VENTURE CAPITAL, PRIVATE EQUITY AND HEDGE FUNDS: STRUCTURE AND RISK EXPOSURES

By
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I. The Venture Capital and Private Equity Business

Venture capital and other private equity funds (including leveraged buyout funds) are forms of high-risk, but potentially high-return investing. This paper will concentrate primarily on venture capital funds, but many of the structural and other concepts are equally applicable to private equity funds.

Fund Structure

Typically a venture capital firm will solicit investors for a fund of between $10 million and $1 billion in capital, although most funds are at the lower end of this range. Venture capital (and private equity) funds typically are structured as limited partnerships (more recently, though still to a lesser extent, they often are formed as limited liability companies). Investors in the fund purchase one or more units of limited partnership interests. The managers of the fund (*i.e.*, the venture capitalists) determine how the fund invests its money in developing companies, and act as general partners of the limited partnership (or managers of an LLC). Usually, the limited partners contribute 99% of the capital of the fund through their purchase of limited partnership interests in accordance with capital commitments. The general partners contribute the remaining 1% of the committed capital of the fund by purchasing their general partnership interests.

Fund Development Stages

A venture capital fund passes through four stages of development, lasting for a total of perhaps ten years. During the first stage, the fund raises capital. Typically, the general partners of the fund spend from six months to a year obtaining capital commitments from potential limited partners. Potential limited partners include private and public pension funds, insurance companies, banks, corporations, wealthy individuals, charitable foundations and endowments.

Once the venture capital fund has sufficient committed capital, the second stage comprises identifying, reviewing and investing in portfolio companies. This stage lasts from three to six years. Typically, the general partners identify potential portfolio companies through reading trade press, attending trade conferences and speaking to those familiar with the particular industry. Additionally, many funds have a particular industry or industry group focus in which

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the general partners have significant expertise or experience. Once a particular company is identified as a potential investment, extensive research is done on the company and its market. This process, called "due diligence," may ultimately convince the general partners to make an investment in that company. Then, the company in which the investment is made becomes a "portfolio company" of the venture capital fund.

During the third stage of the fund, the general partners spend their time working with the fund's portfolio companies to increase their value. The venture capital fund's investment in a portfolio company may include preferred stock, warrants to purchase preferred or common stock, convertible debt securities, or a combination of the foregoing, generally depending on the nature of the fund and the relative attractiveness of the portfolio company. In addition to this financing, the venture capital fund, through its general partners, often places a representative on the Board of Directors of the portfolio company. As a Board member, this representative offers strategic advice to the portfolio company's management and assures that the venture capital fund's interests are considered.

The fourth and final stage in the life of a venture capital fund is its closing. By the expiration of the fund, it should have liquidated its positions in all of its portfolio companies. Liquidation usually occurs in one of three ways: an initial public offering of the stock of the portfolio company (an "IPO"); the sale of the company to a third party; or bankruptcy. Note, however, that stages two through four often overlap with respect to different portfolio companies. Some investments may therefore be liquidated as other new investments are being researched and made.

Fund Liquidity Events

Typically, initial public offerings earn the greatest return on venture capital investments. Once a portfolio company goes public, the venture capital firm realizes value from its initial investment. For example, if over the course of several rounds of financing, the venture capital fund has bought 40% of a company for $6 million and the company achieves a public market capitalization of $150 million, then the value of the venture capital fund's investment has grown to $60 million. In this example, the venture capital fund's investment has enjoyed a ten-fold return.

According to the National Venture Capital Association ("NVCA"), forty-three venture funds raised $3.4 billion from investors in the fourth quarter of 2008, down 49% in number and 71% in volume, respectively, from the same period in 2007. The 4Q '08 number and total amount raised represented the lowest quarterly numbers in the last five years. Over the last year, the amount raised totaled $28.0 billion, a 21.4% decrease from 2007.

Likewise, in 2008 venture capital funds invested $28.3 billion in 3,808 deals. This represents an 8% drop in volume, and a 4% drop in number over 2007. This was the first yearly decline in total investments in five years. In Q4, 2008, $5.4 billion was invested in 818 deals. This was 26% lower than Q4, 2007.

The IPO market for VC-backed companies is clearly being affected by broader U.S. economic uncertainty. Indeed, no venture-backed IPOs occurred in the fourth quarter of 2008, compared to 31 in the fourth quarter of 2007. Similarly, the total dollar amount of M&A deals for venture-backed companies was $28.8 billion, down from $31.4 billion in 2007.

Successful venture capital firms make a profit on about 50% of their portfolio company investments and lose money on the other 50%. According to the NVCA, venture funds had an average one-year return of -1.6% during the 12-month period ending September 30, 2008, compared to 17.5% for the 12-month period ending June 30, 2007..

Venture Capitalist Compensation

Venture capital firms receive compensation for their investment and management activities in two ways. First, they usually receive an annual management fee paid by the fund to a management corporation that employs the venture capitalists and their support staff. The annual management fee ranges from 1% to 2 1/2% of committed capital. In addition, the venture capital firm usually receives compensation through the allocation of the net income of the fund. The fund's primary source of net income is capital gains generated from the sale of stock of the companies in which the fund has invested. The general partners of the fund generally receive 20% of the net capital gains distributed while the limited partners receive the remaining 80%.

Portfolio Company Selection and Development

Because of competition among venture capital funds for promising portfolio company investments, venture capital firms have developed specialized investment strategies that concentrate on specific industries in particular stages of corporate development. Usually, the focus on a particular industry reflects the experience of the general partners of the venture capital fund. This experience makes the general partner a potential valuable addition to the Board of Directors of potential portfolio companies in that industry. Popular areas of expertise in the venture capital industry include e-commerce, web content, biotechnology, computer software, communications, retail and other specialty niche areas.

The particular stages of corporate development where venture capital financing can occur are: early stage; expansion financing; and acquisition/buy out financing. Generally, the later the stage of the company financing, the smaller risk for the venture capital fund. Therefore, funds that invest in later stage companies must pay a higher valuation for their equity positions. Typically, venture capital funds hope to achieve a return on their investment in start-ups within one to five years and, in established companies, within two to four years.

Early stage financing is an initial infusion of capital provided to entrepreneurs with little more than a business concept. These funds are used to conduct both market research and product development. Once research and development are underway and the core management team is in place, start-up financing can be obtained to recruit an experienced management team, to buy additional equipment and to begin a marketing campaign. Early stage financing enables a portfolio company to initiate a full-scale manufacturing and sales process to launch its products into the market.

Early stage venture capital firms had a one-year loss of 27.6% as of December 31, 2002 according to the NVCA. This was a significant reversal from the 12 months that ended September 30, 1999, when venture capital funds which had made early stage financing investments reaped a stunning 91.2% one year return. As of September 30, 2008, early stage venture capital firms had a one-year return of only 0.2%. which, although outperforming all major indexes for the same period, clearly pales in comparison to the record achievements reached in 1999.

Expansion financing assists companies that are already selling product. At this stage a portfolio company may raise between $1 million to $10 million to attract additional personnel to its sales, marketing and engineering teams. Because many companies are not yet profitable at this stage, venture capital financing is used to offset negative cash flow.

Third stage or mezzanine financing, if necessary, enables major expansion of the company, including plant expansion, additional marketing or the development of additional products. At this stage of venture capital financing, the portfolio company is usually break-even or even profitable.

What differentiates venture capital investors from passive investors is a long-term involvement with their investments. As active Board participants, venture capital investors offer their unique set of experience and skills. Successful venture capital firms arrange for the long-term financing of their portfolio companies and aid in developing the management team, advisory boards, new product ideas, strategic relationships and key customers and accounts.

Venture Capital Volume

In 2004, venture firms invested $21.6 billion in 2,966 deals. According to the PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association MoneyTree Survey, this marked the first increase in venture capital investing after three years of consecutive declines. In 2005, venture capitalists matched 2004 by investing $21.7 billion in 2,939 deals. In 2006, venture capitalists invested $25.5 billion in 3,416 deals, a ten percent increase over 2005 in deal volume and 12% in dollar value. In 2007, venture capitalists invested a total of $29.4 billion in 3,813 deals, the highest investment total in six years. Even in the current economic turmoil, venture capitalists invested $28.3 billion in 3,808 deals in 2008.

The high demand for alternative investments fueled venture capital fundraising in 2005 with 228 funds attracting $28.3 billion. The NVCA reported that venture fundraising had another strong showing in 2006, recording the highest fundraising year since 2001, with 229 venture funds raising $31.7 billion. This positive trend continued in 2007, with 235 venture firms raising $34.7 billion, but fell back in 2008 as 211 venture firms raised only $28.0B.

Private Equity Volume

Private equity funds raised $265.6 billion in 2008, down 18% from the $325.8 billion raised in 2007. Following the bankruptcy of Lehman in September, 2008, the availability of credit to finance buy-outs deals evaporated. Global buy-out volume declined by 71% to $185.5 billion in 2008, from $632.8 billion in 2007, according to Dealogic. Up until the Lehman bankruptcy, sales of portfolio companies to strategic buyers in 2008 were ahead of 2007. By the end of 2008, however, sales of private equity sponsored companies to strategic buyers fell by 53% to $146 billion from $309.3 billion in 2007. There were only $5.1 billion of these sales in Q4 2008.

II. The Hedge Fund Business.

A hedge fund is not necessarily a fund that "hedges" its investments at all. Rather, hedge funds include almost any fund not registered with the SEC that invests in a portfolio of generally liquid securities (equity, fixed-income, derivatives, currencies, etc.). Unlike venture capital and private equity funds, a hedge fund usually does not seek to play a role in the management of its portfolio securities.

Experts estimate that the hedge fund industry has a total of $1.5 trillion in total assets under management, and the industry has grown at about 20% per year with approximately 9,900 active hedge funds. While the industry was largely unregulated in the past, making any estimate hard to validate, the new regulatory efforts by the Treasury Department and the SEC allow the government to track the industry like it has not done before. Pursuant to authority granted by the Securities Exchange Act of 1934, the Treasury Department has adopted rules that govern the reporting of large positions in U.S. Treasury securities by persons who participate in the government securities market, including registered investment advisers and hedge funds.

The appeal of hedge funds to investors is obvious – they have the ability to offer absolute returns uncorrelated to the general equity markets. During the last 18 years, the S&P 500 Index has had 17 negative quarters, totaling a negative return of 113%. During those negative quarters, the average U.S. equity mutual fund had a total negative return of 115.7%, while the average hedge fund had a total negative return of only 10.3%, displaying the ability of hedge funds to preserve capital in falling equity markets.

Historically, the majority of hedge fund investors were high net worth ("HNW") individuals who typically invested in such funds through various distribution channels: "finders"/consultants, "family offices" such as Rockefeller & Company, private banks, brokers, and funds of funds. More recently the trend is to lower limits on minimum investments for individuals.

Modern portfolio theory recognizes that a certain percentage (such as 5%) of a diversified portfolio should be in "alternative investments" such as hedge funds. A desire for diversification has helped fuel a trend towards increasing investment by institutional investors, such as endowments, pension funds and corporations in hedge funds.

Institutional money, which represented less than 4% of hedge fund assets in 1990, increased to 25% by 1999 and is now certainly even higher. Endowments and foundations currently account for about half of all institutional capital. For example, university endowment hedge fund investments reportedly have increased from an average of 7% to 13% of assets in last several years. Recent estimates put certain endowments significantly higher: Princeton – 29%; UNC Chapel Hill – 30%; Univ. of Chicago – 15%; Notre Dame 18-25%.

Hedge Fund Investment Strategies, Liquidity and Fee Structure

Various portfolio strategies are used, including long/short equity (e.g., being long and perhaps leveraged in selected issuers, while shorting others in the same industry based on fundamental research); short selling; arbitrage (exploiting price differentials in related investments such as fixed-income securities or currencies); and merger arbitrage. These strategies are often based on complicated quantitative models.

Unlike most venture capital and private equity funds, which typically use an investor commitment and capital call mechanism, hedge funds usually have ongoing subscriptions, or investments, and redemptions to some extent. This approach is akin to that of mutual funds. The periods for which money is initially "locked-up" following an initial investment, and the frequency of redemption opportunities, can vary greatly in hedge funds, however.

Hedge funds often are structured to pay their advisers a 20% incentive fee (structured either as a performance fee or a carry) and a 1-2% management fee similar to venture capital and private equity funds. However, these fees may vary, and an adviser with an impressive track record may charge incentive fees as high as 45%. The fees are sometimes discounted if an investor is willing to agree to a longer initial lock-up period.

The incentive fee is also usually subject to some restrictions demanded by the market. These restrictions include a loss carryforward provision where no fee is paid unless a net positive return is achieved over a specified period; a hurdle rate provision which requires a minimum investment return, such as Treasury rate of return, before a fee is paid; or a high water mark provision which requires the fund NAV to exceed any previous high before an incentive fee becomes due.

<u>Hedge Fund Portfolio Structure</u>

Entity structure is largely driven by the tax status and considerations of target investors. As with venture capital and private equity funds, most of the U.S. hedge funds historically were organized as limited partnerships, with limited liability companies gaining favor more recently. Offshore hedge funds are organized as various types of corporations or partnerships depending on the jurisdiction used (Cayman Islands, Bermuda, etc.) and the desired tax consequences.

A simple "stand alone" fund structure like those described above works well if targeting only one type of investor, such as U.S. taxable HNW individual or non-U.S. investors. "Side-by-Side" funds use parallel portfolios achieved through aggregation of trades to attract a full range of investors. HNW individuals and other U.S. taxable investors typically invest in the U.S. fund. Non-U.S. investors seeking to avoid ECI (Effectively Connected Income) would invest in the parallel offshore fund.

"Master-Feeder" funds are most commonly used where the manager wants to run just one portfolio while marketing to different types of investors. There are several disadvantages to a "master-feeder" fund, including additional costs related to additional entities, double layer accounting, and possible cross liability depending on structure. Typically an offshore master-feeder fund is set-up as a corporation or partnership, with an onshore U.S. partnership feeder fund and an offshore corporation feeder fund. This achieves the same tax results as discussed for a side-by-side fund.

"Mini Master-Feeder" funds are a variation where U.S. taxable investors invest directly in a U.S. master fund, and non-U.S. and U.S. tax-exempt investors invest through an offshore corporation that effectively is treated as another limited partner of the master fund. While this retains the advantage of a single portfolio, the tax analysis is more complicated and the presence of non-U.S. investors in the U.S. master fund arguably increases the risks of securities law complications. The non-U.S. investors are also more closely connected to U.S. jurisdiction since their investment effectively is in a U.S. entity, and they may be more comfortable in the side-by-side model.

Alternatively, in a mini master-feeder structure the master fund may be an offshore entity set-up as a "limited duration company" that elects pass through U.S. tax treatment, allowing U.S. taxable investors to avoid the Passive Foreign Investment Company (PFIC) provisions and other unfavorable provisions of the U.S. tax code that could make the structure problematic.

Finally, there are "Fund of Funds" structures. These are popular outside the U.S. and increasingly popular among U.S. investors. Essentially they are hedge funds that diversify hedge fund risk by investing in other hedge funds. Investors choose to pay a double layer of fund fees in order to have the convenience of one investment that applies appropriate diversification theory rather than directly screening and buying multiple hedge funds.

Hedge Fund Volume

The Credit Suisse Tremont Hedge Fund Index (comprised of 496 hedge funds) dropped 19% in 2008. This was the first double-digit loss since this index was created in 1994. During 2008, by comparison, the S&P 500 Index dropped 37%. The Barclay's Global Aggregate Bond Index, however, rose 5%.

At the end of 2008, total assets under management within hedge funds was $1.5 trillion. Hedge fund assets dropped $582 billion in 2008, $149 billion of which was due to investor redemptions.

Approximately 1,300, or 17%, of hedge funds liquidated between January and October, 2008. According to industry estimates, approximately 25% of hedge funds today are "impaired." This means that the hedge funds have either imposed gate restrictions, suspended redemptions completely, or placed distressed illiquid assets in "side-pocket" vehicles.

III. Risk Exposures to Venture Capital Firms

Introduction

Legal liability arises when a duty to fulfill a legal obligation is not carried out. A legal obligation and the duty to fulfill it can be created either by an agreement (a contract) or by operation of law. A legal obligation created by operation of law (common law or a statute) generates a duty in tort to fulfill it. Whether a duty is created by a contractual obligation or a tort obligation generally does not affect the scope or extent of the duty. The origin of the duty, however, does affect the type and extent of damages recoverable for failure to properly carry it through.

Like directors in business corporations, the general partners of venture capital and private equity funds have obligations to their limited partners, the investors or "shareholders" of the fund. Unlike directors in business corporations however, the general partners (and the venture capital and private equity firms they represent) also have potential liability to the fund's portfolio companies. In fact, claims against venture capital and private equity firms and their principals by portfolio companies and constituents of those portfolio companies such as investors and founders are common.

Fraud and Securities Claims

General partners and their affiliated venture capital and private equity firms have been sued for fraud, breach of contract and securities law violations (federal and state) relating to the fund's investments in, or dealings with, portfolio companies. In these cases, plaintiffs allege that the fund through its general partners dominated or controlled the Board of Directors of the portfolio company and then abused that power for their own self-interest to the detriment of the portfolio company and its other shareholders.

The risk of these claims grows in proportion to the involvement of the venture capital or private equity fund in the operations, management and financing of the portfolio company. This involvement is quite predictable because, as noted above, the funds promote it in attracting potential portfolio company investments.

When these claims are brought, individual general partners of the fund, as well as the venture capital firms by which they are employed are named as defendants. Joining these parties as defendants is justified on the basis that they are the ones who actually exercise the control, make the decisions and deal with the individuals who claim to have been damaged. Under various controlling person theories, these individuals face the same degree and magnitude of liability exposure as the venture capital and private equity firm itself.

The following cases are examples:

> In re Archway & Mother's Cookie Co. Creditors sued private equity firm for allegedly participating in securities fraud in time period leading up to portfolio company's bankruptcy. Creditors allege that firm orchestrated and/or knew about phony sales and inflated inventory.
>
> Ford Motor Co. v. Angelo, Gordon & Company, L.P. Shareholders of portfolio company sued private equity firm for alleged fraudulent transfer by which firm allegedly drained solvent entity of all cash, leaving it insolvent.
>
> Mervyn's LLC v. Cerberus, et al. Bankrupt portfolio company sued private equity firms alleging that structure of buyout by private equity firms and subsequent transactions led to portfolio company's bankruptcy.
>
> Refco Litigation Trusts v. T.H. Lee, et al.: Litigation trusts established in portfolio company's bankruptcy sought more than $1 billion in purported damages allegedly caused by private equity firm's alleged conflicts of interest and mismanagement. Trusts alleged that the private equity firm and its representatives on the portfolio company's ignored and concealed adverse information to further interest of the private equity firm over those of the portfolio company.

<u>In re Just for Feet, Inc.</u> Bankruptcy trustee brought suit on behalf of debtor seeking damages for alleged mismanagement by private equity firm's representatives on portfolio company's board of directors, among others. Trustee alleged that mismanagement led to deepening insolvency that prevented successful reorganization of company in bankruptcy.

<u>ABRY Partners v. F&W Acquisition LLC, et al.</u> Private equity firm that purchased a portfolio company sued the private equity seller for alleged making knowing misstatements in the portfolio company's financial statements. The buyer alleged that the seller caused and/or knew about the portfolio company's artificial inflation of its EBITDA through channel stuffing, back starting and a variety of other accounting machinations, causing the buyer to overpay for the portfolio company by some $100 million.

<u>In re Redback Networks, Inc. Securities Litigation</u>. Shareholders in Redback brought class action claims for securities fraud against officers, directors and "controlling" shareholders of the company. Named defendants included a partner in Sequoia Capital who also served at various times as Chairman of the Board, CEO, and a director and audit committee member of the company. The shareholders alleged that the defendants engaged in a series of transactions that had the purpose and effect of creating the false appearance of legitimate revenue, allowing Redback to meet or exceed analysts' targets and maintain an artificially high stock price. For example, according to the complaint, nearly 20% of Redback's booked revenue between July 2000 and June 2001 was obtained by bribing decision-makers at Redback customers to order products they did not need. The alleged scheme, which the Complaint alleges unraveled when customers refused to buy any more unnecessary product, allowed Redback to reach a maximum stock price of $382 per share and a market capitalization of $43 billion. After the defendants had sold over $178 million in allegedly artificially inflated Redback stock, Redback's share price cratered to less than $1.00 per share in August 2002.

<u>In re Viewlogic Systems Securities Litigation</u>. Shareholders in Viewlogic brought class action claims for securities fraud against officers and directors of the company. Named defendants included a "controlling officer of the largest venture capital firm that arranged the Company's initial public offering" who also was a director of the company. The shareholders alleged that the defendants engaged in a scheme to artificially inflate Viewlogic's stock price so that they could sell their shares in the company on the open market at inflated prices. In particular, the Complaint alleged that the defendants caused Viewlogic to meet ever-increasing quarterly forecasts by "channel-stuffing" and other

inappropriate accounting gimmicks as its core schematic business remained flat.

In re Viisage Technology, Inc. Securities Litigation. Shareholders in Viisage brought class action claims against officers and directors of the company. Named defendants included the CEO of Odeon Venture Capital AG, who also served as a director of the company pursuant to Odeon's investment. The shareholders alleged that the defendants issued false and misleading statements to artificially inflate and prop up Viisage's stock price, while these insiders sold shares at inflated prices.

In re Triton Network Systems, Inc. Securities Litigation. Shareholders in Triton brought class action claims against officers and directors of the Company; the underwriters and managers of Triton's IPO; Triton's auditor; and Oak Investment Partners, a venture capital firm and shareholder in Triton that allegedly was a control person of Triton at all times material to the lawsuit. The director and officer defendants allegedly issued falsely positive statements and omissions in Triton's IPO Prospectus and various SEC filings and press releases that stood in stark contrast to internal reports of chronic and pervasive problems with Triton's product. These defendants also allegedly systematically overstated Triton's revenues to conceal the company's problems. Although Oak Investment Partners and one of its general partners were named in the lawsuit, they were not alleged to have actively participated in the purported accounting and securities fraud at the company. Instead, they were alleged, by reason of their stock ownership and other factors, to have been controlling persons of the company and to have had and exercised the power and influence to cause the other defendants to engage in the alleged wrongdoing.

Alantec Inc. Litigation. The founders of Alantec sued three venture capitalists and the partnerships with which they were associated. The founders had been forced out of the company when it was foundering. After regrouping under new management, the company went public and ultimately was sold for $770 million in 1996. The founders alleged that the venture capitalists seized control of the company and diluted the value of the founder's holdings by issuing new stock at below market prices. The founders charged that they lost the rights to stock ultimately worth $40 million. After 18 days of testimony before a jury, the case settled for $15 million prior to closing arguments.

In re Alert Holdings, Inc. Litigation. A venture capital corporation loaned and invested substantial monies to Alert Holdings, a parent company which conducted its business through a number of subsidiaries. The venture capital company obtained one seat on the board of directors and various rights through its securities holdings and loan agreements. After the company filed for bankruptcy, lawsuits were filed against the venture capital company and its directors and officers by public investors, the bankruptcy trustee and other company insiders. The lawsuits alleged that the venture capital defendants dominated and controlled the company, caused it to enter into various speculative investments in order to make it more dependent upon the venture capital company, forced the company to enter into unreasonable loan transactions with the venture capital company, undertook a scheme to acquire control of the company, failed to identify and respond to continuing financial deterioration of the company, and misrepresented to investors the true condition and prospects for the company. The litigation was settled pursuant to which the venture capital defendants and their insurers collectively contributed approximately $24 million.

<u>Bozsi Ltd. Partnerships v. Lynott</u>, 676 F. Supp. 505 (S.D.N.Y. 1987). Managing directors and co-chief executive officers of a venture capital company were sued by directors and officers of Tacoma Boatbuilding Co., by way of a third party complaint which alleged a failure by the venture capital defendants to investigate adequately Tacoma Boatbuilding's finances and further alleged the dissemination of misleading documents. (The Tacoma Boatbuilding directors and officers had themselves been sued by investors in Tacoma Boatbuilding.) The suit concerned the alleged loss of a $12.5 million investment upon Tacoma Boatbuilding's bankruptcy.

<u>Bowers v. Allied Capital Corp.</u> 1991WL 335252 (D. Maine 1991). Plaintiffs, who were the founders of Consolidated Auto Recyclers ("CAR"), alleged that the defendants, including a venture capital firm, and several of its officers and affiliates, conspired to fraudulently acquire ownership and control of CAR without compensating the plaintiffs for their interests in the company as its principal stockholders. Plaintiffs' complaint was based upon RICO, federal securities laws, and a number of state law claims. Plaintiffs sought $63 million in damages.

<u>Strassman v. Fresh Choice, Inc.</u> 1995 WL 743728 (N.D. Cal. 1995). Purchasers of Fresh Choice shares brought a securities class action against Fresh Choice, its largest shareholder, Rosewood Venture Capital, Inc. and six individual directors and officers of Fresh Choice, including a director who was also a principal of Rosewood. Plaintiffs alleged that the defendants issued false and misleading information about Fresh Choice to artificially inflate the price of its stock. Plaintiffs alleged the defendants misrepresented Fresh Choice's prospects for adding

new restaurants, issued misleading optimistic earnings projections, and misrepresented Fresh Choice's financial condition.

Macksey v. Egan, 36 Mass. App. Ct. 463, 633 N.E.2d 408 (1994). A shareholder in Extraversion, Inc. brought suit against the individual general partners of a venture capital partnership for deceit, breach of contract and violation of consumer protection laws. The plaintiff alleged breach of an agreement under which the venture capital firm and its individual general partners would gain control of Extraversion and purchase plaintiff's shares.

Alexander v. Centrafarm Group, N.Y., 124 F.R.D. 178 (N.D. Ill. 1988). Shareholder in Centrafarm brought derivative and class action claims for securities fraud and state law violations against directors and controlling shareholders who took the corporation private. Named defendants included Warburg Pincus & Company and Lionel Pincus, the managing partner of Warburg Pincus and a director of the company. Other Centrafarm directors affiliated with venture capital firms also were named as defendants. Plaintiff alleged that the defendant directors and controlling shareholders of Centrafarm prepared and disseminated a proxy statement which was false and misleading.

In re Ross Systems Securities Litigation, 1994 WL 583114 (N.D. Cal. 1994). Venture capital firm general partners, who were also corporate directors of Ross Systems, Inc., were sued in a class action for allegedly knowingly and/or recklessly issuing misleading statements designed to keep Ross' stock prices artificially high in order to sell shares at inflated prices. Plaintiffs alleged liability of the individual defendants based on theories of aiding and abetting, conspiracy and control person liability. Ross reportedly settled the suit by distributing $3.5 million in stock to plaintiffs.

Walmart v. Amazon.com. In October, 1998, Walmart Stores, Inc. filed a lawsuit against Amazon.com Inc. and its main venture capital investor Kleiner, Perkins Caufield & Byers in state chancery court of Benton County Arkansas. In Walmart's complaint it charged that Amazon.com, Drugstore.com, Kleiner Perkins and former Walmart executive turned Amazon.com Chief Investment Officer Richard Dalzell all violated the Arkansas Trade Secrets Act by hiring several Walmart information systems employees, as well as employees of firms that consulted with Walmart on its database in connection with starting Drugstore.com. In April, 1999, the suit was settled without any monetary payment. Amazon.com did agree, however, to reassign some of the former Walmart employees to jobs that were not the same as the positions they held at Walmart. Amazon.com also agreed to return information brought over by former Walmart employees related to Walmart's database of customer and product information. Finally, Amazon.com agreed not to actively recruit any Walmart employees for a year. This suit is another example of how venture capital firms can be drawn into litigation involving their portfolio companies as a result of their participation in strategic decisions by those portfolio companies.

<u>David M. Nickles, Trustee vs. Vestex Corporation</u>. In July, 1998 the Bankruptcy Court in this case awarded double the actual damages of $1,248,000 sustained by the Debtor Marketechs, Inc. These damages were sustained when Vestex, a venture capital firm, refused to make payments due under a venture capital investment contract. The Bankruptcy Court found that the principal of Vestex had strung Marketechs along by constantly telling it that the required funding was forthcoming. The Bankruptcy Court further found that this was done to coerce Marketechs into settling for substantially less so that it would be forced to renegotiate the terms of the original agreement in Vestex's favor. Significantly, the Bankruptcy Court also ruled that the principal of Vestex also incurred liability personally. Citing Massachusetts state court cases, the court wrote that "like a party who commits a tort while acting in a representative capacity, one who commits a violation of [Massachusetts General Laws] Chapter 93A incurs personal liability even though he or she acts as the agent or employee of another."

<u>ArsDigita Corp. v. Greenspun</u>. In April, 2001, Philip Greenspun, who co-founded ArsDigita Corp. in 1997, was sued in Delaware state court by this Cambridge, Massachusetts Web publishing company for alleged breach of the venture capital funding agreement he signed in March, 2000. Through shareholder proposals, Greenspun attempted to regain the CEO post he lost a month after venture capital firms Greylock Partners and General Atlantic Partners invested $38 million in the company. The lawsuit ended with a settlement in June 2001. As a result of the settlement, Greenspun resigned from ArsDigita's board and agreed to forego any management or stockholder control.[*]

<u>Gill v. Three Dimension Systems, Inc., et. al.</u>, 87 F.Supp.2d 1278 (M.D. Florida 2000). An inventor brought a Rule 10b-5 securities fraud action against a venture capital firm and its affiliates. The plaintiff developed technology for manufacturing orthotic devices. The defendants provided capital and management experience. The parties agreed that the plaintiff would be the president of the corporation. After several years of development, the plaintiff

[*] Greenspun, according to the New York Times, thereafter toured the country in a new Winnebago.

> claimed that he had been "frozen out" of the business by the defendants who had no intention of honoring their initial obligations. Due to his termination, the plaintiff alleged that his investment in the company diminished.

Investor Claims

The general partners of a venture capital or private equity fund owe their limited partner investors the fiduciary duties of care and loyalty. They must act as reasonably prudent persons and not engage in personal activities which would injure or take advantage of the fund or its investors. They also must make sure that the types of investments which the fund makes are consistent with the investment objectives spelled out in the limited partnership agreement creating the fund and the investment materials such as the private placement memorandum which were used to solicit investments by the limited partners.

As noted earlier, even successful venture capital firms experience a 50% failure rate in their investments. If the venture capital or private equity firm is not successful in realizing significant returns on its remaining investments, disgruntled investors may review the investment decisions by the general partners to determine whether they adhered to the promised investment guidelines. Even if a particular portfolio company investment was within the fund's guidelines in terms of industry and investment stage, the limited partners may maintain that the unsuccessful investment was the product of inadequate or negligent due diligence on the part of the general partners.

> I-Enterprise Co. LLC v. Draper Fisher Jurvetson Management Co. IV, LLC, et al. An investor in two venture capital funds sued the funds and fund managers alleging that the defendants made material misrepresentations and omissions in the marketing of the two funds, misrepresented their own investments in the funds and their success in other prior funds, manipulated performance to avoid distributions, failed to devote adequate time to managing the affairs of the funds (instead spending their time promoting other funds), and made false and misleading statements about the management fees they would charge the funds. Plaintiff alleged that it had suffered $40 million in damages, while the defendants had paid themselves over $80 million in fees and received another $30 million in other distributions from the funds.

> The Public Institution for Social Security v. The CIC Group, Inc., et al. An investor in a venture capital fund sued the fund and its managers alleging that the fund had misrepresented its investment strategy and the management fees that the managers would charge the fund. In particular, the plaintiff alleged that, just a few months after it had been induced to invest by representations that the fund would invest in privately held, early stage Internet–related companies, the defendants changed the fund's investment strategy to invest in biotechnology, wireless communications, and media and energy companies. This shift in strategy, undisclosed to the

investor, was allegedly accompanied by a change in management structure that caused the fund to incur higher management fees.

Lincoln National Life Insurance Company v. Silver, 1995 WL 591458 (N.D. Ill. 1995). The defendant was sued for improper management of two venture capital funds, each of which were limited partnerships run by a venture capital fund which he controlled. The plaintiff, a limited partner, alleged that the fund in which it had invested was supposed to be investing in healthcare companies. Instead, the fund heavily invested in computer companies which the defendant knew were experiencing severe cash flow problems and were on the verge of failing. Plaintiff alleged RICO violations, breach of fiduciary duty, securities law violations and common law fraud. Plaintiff recovered a judgment of almost $23 million, including reasonable costs and attorneys' fees.

Benchmark Capital v. Juniper Financial Corp. and Canadian Imperior Bank of Commerce. In July, 2002, Benchmark Capital, an initial investor in Juniper Financial Corp. sued Juniper and Canadian Imperial Bank of Commerce ("CIBC") in Delaware State Court. Benchmark alleged that CIBC, along with Juniper management, was violating the rights of the company's early investors. Benchmark sought to block a fourth round of investment led by CIBC that, allegedly would reduce significantly the value of shares held by early investors and increase CIBC's stake from 52 percent to 89 percent. Although the terms of Juniper's third round of financing ensured that early investors would be diluted much more than CIBC if any later financing was done at a lower value, Benchmark claimed that Juniper's board violated the company's charter by approving the fourth round without a required vote by earlier investors. Benchmark's request for a preliminary injunction was denied.

Employment Claims

The general partners of venture capital and private equity funds and their firms have been sued by employees of portfolio companies. These claims have been made on the basis that the funds through representatives of their general partners have exercised control over the employment decisions of the portfolio companies. Examples of these cases include:

Austin v. Archway Cookies, LLC, et al. Former employee sued private equity firm and portfolio company alleging that firm controlled portfolio company concerning abrupt termination of portfolio company employees without allegedly required advanced notice.

Foster v. Churchill, 215 A.D.2d 155, 626 N.Y.S. 2d 115 (1995). The discharged former chief executive officers of Microband

Companies, Inc. sued venture capital funds and fund managers for tortious interference with employment contracts. Plaintiffs had established Microband and remained as chief executive officers when the company was sold. The plaintiffs alleged that the venture capital funds that had invested in Microband, and the funds' managers, interfered with the executives' employment contracts by instigating their discharges "for cause" in order to avoid severance payments.

Mayo v. Schooner Capital Corp., 825 F.2d 566 (1st Cir. 1987). An engineering consultant sued a venture capital company and its president for breach of an alleged oral employment contract. Plaintiff claimed contract damages in the amount of $802,000, plus an equity share of 10-15% in Continental Hydro Corp. Plaintiff asserted that the venture capital company's president had offered him an employment contract on behalf of Schooner, its president and Continental Hydro.

Hedge Fund Claims

The following are recent examples of similar claims in the hedge fund context:

Del Guidice v. S.A.C. Capital Management, et al. A class of investors who sold stock in a specialty pharmaceutical company (Biovail) sued a group of hedge funds and hedge fund managers for allegedly violating securities laws. In particular, the plaintiffs alleged that the hedge funds and their managers took short positions in Biovail stock and then caused purportedly independent analysts to publish fraudulently negative reports concerning Biovail in a successful effort to drive down Biovail's stock price. This worked to the benefit of those holding short positions, including the hedge funds, and the detriment of those owning Biovail stock, including the plaintiffs. Plaintiffs sought compensatory and punitive damages based upon alleged violation of section 10(b) of the Exchange Act and Rule 10b(5) thereunder.

In the Matter of Joseph W. Daniel. The SEC found that Daniel, who was responsible for valuing private placement investments in a hedge fund known as the Critical Infrastructure Fund, improperly inflated the value of many of the fund's private placement investments and failed to write down their value when the investments performed poorly. As a result, the fund's private investments were overvalued, account statements sent to investors in the fund misrepresented the investors' balances and the fund's performance, certain investors were overpaid upon withdrawing their investments to the further detriment of other investors, and the assets and performance of the fund were misrepresented to potential investors. Defendant was charged with violations of section 17(a) of the Securities Act, sections 206(1) and 206(2) of the Advisers Act and section 10(b) of the Exchange Act and Rule 10b(5) thereunder.

In the Matter of Vincent Montagna. The SEC found that Montagna raised and then lost approximately $10 million invested by approximately 70 investors in his two hedge funds. Montagna obtained the investments by causing extremely positive false performance claims to be disseminated to prospective investors, retained investors by concealing the declining value and high risk of the hedge funds' holdings, and lost the majority of the raised funds by investing in small, high risk private companies, with respect to several of which Montagna had conflicts of interest. Defendant was charged with violations of section 17(a) of the Securities Act, sections 206(1) and 206(2) of the Advisers Act and section 10(b) of the Exchange Act and Rule 10b(5) thereunder.

In the Matter of Northshore Asset Management, LLC, et al. The SEC found that Northshore's principals made misrepresentations to investors in Northshore's hedge funds, made numerous impermissible transactions, diverted approximately $37 million of the funds' assets to their own control, and refused to honor valid redemption requests from investors. In particular, Northshore purchased two hedge funds whose private offering memoranda represented that their investment portfolios would consist primarily of common stocks and cash equivalents. Northshore's principals then failed to disclose the change in control to investors, invested the funds' assets in investments that were inconsistent with the funds' represented investment approach and as to which Northshore's principals had conflicts of interest, engaged in self-dealing with the funds' assets, made numerous misrepresentations and omissions to conceal their actions, and wrongfully refused to honor valid redemption requests by investors. Defendants were charged with violations of section 17(a) of the Securities Act, sections 206(1) and 206(2) of the Advisers Act and section 10(b) of the Exchange Act and Rule 10b(5) thereunder.

In the Matter of Charles R. Harris, Tradewinds International, LLC, and Tradewinds International II, L.P. The SEC found that defendant Harris raised at least $10 million from over thirty investors through false and misleading statements, suffered large unreported losses and used funds for personal uses, and then misrepresented to investors the performance of and asset values of the hedge fund. In particular, Harris told investors in 2003 that Tradewinds II's net asset value was between $18 and $23 million, when its true net asset value was between $30,000 and $1.1 million. Harris's wrongdoing was discovered when he sent e-mails and DVDs to certain key investors confessing the losses and false reports and claiming he was sailing abroad to recover the losses in offshore trading. Defendants were charged with violations of section 17(a) of the Securities Act and section 10(b) of the Exchange Act and Rule 10b(5) thereunder. The purchasers of limited partnership interests in the fund also brought a class action against the defendants.

<u>In the Matter of Beacon Hill Asset Management LLC, et al.</u> The SEC found that the four principals of Beacon Hill together implemented a fraudulent scheme that resulted in investors losing more than $300 million. Beacon Hill was the investment manager of three feeder funds and held their assets and traded on their behalf through a master fund as to which it was also the investment manager. Beacon Hill misrepresented its pricing methods to its investors, manipulated its valuation methods to conceal investment losses and inflate assets under management (and, thus, commissions), failed to disclose material changes in its hedging and trading strategies, and traded between funds to mask investment losses. Finally, three of the principals of Beacon Hill liquidated approximately $16 million of their own investments at inflated prices before disclosing the funds' losses to investors. Defendants were charged with violations of section 17(a) of the Securities Act; sections 206(1), 206(2) and 206(3) of the Advisers Act; and section 10(b) of the Exchange Act and Rule 10b(5) thereunder; and unjust enrichment.

<u>In the Matter of Global Money Management, L.P. LF Global Investments, LLC, and Marvin I. Friedman.</u> The SEC found that Friedman used two entities to conduct a securities fraud scheme that stretched from 1993 through 2004. Through LF Global, and using written materials containing false information as to aggregate value of assets (overstated by between $94 and $111 million) and fund performance, Friedman offered and sold millions of dollars in limited partnership interests in the Global Money fund. Touting himself as having "substantial investment experience," Friedman also failed to inform investors that he had previously been barred by the NASD. The SEC complaint does not discuss how funds were lost, nor the total amount of damages. The defendant were charged with violations of section 17(a) of the Securities Act, sections 206(1) and 206(2) of the Advisers Act and section 10(b) of the Exchange Act and Rule 10b(5) thereunder.

<u>In the Matter of Burton G. Friedlander, et al.</u> The SEC found that Friedlander, an unregistered investment advisor acting through various entities, misrepresented and artificially inflated the net asset value of the hedge fund he controlled. Through these manipulations and misrepresentations, Friedlander induced investments in the hedge fund and convinced investors to remain

in the fund as he redeemed his own interests in the fund at inflated values. Friedlander also converted fund assets for his own personal use. Defendants were charged with violations of section 17(a) of the Securities Act, sections 206(1) and 206(2) of the Advisers Act and section 10(b) of the Exchange Act and Rule 10b(5) thereunder.

<u>In the Matter of Michael Lauer, Lancer Management Group, LLC and Lancer Management Group II, LLC</u>. The SEC found that the defendants fraudulently manipulated the closing prices of various Over-The-Counter Bulletin Board and pink sheet quoted stocks and distributed false and misleading performance and net asset value information to investors, allowing the defendants to amass hundreds of millions of dollars in investments and earn tens of millions of dollars in fees. In particular, the defendants assigned values in the hundreds of millions of dollars to thinly traded stocks whose issuers had virtually no operations or earnings. Defendants were charged with violations of section 17(a) of the Securities Act, sections 206(1) and 206(2) of the Advisers Act and section 10(b) of the Exchange Act and Rule 10b(5) thereunder. Lauer and various major companies that provided services to his hedge funds were also sued by investors and the bankrupt limited partner in attempts to recover hundreds of millions of dollars invested in Lauer's hedge funds.

<u>In the Matter of Sane Capital, LLC and Evan Misshula</u>. The SEC found that defendant Misshula misappropriated fund assets and deposited them into his personal bank account. To conceal his conduct from investors, defendant sent investors fictitious quarterly reports that failed to disclose that he had converted some of the fund's assets to his own personal use, and falsely represented that the investors had made substantial returns on their investments. Defendant was charged with violations of section 17(a) of the Securities Act, sections 206(1) and 206(2) of the Advisers Act and section 10(b) of the Exchange Act and Rule 10b(5) thereunder.

<u>In the Matter of CapitalWorks Investment Partners, LLC and Mark J. Correnti</u>. The SEC instituted and simultaneously settled administrative proceedings alleging that defendant CapitalWorks violated antifraud provisions of the Advisers Act and defendant Correnti aided and abetted CapitalWorks' violations, in connection with false and misleading representations to prospective clients, current clients, and consultants regarding the results of a prior Commission examination. Additionally, CapitalWorks, aided and abetted by Correnti, violated Rule 206(4)-7 under the Advisers Act, which required investment

advisers to adopt by October 5, 2004 written procedures reasonably designed to prevent violations of the Advisers Act.

In the Matter of Sharon Vaughn and Directors Financial Group, LTD. The SEC alleged, among other things, that in the course of investing $25 million of its hedge fund assets in a fraudulent "Prime Bank" scheme, defendants made material misrepresentations to the fund's investors regarding the fund's trading strategy, permitted investments, and risk of loss and did not properly investigate the Trading Program investment before committing the fund's assets.

Based on these allegations, defendants were charged with violating section 17(a) of the Securities Act, section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and sections 206(1) and 206(2) of the Advisers Act. Defendants agreed to the entry of an order of permanent injunction.

Robert Oaks, Jr. and Joseph R. Huard. The SEC alleged that from approximately January through November 2002, Huard participated in a manipulative trading scheme including, among other things, marking the close at month-end in numerous small cap securities comprising a substantial portion of hedge fund portfolios. During this period, Huard received and executed 165 buy trades on the last day of the month in various penny stocks in the hedge funds' portfolios with the intent of affecting the price of the security and thereby inflating the value of the hedge funds' portfolios. Oaks was charged with failure to supervise Huard with a view to preventing Huard's manipulative trading practices during this period. As a result, defendants were found in violation of section 10(b) of the Exchange Act and Rule 10b-5 thereunder and ordered to pay a civil money penalty of $25,000 to the United States Treasury.

Global Crown Capital, LLC, J&C Global Securities Investments, LLC, Rani T. Jarkas, and Antoine K. Chaya. Defendants were hedge fund managers who exaggerated the fund's performance in order to conceal trading losses from the fund's investors. In the first three months of operation in early 2003, the value of one of the hedge funds declined by over 20%. In response, defendants decided to form a purported "redemption reserve" of $228,000 and planned to use their own cash to fund the reserve. They then calculated the fund's performance, obscuring the substantial trading loss by adding the $228,000 amount to the funds' total value. Defendants never disclosed this to the investors, nor did they fund the $228,000 reserve at the time.

Defendants were charged with violations of Sections 206(1) and 206(2) of the Advisers Act.

In the Matter of Maxwell Investments, LLC, Gary J. Maxwell, and Bart D. Coon. The SEC instituted and simultaneously settled administrative hearings against defendants, alleging that although Maxwell Investments, through Gary Maxwell and Coon, solicited clients by claiming that it would not receive management fees from any hedge fund until the first year of the fund's existence, it was, in fact, regularly withdrawing management fees from the brokerage accounts of four of the funds during the first year of the fund's existence. Defendants also misrepresented the firm's method of calculating management fees, causing the firm to overpay itself by at least $839,670 in 2003. Defendants did not disclose vital information to investors such as the firm's overpayment of management fees, the transferring of assets from some funds to cover maintenance requirements in the trading accounts of other funds, and the material conflict of interest created by these inter-fund transfers.

The SEC also found that defendants failed to maintain adequate Capital Accounts and financial books and records. As a result, defendants were charged with violation of section 17(a) of the Securities Act, 10(b) of the Exchange Act and Rule 10b-5 thereunder, and sections 204, 206, and 207 of the Advisers Act.

SEC v. Barry A. Bingham and Bingham Capital Management Corp. The SEC alleged that Bingham used misrepresentations and omissions of material fact to defraud at least 22 investors in Bingham Growth Partners, L.P., a hedge fund that Bingham created and managed through Capital Management, an unregistered investment adviser. Bingham offered and sold at least $1,826,218 of shares in the fund, and at least $459,483 of these shares were offered and sold through Bingham's misrepresentations to investors about the fund's past returns. Additionally, between July 2001 and November 2002, Bingham misappropriated approximately $141,637 in Growth Partners' assets, and by November 2002, the assets of Growth Partners had been wholly depleted by a combination of Bingham's trading losses and his misappropriations.

The SEC obtained a default judgment against defendants on April 21, 2006. Defendants were ordered to pay fines and disgorge their profits and interest.

SEC v. Scott R. Sacane, et.al. The SEC charged the defendants for their involvement during 2002 and 2003 in fraudulent schemes concerning the purchase and sale of the common stock of two biotechnology companies: Esperion Therapeutics, Inc. and Aksys Ltd. The complaint alleged that the defendants manipulated the price of both Esperion and Aksys stock by making regular and substantial purchases of both stocks through the hedge funds that they managed and concealing these purchases by failing to file various forms and schedules with the SEC as required by the federal securities laws and making false filings with the SEC. The court entered a final judgment by consent against defendants ordering them to pay $185,591 in fines and disgorgement.

SEC v. K.L. Group, LLC, et.al. From 1999 through February 2005, defendants fraudulently convinced investors to invest and remain invested with their hedge funds through misrepresentations and omissions to investors concerning the returns on and security of investments of the funds. The defendants committed this fraud through offering materials, brochures, website postings, and account statements. The SEC obtained a default judgment against defendants in August 2005. As part of the default judgment, the court issued a permanent injunction against defendants.

SEC v. Jon E. Hankins, et. al. The SEC alleged that Hankins and other defendants concealed from investors large investment losses and were seeking to unfairly honor a redemption request at inflated values to cover up the fraud. In particular, the SEC alleged that Hankins and Tenet made numerous false statements to investors of the Convertible Opportunities Fund, as well as to investors in another hedge fund managed by Tenet and Hankins, Tenet Offshore Capital Partners Ltd. On June 22, 2005, the Court granted, among other emergency relief, the appointment of a temporary receiver over the Convertible Opportunities Fund and Tenet. On July 13, 2005, the court entered a preliminary injunction ordered on consent against defendants.

Madoff - Hedge Fund Liability in Light of Fraud

As noted above, most claims against hedge funds, their managers and their investment advisors can involve dishonest schemes in which hedge funds managers and advisors allegedly defrauded investors through deceit. The public's concern over such scandals has intensified after investment manager Bernard Madoff was arrested in December 2008 for allegedly defrauding investors out of more than $50 billion. Angry investors have brought claims against various investment advisors who recommended that they invest with Madoff in the first place. This is particularly true with respect to so-called "feeder funds" or "funds of funds" which were professionally managed by advisors who were expected to perform a certain level of due diligence before making investments on behalf of those funds.

i. Feeder Fund/Fund of Funds Liability – Bayou Capital Case

Several investor suits have been filed against investment advisors of so-called "feeder funds" or "funds of funds" that invested with Mr. Madoff. Those investors claim that the defendants failed to adequately investigate Mr. Madoff. The investors usually then claim breach of fiduciary duty, gross negligence, breach of the investment advisor contract and unjust enrichment. Whether the courts allow those claims to proceed, however, will depend heavily on how the United States Court of Appeals for the Second Circuit rules in *South Cherry Street LLC v. Hennessee Group LLC* (*In re Bayou Hedge Fund Litig.*, 534 F.Supp.2d 405 (S.D.N.Y. 2007)), now pending before it.

The *South Cherry* case involved a similar hedge fund ponzi scheme perpetrated through Bayou Group LLC. South Cherry Street LLC allegedly invested $1.15 million in Bayou Group affiliates based on the recommendation of its investment advisor, Hennessee Group LLC. Hennessee Group apparently specialized in advising clients about investments in hedge funds. Hennessee Group allegedly represented to South Cherry that it conducted a "rigorous five-step due diligence review" before recommending that any client invest in a particular hedge fund. Hennessee Group then apparently issued positive reports about Bayou Group and recommended that South Cherry invest in certain hedge funds managed by Bayou. South Cherry claims that once the Ponzi scheme came to light, it became apparent that Hennessee Group either failed to perform the promised due diligence or that it did so in a deficient manner. Based on these allegations, South Cherry alleged in its Amended Complaint violations of Section 10(b) of the Securities Exchange Act of 1934, breach of contract and breach of fiduciary duty.

The United States District Court of the Southern District of New York, however, dismissed the action in its entirety. With respect to the Section 10(b) claims, the Court noted that the failure to perform due diligence is not the same as "actual knowledge or closing one's eyes to a known 'danger,' or participating in fraud." The Court also pointed out that due diligence may not have uncovered the fraud. The Court then dismissed the breach of contract claims based on the statute of frauds, concluding that the oral agreement relied upon was not enforceable. Finally, with respect to the breach of fiduciary duty claims, the Court concluded that there is no private right of action under the Investment Advisers Act of 1940 and that any common law claim is preempted by New York's blue sky law, which authorizes only the New York attorney general to enforce its provisions.

As noted above, the *South Cherry* case is currently on appeal to the United States Court of Appeals for the Second Circuit. Commentators agree that how the Second Circuit rules on this case will have a significant impact on the feeder fund claims in the Madoff matter. If the court rules that Hennessee Group can be held liable under either Section 10(b) of the Exchange Act or for breach of fiduciary duty based on its alleged failure to uncover the Bayou Ponzi scheme through due diligence, then we can expect similar claims involving investment managers in the Madoff cases to survive motions to dismiss. Furthermore, there is nothing in the current *South Cherry* decision to prevent suits from proceeding on the alleged breach of an investment advisory agreement. However, those agreements, particularly in the hedge fund context, typically protect investment managers and advisors from liability through "iron-clad" indemnification and limitations of liability provisions.

ii. Other Actions to Watch Out For

Attempts to make hedge fund managers and advisors liable in the current economic environment are not limited to claims involving investments with Mr. Madoff. Last year, for example, several investors filed actions against Bear Stearns based on the highly publicized collapse of two hedge funds managed by it. See *Barclays, PLC v. Bear Stearns Asset Mgmt. Inc.,* No. 07-CV-1140 (S.D.N.Y.); *Eastside Holdings, Inc. v. Bear Stearns Cos. Inc.,* No. 08-CV-2793 (S.D.N.Y.). We also expect to see more claims involving Beacon Hill Asset Management, which allegedly inflated the net asset values of one of the funds managed by it in order to meet investor expectations.

Several other Ponzi schemes have also come to light after news broke about the Madoff scheme. For example, federal authorities have accused James Nicholson of defrauding investors in his Westgate Capital fund out of over $900 million. Federal investigators have also accused Paul Greenwood and Stephen Walsh of similar fraudulent activity in WG Trading Company LP and Westridge Capital Management Inc. – both run by them. The University of Pittsburgh and Carnegie Mellon University have sued Westridge, Greenwood and Walsh for the return of more than $114 million that the two institutions invested with them. Finally, the Securities and Exchange Commission has sued R. Allen Stanford over an alleged $8 billion fraud involving the Stanford Group controlled by him.

<u>Claims Under the Investment Advisers Act and Investment Company Act</u>

With respect to the Investment Advisers Act, venture capital and private equity firms have traditionally taken the position that they are not "advisers" as defined in the Act, <u>i.e.</u>, no advisory relationship exists between them and either the fund or the limited partners of the fund. Alternatively, they maintain that they are entitled to the exemption from registration found in Section 203(b) because they have fewer than 15 clients (their only client is the fund itself), and they do not hold themselves out generally to the public as an investment adviser.

In October 2004, the SEC adopted Rule 203(b)(3)-2, requiring hedge fund advisers to register with the SEC under the Investment Advisers Act and eliminating their ability to rely on the registration exemption designed for advisers providing advice to a small number of clients. The SEC intended the rule to permit the SEC to collect information about the operations of hedge fund advisers, conduct examinations of hedge fund advisers, force hedge fund advisers to adopt basic compliance controls to avoid violations of federal securities laws, improve disclosures made to future and current hedge fund investors, and prevent felons and other persons with disciplinary records from managing hedge funds.

However, the U.S. Court of Appeals for the District of Columbia Circuit struck down the Rule 203(b)(3)-2 in *Goldstein v. SEC,* 451 F.3d 873, 875 (D.C. Cir. 2006). Specifically, the court held that hedge funds escape SEC regulation under the Investment Company Act because "investment vehicles that remain private and available only to highly sophisticated private investors have historically been understood not to present the same dangers to public markets as more widely available public investment companies." *Id.*

In an attempt to clarify its authority to bring enforcement actions against advisers that defraud hedge fund investors, the SEC responded to *Goldstein* by adopting Rule 206(4)-8 in July 2007. The new rule makes it "a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser to a pooled investment vehicle to make false or misleading statements to, or otherwise to defraud, investors or prospective investors in that pool." The rule applies to all investment advisers to pooled vehicles, *regardless* of whether the adviser is registered under the Investment Advisers Act. Only the government, as opposed to private litigants, may bring action to enforce Rule 206(4)-8.

In addition to these developments, two enforcement actions by the SEC reflect an increased SEC focus on compliance by fund advisers with Section 206 of the Investment Advisors Act. *In the Matter of John D. Carifa*, Advisers Act Rel. No. 26859 (April 28, 2005) and *In the Matter of Michael J. Laughlin*, Advisers Act Rel. No. 26860 (April 28, 2005) were enforcement actions brought by the SEC against two former officers in investment adviser Alliance Capital Management, L.P. Alliance Capital acted as investment adviser to the Alliance Capital mutual funds. In return for investments in Alliance Capital's hedge funds, Alliance Capital provided "timing capacity" in certain of its mutual funds at a ratio of 10:1 to Daniel Calugar, the owner and President of Security Brokerage, Inc., a registered broker-dealer in Las Vegas, Nevada.

Alliance Capital's single largest timer was Calugar, who at his peak in 2003, had $220 million in timing capacity in Alliance Capital's funds. Shortly after negotiating an initial agreement with Alliance Capital in April 2001, Calugar began timing the Tech Fund and the Alliance Growth Mutual Fund, and invested in Alliance Capital hedge funds, including a hedge fund managed by the Tech Fund managers.

In June 2001, Alliance Capital agreed to increase Calugar's market timing capacity to $100 million in the Tech Fund and $20 million in the Premier Growth Fund with four round trips per month in return for a 20% investment in Alliance Capital hedge funds. Both defendants, Carifa and Laughlin, were aware that Calugar was a market timer at Alliance Capital. Later that year, Alliance Capital continued to increase Calugar's market timing capacity and Calugar continued to make additional investments in Alliance Capital hedge funds consistent with the agreed ratios.

In January of 2002, the Tech Fund portfolio manager complained about a large exchange Calugar made in the Tech Fund, and Alliance Capital cancelled Calugar's trade. Calugar responded by email, suggesting the possibility of transferring some market timing funds from the Tech Fund to another one of the Funds, or redeeming part of his investments at Alliance Capital and investing funds elsewhere. Calugar and Alliance Capital had further discussions regarding the terms of his timing capacity in the Funds. Following those discussions, Laughlin sent Carifa an email noting the benefits of a potential renegotiated agreement. In an email reply, Carifa noted the financial benefit to Alliance Capital from the relationship with Calugar in the form of increased management fees. An agreement was later renegotiated with Calugar that greatly benefited Alliance Capital.

By January 2003, Calugar's investments were critical to Alliance Capital's hedge funds such that the funds could not survive without Calugar. The SEC found that although Carifa and Laughlin were aware that Calugar's timing activity and hedge fund investments were linked, and that such linkage should not continue, they took no additional steps to inquire whether Calugar's market timing had harmed the Tech Fund's performance, they did not take sufficient steps to ensure that Calugar's market timing had not harmed the Tech Fund's performance and they did not take sufficient steps to ensure that Calugar's market timing was addressed. Defendants also did not advise the Funds' Board of Directors about the conflict of interest created by Alliance

Capital entering into a market timing agreement with Calugar that was potentially harmful to the funds, but that increased Alliance Capital's advisory fees from the funds.

Based on these facts, the SEC found that both Carifa and Laughlin violated Section 206 of the IAA, the Act's broad anti-fraud provision. Because of those violations, both Carifa and Laughlin were: ordered to cease and desist from any future violation of Section 206; suspended from being associated with any investment adviser for a period of 12 months; and fined $375,000 each.

Because Section 206 does not provide for a private right of action, these proceedings will not directly support copycat cases by members of the plaintiffs' bar. Nevertheless, hedge fund investors could maintain state law claims for breach of fiduciary duty based upon allegedly misleading communications to them by the investment adviser to the fund based on the SEC's Section 206 analysis in these proceedings. Perhaps even more significantly, these proceedings indicate that as a result of the massive publicity concerning the stability of hedge funds generally, the SEC is now devoting resources to compliance by investment advisers to hedge funds as well.

Regarding the fund itself and the Investment Company Act, funds rely almost entirely on Section 3(c)(1) for their exemption from that Act. Section 3(c)(1) excludes from the definition of an investment company "Any issuer whose outstanding securities (other than short- term paper) are beneficially owned by not more than one hundred persons, and which is not making and does not presently intend to make a public offering of its securities."

IV. Summary

Two aspects of venture capital, private equity and hedge funds create significant risk exposures. First, in recent years investors have enjoyed extraordinary returns on their investment in these funds leading them to invest staggering sums of money in them. These historical levels of return could not be sustained indefinitely. Now that the inevitable fall-off has occurred, investors are scrutinizing the investment decisions made by their fund's general partners to determine: (1) whether they complied with the fund's investment guidelines; and (2) even if so, whether they resulted from adequate due diligence. If the limited partner investors conclude that neither condition was met, litigation will surely follow.

Second, the evaporation of the credit market following the Lehman bankruptcy in September of 2008 produces challenges for both private equity and hedge funds. The lack of abundant credit is forcing buy-out firms to do "all equity" deals, buy minority rather than controlling positions, and even ask for seller financing. Conversely, due to the absence of a viable IPO market and the unwillingness of well-capitalized companies to spend their cash to buy portfolio companies, private equity firms increasingly must consider monetizing their investment in a portfolio company through a Chapter 11 proceeding. Hereto, however, they find that Debtor-In-Possession and exit financing is now substantially more expensive (Libor plus 5-7%) over last year (Libor plus 2 ½%).

Similarly, the lack of available credit, as well as the volatility in the equity markets during the 3rd quarter of 2008, have forced hedge fund managers to deleverage their portfolios substantially. Furthermore, hedge fund managers have been forced to increase their cash positions not only because of higher credit costs, but also because of substantially higher investor redemption demand. In light of these trends, analysts wonder whether hedge fund managers can maintain their historical level of returns. Estimates are that the assets under management in the global hedge fund industry will shrink by as much as 30% in 2009.

Third, venture capital funds promote themselves to potential portfolio companies by the business experience of their general partners. The fund promises that if the start-up company accepts an investment from the fund, the fund will place a representative on its Board who can then help the portfolio company in a myriad of ways. If this aid does not lead to a successful public offering or sale of the portfolio company, however, the other constituents of the portfolio company, such as its founders or other shareholders, may then claim that the venture capital fund's assistance was merely designed to protect its own investment and not to advance the general interest of the portfolio company. Likewise, employees of the portfolio company may claim that adverse employment decisions involving them were the product of unfair and improper meddling in the portfolio company's business affairs by the venture capital fund.

By understanding the businesses of venture capital, private equity and hedge funds and the various relationships within those businesses, a clearer understanding of the risk exposures for those businesses develops.