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REPRINTED FROM:
CORPORATE DISPUTES MAGAZINE
APR-JUN 2019 ISSUE

www.corporatedisputesmagazine.com

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PERSPECTIVES

CAVEAT EMPTOR: LESSONS LEARNED FROM THE GREAT CREDIT CRISIS

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Investors, and others, burned by the 2008 credit crisis, have a sense of foreboding that we are at the end of another business cycle. While some dismiss this as an alarmist concern that ignores fundamentals, we see contemporary indicators that led to the great credit crisis, hedge fund collapse and Madoff blow-up: mounting inflationary pressures, rising debt yields, volatility in equity markets and so-called 'dumb' money flowing into little understood alternative asset classes.

The silver lining to the 2008 crisis – if there is any to be found – is that it provided a case study on risk management and asset recovery for funds and their investors. While it is unlikely we will face anything approaching the magnitude of the 2008 meltdown in the near future, fund managers, liquidators, institutional investors and high-net-worth individuals should study the lessons learned from the past to react to any future crisis

The first ripple in a wave of financial institution failures (and near-failures), including Bear Stearns and IndyMac Bank, came in 2007 when mortgage giant Freddie Mac announced it would no longer buy the riskiest subprime loans. The situation escalated with the failure of Lehman Brothers which presaged numerous private fund collapses. These fallen dominoes led to the worst global financial collapse since the Great Depression.

Many funds faced net asset value concerns, as investors lost confidence in funds whose documents

had given broad discretion to managers to invest in hard to value assets. In many cases, this broad discretion had led to abuse and limited the scope of investor audits. Exasperating liquidity concerns, cash and liquid assets were depleted, in many cases, to pay the standard 2/20 fund management fee: 2 percent of assets under management and 20 percent of any increase over the high-water mark.

Lack of liquidity, driven by many funds' drift into long-term and undisclosed positions, led to redemption freezes, effectively transforming open-ended funds to closed funds with little transparency and ill-fitting management and fee structures. The panic spread to even safe-haven assets because the lack of liquidity in highly leveraged and illiquid funds created a rush to redeem from well-managed, mostly-liquid funds, in order to meet the cash needs of investors. Fund managers were caught between holding illiquid positions where there was no market for the underlying assets or engaging in a fire sale which left non-redeeming investors holding the least valued and least liquid assets. As a result, many fund managers claimed that provisions in fund documents allowed them to suspend redemptions or redeem capital on a staggered basis.

The credit crisis left many funds and financial institutions facing bankruptcy, liquidation and controlled wind-downs. The biggest victim of the dominos that fell in 2018 was confidence in the marketplace, however. This culminated with the arrest of Bernie Madoff and the resulting disclosure of his Ponzi scheme. While Bernard L. Madoff Investment Securities LLC (BLMIS) was a regulated broker, its collapse led to the failure and liquidation of numerous pooled investment vehicles, such as feeder funds and fund of funds. The Madoff debacle spawned a litigation industry of Securities Investor Protection ACT (SIPA) claims, insolvency litigation and rampant clawback disputes. Left without other options, litigation became a tool for investors and institutions to recoup losses.

Will history repeat itself? Disruptions in trade and tariff policies have led to large fluctuations in the equity markets, creating the one thing in the market investors will not stomach: volatility. A rise in interest rates has caused principle losses in bonds, lower equities valuation because of competition from bond yields, and higher interest payments for corporations, the government and individuals in debt. The total debt of American non-financial corporations, as a percentage of GDP, reached a record high of 73.3 percent and Chapter 11 bankruptcies are up 63 percent from a year ago.

Questions surrounding the credit default swap marketplace (used to effectively short the bond market), which have not been broached since 2008, have re-emerged. This has coincided with an uptick in Securities and Exchange Commission (SEC) regulatory activity, with an emphasis on those funds that specialise in illiquid debt. The SEC and Commodity Futures Trading Commission (CFTC) have also been focused on little understood asset

classes like cryptocurrency funds and initial coin offerings (ICO) that are often run by novices in the investment industry. There is always a risk that some combination of these factors could lead to investor panic, liquidity risk and, ultimately, redemption freezes by funds.

If we encounter another significant financial event that impacts the fund industry, the 2008 financial crisis showed that investors should take certain 'post event' actions to prevent further destruction of value. These actions include: demanding transparency from the fund, seeking redemption at the first sign of trouble, making valuation demands, reviewing fund documents, understanding fiduciary duties and the use of litigation.

First and foremost, investors should demand transparency regarding the status of the fund as early as possible, and not sit idly by and wait for fund managers to report issues. By demanding information early, investors can become informed about the fund's (and manager's) activities, asset allocation and potential risk exposure. Limited

partners should investigate whether fund assets have been frozen and demand that the investment manager specify the type and status of such assets so as to ensure confidence in the manager's investment choices. As a general partner (in most private funds), the fund manager owes limited partner investors fiduciary duties. Investors should make sure to ask the right questions, and review the appropriate information, to ensure that a manager fulfils those duties.

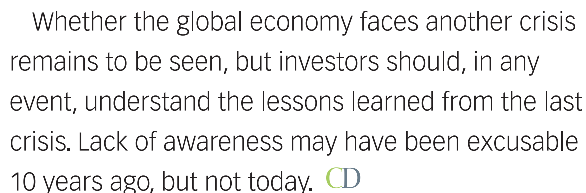
Second, investors must ensure that fund managers properly comply with redemption requests and have a sound basis for the value of the fund. During the 2008 financial crisis, some investors who made early redemption requests were later subject to clawback actions. In many cases, the fund manager was found to have inflated the value of the fund to the (albeit short-lived) benefit of these early redeemers. Accordingly, investors must have confidence in the fund's basis for quantifying its assets – something that holds particularly true in the context of redemptions or where a fund holds hard-to-value assets.

Third, investors must understand the fund's governing documents and, specifically, the investors' and the manager's rights and obligations under the agreements. These agreements may raise additional hurdles for investors looking to act quickly to protect their investments. For example, during the last financial crisis, many average investors were surprised to learn that some funds had provided lead investors with enhanced redemption rights – meaning that they could redeem their investments with less notice than provided in the limited partnership agreement. Similarly, many investment managers asserted that their fund agreements allowed them to create side pockets that allowed them to segregate certain asset classes, which often included illiquid and hard to value positions. These types of obstacles can have a material impact on investors' strategy and approach following a significant financial event.

"Whether the global economy faces another crisis remains to be seen, but investors should, in any event, understand the lessons learned from the last crisis."

Finally, the financial crisis showed that investors or liquidators must, at least, explore litigation to protect their investments. While each situation is different, litigation may, when used appropriately,

lead to cash payouts, enhanced liquidity, reduced or deferred management compensation, independent valuations, negotiated liquidation plans, redemptions in-kind, control of the fund and discharge of fiduciary duties. In the aftermath of the 2008 financial crisis, funds and liquidators, even those overseas and offshore, had success utilising the US court system. Compared to Commonwealth legal systems, the benefits of US litigation include a more favourable pleading standard, the ability to bring off-contract claims, enhanced settlement opportunities as a result of every party having to cover their own legal fees (regardless of outcome) and expansive discovery. To litigate in US courts, a foreign entity's use of the New York banking system – or other connection to US markets – may, in some cases, be enough for a US court to assert jurisdiction over a claim or to obtain court-ordered discovery into assets or documents located in the US. Each situation is different, and investors and liquidators should review their fund agreements with counsel and investigate the fund's connection to the US prior to considering this approach.



Whether the global economy faces another crisis remains to be seen, but investors should, in any event, understand the lessons learned from the last crisis. Lack of awareness may have been excusable 10 years ago, but not today. CD

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