead of cash; (5) redemption fees; and (6) redemption gates.[4] This alert focuses on gates and suspensions.

The essential purpose of a gate is to limit the amount that can be redeemed from the fund during a particular redemption period. A gate may be imposed at the fund level or the investor level. For a fund gate, redemption requests of all investors in aggregate during a given period may not exceed a percentage of the total value of the fund, often 20% or 25%.[5] If the total requests exceed this amount, each investor's request is reduced on a pro-rata basis.[6] An investor-level gate limits each investor's redemption request to a specific percentage of its investment. While fund-level gates were more common before the 2008 financial crisis, investor-level gates have proliferated in its wake.[7] Gates may be automatically applied, invoked at the discretion of the fund manager, or subject to waiver provisions.[8]

Suspension provisions typically allow the manager to suspend redemptions temporarily or indefinitely, in the manager's discretion, when certain conditions are met.[9] Most suspension provisions provide for full suspension, but they may also allow for partial suspension, limiting redemptions to a particular asset or group of assets.[10] A partial suspension is functionally similar to a gate.[11] Like other liquidity restrictions, suspensions were widely used during the financial crisis. They remain a common tool and will likely see increased use as economic challenges persist.

Although fund documents often give managers "sole discretion" regarding when to invoke redemption restrictions, there are several notable legal limits on their operation. First, the SEC may regulate their application to the extent that it finds fraudulent or misleading statements, omissions, or conduct with respect to investors. For example, a fund manager may be prohibited from giving more favorable treatment to some investors without telling others. Second, contract principles may limit the application of a gate or suspension provision. And third, a fund manager's fiduciary duties to the fund and its investors may limit application of these provisions. Each of these limitations is examined below.

II. Legal Limits

A. Regulatory Restrictions

Hedge funds have historically been free from federal securities regulation, a design that allows them to take on risky trading strategies like short positions that would be off limits to regulated funds.[12] This changed after the financial crisis with passage of the Dodd-Frank Act.

Title IV of Dodd-Frank Act brought hedge funds under the purview of the SEC, amending the Investment Advisers Act of 1940 ("IAA") to require hedge funds with over $150 million in assets under management to register with the SEC.[13] Registered funds must report a wide range of "systemic risk data" by way of Form PF.[14] Among other things, the fund must report what percentage of the fund's net asset value is subject to a redemption gate or suspension.[15] Although this information is kept confidential, it will be used by the Financial Stability Oversight Council to assess systemic risk.[16] As such, the information could become a basis for future regulation. The SEC may impose penalties for any willful misstatement of material fact on Form PF.[17]

Another regulation promulgated under Section 206 of the IAA provides the SEC with more direct regulatory control. Rule 206(4)-8 prohibits material misstatements and misleading omissions in statements to investors and any "fraudulent, deceptive, or manipulative" act or course of business with respect to investors.[18] It applies to both registered and unregistered funds, and courts have held that even negligent misstatements are actionable.[19]

The SEC has instituted a civil enforcement action under Rule 206(4)-8 against a hedge fund manager, Aria Partners GP, LLC ("Aria Partners"), for failing to disclose its informal redemption policy to all of its investors.[20] The fund's limited partnership agreement required 90 days' written notice for redemption, but Aria Partners had an informal policy of allowing partial redemption after only 60 days' written notice.[21] The informal policy was not set out in writing or widely communicated to investors. When two investors requested redemption at about the same time, Aria Partners applied the 90-day policy to one and the 60-day policy to the other. The market fell after the investors made their requests, and the one who was subject to the longer notice provision received less.[22]

The penalty in the Aria Partners action was a relatively low sum of $150,000, but the IAA and regulations authorize the SEC to seek a civil penalty of up to $500,000 per willful violation, in addition to disgorgement.[23] The SEC may also file a civil claim in a federal district court for up to the same maximum penalty per violation or the gross proceeds, whichever is greater.[24] The calculation of gross proceeds, or "pecuniary gain," need not be precise; one court simply determined the total contributions of defrauded investors, subtracted any distributions, and set a civil penalty that "approximate[d]" that amount.[25] Further, the Department of Justice may bring criminal charges for a willful violation of the IAA, and a conviction carries a maximum penalty of $10,000, five years' imprisonment, or both.[26]

SEC enforcement actions under Rule 206(4)-8 are not uncommon; nearly 400 such actions have been commenced since 2008. The SEC has applied Rule 206(4)-8 in the context of restrictions on redemption, including both gates and suspensions. In one case, a fund manager waived the notice provision for himself and his company when he sought to redeem his shares in the fund, delaying the redemption requests of 55 other investors.[27] Even though the governing document allowed the manager to "waive the notice provisions and otherwise modify the conditions relating to redemption with regard to any shareholder," it did not disclose that the manager could "leapfrog" other outstanding redemption requests.[28] In another case, the SEC sued a manager for suspending redemptions for most investors while secretly honoring them for his friends and family.[29] Under the logic of these actions and the Aria Partners action, a hedge fund could incur liability by adopting an undisclosed policy with respect to when it invokes a redemption restriction and which investors are subject to it. Any departure from the written terms of the fund's governing documents may attract regulatory attention if knowledge of the policy could be material to an investor's understanding of how the redemption gate or suspension will be applied.[30]

B. Private Enforcement

In addition to SEC enforcement, investors *may* have a limited right to sue for violations of Section 206. The Supreme Court has held that the IAA does not provide a private right of action for *damages*, but that there is an implied private right of action for *rescission* under Section 215.[31] That Section provides that any "contract made in violation of any provision" of the IAA or "the performance of which involves the violation" of the IAA is void.[32] Although some decisions hold that rescission under Section 215 is appropriate only when the investment contract itself contains illegal terms or requires illegal performance, other courts have suggested that this language may allow for rescission of an investment contract any time a fund manager violates a provision of the IAA.[33] Relying on such authority, an investor who is harmed by application of a redemption gate or suspension in violation of Section 206 may attempt to sue to rescind the investment agreement under Section 215. An investor's remedy, should the court follow cases that permit such private claims, could include "the legal incidents of voidness," such as restitution, minus any value conferred on the investor, and an injunction against continued operation of the contract, but it would not include any compensation for diminution in the value of the rescinding party's investment.[34] The monetary value of restitution, if allowed at all, could include the value of the rescinding party's investment at the time of rescission, plus commissions, fees, or other compensation paid to the fund manager pursuant to the investment contract.[35]

Contract rights and fiduciary duty obligations may place additional limitations on the exercise of redemption gates and suspensions. These limitations converged in *Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC*.[36] There, the Delaware Chancery Court considered a dispute between a hedge fund manager (Paige) and its seed investor (Lerner) regarding use of a redemption gate. The case provides a useful window on common issues facing redemption restrictions, and it is therefore worthwhile to examine it in some detail.

The relationship between Paige and Lerner was governed by two agreements.[37] A Seeder Agreement obligated Lerner to invest $40 million for a minimum three-year lock-up period, and in return Lerner would receive favorable investment terms, including reduced fees and a share of the fees collected by Paige.[38] The Seeder Agreement contained no gate provision.[39]

A second agreement, the Partnership Agreement, was meant to govern the relationship between Paige and all investors in the fund, including Lerner.[40] The Partnership Agreement contained a fund-level gate provision, which limited redemptions to 20% of the fund's net assets during any given period.[41] The Partnership Agreement further gave Paige "sole discretion" to waive its redemption restrictions for "certain large or strategic investors."[42] By its express terms, the Seeder Agreement could "not be deemed to amend" the Partnership Agreement.[43]

Things went downhill after the parties entered these two agreements. Paige failed to attract any other investors or pursue significant investment opportunities.[44] At the end of the three-year lock-up, Lerner sought to redeem its full investment. Paige refused, insisting that the gate applied.

Lerner sued for breach of contract and breach of fiduciary duty. The court approached the dispute primarily as a matter of contract interpretation, applying well established principles of New York contract law (which applied based on choice of law provisions in the agreements).[45]

First, it observed that contracts must be read as a whole, so as to give meaning to every provision.[46] Where more than one agreement applies, the court may seek to harmonize them, keeping in mind that the more specific agreement governs the more general. Reading the Partnership Agreement and the Seeder Agreement together, the court concluded that the more specific Seeder Agreement's withdrawal provisions supplanted those of the Partnership Agreement. The two were not inconsistent, as the latter specifically contemplated waiver for "certain large or strategic investors."[47]

Second, the court permitted consideration of extrinsic evidence only after determining that the contract terms were ambiguous. Given that the Seeder Agreement was not to "amend" the Partnership Agreement, including, arguably, by waiving its gate provision, the court found enough ambiguity to permit the consideration of extrinsic evidence.[48] Upon doing so, the court determined that the parties' negotiations further demonstrated that the gate provision did not apply to Lerner. During those negotiations, Paige emphasized to Lerner that there was no conflict between the two agreements because the Partnership Agreement allowed modifications like the Seeder Agreement. Paige thus acknowledged that the Seeder Agreement was best viewed as a side letter setting forth Lerner's specific rights, which were fully contemplated modifications, not prohibited amendments to the Partnership Agreement. The court therefore held that the gate provision did not apply and that Paige had breached the Seeder Agreement by failing to return Lerner's entire investment.[49]

The court further held that Paige's fiduciary duty would have required waiver of the gate provision even if there was no contractual waiver. It rejected Paige's argument that her "sole discretion" to determine waiver of the gate provision meant that no fiduciary duty applied. Under Delaware case law, the words "sole discretion" simply meant that a manager did not have to seek guidance or approval from others; they did not absolve a fiduciary of her duties. Although parties to a partnership agreement could free the general partner of fiduciary duties to the partnership, they had to do so in clear and unambiguous terms.[50] Finally, the court held that Paige's invocation of the gate provision was a breach of fiduciary duty because she had repeatedly admitted that her motivation was not to protect the interests of investors in the fund, but only to protect her own interest in collecting fees.[51]

1. Contract Claims

The common contract rules applied in *Paige Capital* are likely to reappear as limits on the use of redemption gate and suspension provisions. Side letters and separate agreements are a common feature of hedge fund governance structures,[52] but parties to those agreements must consider how a court may read them in connection with other governing documents. In reviewing the application of gates (either a decision to limit redemptions, or a decision to exempt certain investors from generally applicable limitations), courts reviewing side letters are likely to consider (a) language in the side letter concerning which provisions are being waived and which are not, (b) language addressing which agreement will govern in the event of inconsistent provisions in multiple governing documents, and (c) whether the contracts at issue clearly waive the existence of fiduciary obligations to fund investors. When a court reviews a contract claim based on the suspension of redemptions, it will likely search the record for evidence that the conditions for suspension set forth in the contract were met.[53]

Parties should also be on the lookout for potential ambiguities. A contract provision that appears unambiguous standing alone may become ambiguous when read in conjunction with a side letter or other separately negotiated agreement. And of course, if the court finds ambiguities, extrinsic evidence of the parties' negotiations may be considered, introducing uncertainty and frustrating parties' expectations. The potential for such uncertainty warrants special care on the part of fund managers in drafting offering documents and on the part of investors in reviewing them for any lack of clarity. For example, if a gate provision states, without elaborating, that redemption requests will be reduced "pro rata," potential investors should consider whether the reduction will be based on the size of each investor's redemption request or the size of each investor's stake before redemption.[54] Similarly, gate provisions should be clear about when fund managers make the determination that the gate threshold has been reached, be it at the time redemption notices are due or on the effective date of redemption.

2. Breach of Fiduciary Duty Claims

Paige Capital further illustrates that a manager's fiduciary duty may restrict application of a gate or suspension provision. It is well established that a general partner owes a fiduciary duty to the partnership.[55] Although Delaware law allows the limited partners to waive fiduciary duties—a waiver likely incorporated in the vast majority of investment fund partnership agreements—any waiver must be clear and unambiguous.[56] Simply giving the manager "sole discretion" to raise a redemption gate does not absolve it of its fiduciary duties.[57] The gravamen of a manager's fiduciary duty with respect to redemption gates is that they must be deployed in the best interests of the hedge fund and its investors, not the manager's own financial needs. A manager's fiduciary duty further includes a duty of candor, and managers may face claims if they allow preferential or excessive redemptions for some investors without disclosing them to other investors.[58] While good faith application of a partnership agreement is a defense to a breach of fiduciary duty claim,[59] the manager must demonstrate good faith.

III. Conclusion

Redemption gates and other liquidity restrictions serve a useful purpose and may be beneficial to investors. Empirical studies suggest that they are a successful way to implement long-term investment strategies.[60] The current global pandemic, and the period of economic difficulty that it is ushering in, may give rise to substantially increased invocations of such restrictions and resulting challenges to their use.

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[1] Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 Berkeley Bus. L.J. 240, 252 (2009).
[2] Nora M. Jordan et al., *Advising Private Funds: A Comprehensive Guide to Representing Hedge Funds, Private Equity Funds and their Advisers* § 20:12 (Sept. 2019); Jamie Sklar, *Schulte Partner Stephanie Breslow Discusses Hedge Fund Liquidity Management Tools in Practising Law Institute Seminar*, The Hedge Fund Law Report, Vol. 5, No. 43 (Nov. 15, 2012) , *available at* https://www.srz.com/images/content/6/7/v2/67761/Breslow-Hedge-Fund-Law-Report-Stephanie-Breslow-Discusses-Hedge.pdf.
[3] Jon Shazar, First Hedge Fund Dies of Coronavirus, DealBreaker.com (Mar. 13, 2020), https://dealbreaker.com/2020/03/solus-shuts-covid-19 (describing dissolution of Solus Alternative Asset Management LP's flagship hedge fund).
[4] Sklar, *supra* note 2; David J. Lestz, *Gates, a Primer (Parts One and Two)*, Bloomberg Law Reports–Securities Law, Vol. 5, Nos. 34 & 35 (2011); Jordan et al., *Advising Private Funds* § 20:10.
[5] Sklar, *supra* note 2.
[6] *Id.*
[7] *Id.*; *see also* Alistair Barr, *Hedge funds try new way to avoid big redemptions*, MarketWatch.com (June 10, 2010), https://www.marketwatch.com/story/hedge-funds-try-new-way-to-avoid-big-redemptions-2010-06-10.
[8] *See* Lestz, *Gates, a Primer*, *supra* note 4.
[9] *See* Sklar, *supra* note 2.
[10] Lestz, *Gates, a Primer*, *supra* note 4.
[11] *Id.*
[12] Wulf Kaal and Dale Oesterle, *The History of Hedge Fund Regulation in the United States*, The CLS Blue Sky Blog (Feb. 29 2016) https://clsbluesky.law.columbia.edu/2016/02/29/the-history-of-hedge-fund-regulation-in-the-united-states/.
[13] *Id.*; *see also* 15 U.S.C. § 80b-3(a) (requiring registration of an "investment adviser," barring qualification for certain exemptions); 15 U.S.C.§ 80b-3(m).
[14] 17 C.F.R. § 275.204(b)-1(a).
[15] SEC Form CF at 30, 34, *available at* https://www.sec.gov/about/forms/formpf.pdf.
[16] Lemke et al., *Hedge Funds and Other Private Funds: Reg and Comp* § 7:24 (Dec. 2019).
[17] 15 U.S.C.A. § 80b-7.
[18] 17 C.F.R. § 275.206(4)-8; *see also* 15 U.S.C. § 80b-6 (§ 206 of the IAA).
[19] *Sec. & Exch. Comm'n v. Gruss*, 245 F. Supp. 3d 527, 603 (S.D.N.Y. 2017); *Sec. & Exch. Comm'n v. Illarramendi*, 260 F. Supp. 3d 166, 175 (D. Conn. 2017), *aff'd* , 732 F. App'x 10 (2d Cir. 2018).
[20] *In the Matter of Aria Partners Gp, LLC, Respondent*, Rel. No. 4991, 2018 WL 4002143, at *1 (Aug. 22, 2018).
[21] *Id.* at *2.
[22] *Id.*
[23] *Id.* at *4; 15 U.S.C.A. § 80b-3(i) (authorizing the SEC impose a civil penalty in administrative proceedings and setting the amount); *id.* § 80b-3(j) (disgorgement and accounting).
[24] *See Illarramendi*, 260 F. Supp. 3d at 183–84 (ordering disgorgement of $25.8 million and a $1 million penalty); *see also* 15 U.S.C. § 80b-9(e) (providing for SEC enforcement actions and penalties).
[25] *See S.E.C. v. Haligiannis*, 470 F. Supp. 2d 373, 384–86 (S.D.N.Y. 2007) (imposing a $15 million civil penalty after calculating disgorgement in approximately that amount).

[26] 15 U.S.C. § 80b-17.
[27] *In the Matter of Mark R. Graham, Blue Capital Mgmt., Inc., & Blue Alternative Asset Mgmt., L.L.C., Respondents*, Rel. No. 5000, 2018 WL 4242060, at *6 (Sept. 6, 2018).
[28] *Id.*
[29] *Sec. & Exch. Comm'n v. Conrad*, 354 F. Supp. 3d 1330, 1340 (N.D. Ga. 2019) (granting summary judgment to SEC on claim under Section 206 based on manager's suspension of redemption without disclosing to investors that redemption requests were still being granted for manager's friends and family).
[30] Lemke et al., *Hedge Funds and Other Private Funds: Reg and Comp* § 5:21 ("[T]he fund manager must make disclosure to *all* fund investors that such notice or other requirements are sometimes waived.")
[31] *Transamerica Mortg. Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11, 18–21 (1979).
[32] 15 U.S.C. § 80b-15(b).
[33] *Compare Omega Overseas Partners, Ltd. v. Griffith*, 2014 WL 3907082, at *2–3 (S.D.N.Y. Aug. 7, 2014) ("[Section] 215(b) voids a contract only where the contract would be invalid under [the common-law principle that illegal contracts are invalid]—that is, where the contract was made illegally or requires illegal performance."), *with In re Evergreen Mut. Funds Fee Litig.*, 423 F. Supp. 2d 249, 262 (S.D.N.Y. 2006) ("Courts in this Circuit have routinely permitted Section 215 claims to proceed irrespective of whether the contracts themselves violated the IAA.").
[34] *Transamerica*, 444 U.S. at 19, 24 n.14.
[35] *Douglass v. Beakley*, 900 F. Supp. 2d 736, 746 (N.D. Tex. 2012) ("Thus, the only apparent remedy available to an aggrieved investor under the IAA, aside from rescission, would be commissions, fees, or other compensation paid to the investment advisor pursuant to the investment contract.").
[36] 2011 WL 3505355, at *1 (Del. Ch. Aug. 8, 2011).
[37] *Id.* at *4.
[38] *Id.* at *4–5.
[39] *Id.* at *19.
[40] *Id.* at *1.
[41] *Id.* at *17.
[42] *Id.*
[43] *Id.* at *4.
[44] *Id.* at *9–12.
[45] *Id.* at *16.
[46] *Id.* at *22.
[47] *Id.*
[48] *Id.*
[49] *Id.* at *26–28.
[50] *Id.* at *28–32.
[51] *Id.* at *32–35.
[52] *See* Shadab, *Law and Economics*, *supra* note 1, at 248–49.
[53] *See Hunnicutt & Co. v. Thinkstrategy Capital Mgmt., LLC*, 910 N.Y.S.2d 762 (N.Y. Sup. Ct. 2010) (denying motion to dismiss breach of contract claims based on suspension of redemptions in violation of partnership agreement).
[54] *See* Lestz, *Gates, a Primer*, *supra* note 4.
[55] *See, e.g.*, *In re Soundview Elite Ltd.*, 594 B.R. 108, 127 (Bankr. S.D.N.Y. 2018) ("As a fiduciary, a fund manager must place the fund's interests before its own while exercising due care in the decision-making process."); *Brinckerhoff v. Enbridge Energy Co.*, 2011 WL 4599654, at *7 (Del. Ch. Sept. 30, 2011) ("It is established Delaware law that a general partner owes a partnership fiduciary duties similar to the duties directors owe to a corporation.").
[56] Del. Code Ann. tit. 6, § 18-1101(a)–(e); *Miller v. Am. Real Estate Partners, L.P.*, 2001 WL 1045643, at *8 (Del. Ch. Sept. 6, 2001) ("[I]t is fair to expect that restrictions on fiduciary duties be set forth clearly and unambiguously."); *see also* Houman B. Shadab, *Hedge Fund Governance*, 19 Stan. J.L. Bus. & Fin. 141, 202 n.38 (2013) ("An empirical study of publicly traded limited partnerships and limited liability companies did find, however, that an overwhelming majority either eliminated fiduciary duties or waived manager liability arising from their breach.").
[57] *Seibold v. Camulos Partners LP*, 5176-CS, 2012 WL 4076182, at *8–10 (Del. Ch. Sept. 17, 2012), *judgment entered*, (Del. Ch. 2012) (holding that fund managers breached partnership agreement by withholding redemption funds without extraordinary circumstances and ordering redemption).
[58] *Albert v. Alex. Brown Mgmt. Servs., Inc.*, 2005 WL 5750601, at *24 (Del. Ch. June 29, 2005) (denying motion to dismiss breach of fiduciary duty claims regarding managers' allowance of excessive redemptions without disclosure to plaintiff shareholders, whose redemption requests were suspended when liquidity later became scarce).
[59] *See* Del. Code Ann. tit. 6, § 17-1101(e).
[60] Shadab, *Law and Economics*, *supra* note 1, at 280.