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REPORT

HEDGE FUNDS

Redemptions From Failed Hedge Funds: How Should They Be Treated by Courts?

BY SHELDON L. SOLOW

Perhaps the most recent newsworthy investment vehicle is the ''hedge fund.'' Although they share characteristics with other investment vehicles, neither the federal securities law nor the federal commodities law defines a hedge fund.[1] Currently more than 8,000 hedge funds operate domestically and offshore and an estimated $870 billion is invested in such funds in the United States with that amount expanding on an almost exponential basis.[2]

Hedge funds solicit investors directly or through registered broker-dealers in private offerings. To avoid registration under the federal securities laws, investment in hedge funds is restricted to wealthy individuals or institutional investors.[3] Traditionally, institutional investors such as pension plans, banks and insurance

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[1] *See Implications of the Growth of Hedge Funds: Staff Report for the United States Securities Exchange Commission* 3 (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf (defining a hedge fund as ''an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act.''); *see also Goldstein v. SEC*, 451 F.3d 874-75 and n. 1 (D.C. Cir. 2006) (''hedge funds are notoriously difficult to define. The term appears nowhere in the federal securities laws, and even industry participants do not agree upon a single definition. . . . Hedge funds are usually differentiated from other exempted investment vehicles like private equity or venture capital funds by their investing and governance behavior.'').

[2] As the Securities and Exchange Commission (hereinafter, the ''SEC'') recognizes, ''it is difficult to estimate precisely the size of the hedge fund industry because neither we nor any other governmental agency collects data specifically about hedge funds.'' Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054-01, 72056 (Dec. 10, 2004). Accordingly, estimates of the number of hedge funds and assets under their control vary significantly. *See, e.g.*, Scott J. Lederman, *Nuts & Bolts of Financial Products 2007: Understanding the Evolving World of Capital Market & Investment Management Products, Hedge Funds*, 1589 PLI/Corp. 309, 314 (estimating that the hedge fund industry manages over $1 trillion and that there are an excess of 8,000 funds operating both domestically and offshore).

companies provided the majority of fund investments.[4] Other investors, such as universities and charitable organizations, have helped to fuel the recent growth.[5] In addition, funds of hedge funds, which invest exclusively in other hedge funds and offer their shares to the public, have made hedge funds more broadly available to the investing public and have concomitantly increased the size of assets under hedge fund management.[6]

One result of the increased capital under hedge fund management has been a growth in the influence of hedge fund advisers. These advisers currently exert a significant influence in the securities market. The vast amounts invested have created a new elite class of money managers capable of generating huge fees.[7] For instance, the annual average compensation for a top hedge fund manager in 2005 was $363 million.[8]

But with this increased investment activity there are also significant failures.[9] Funds such as Bayou Group, Manhattan Investment Fund, Amaranth Advisors LLC and Marin Capital all have collapsed within the past three years. Adding to the disturbing nature of these failures is that hedge funds are largely unregulated and a number of the failures involve fraud and/or misappropriation of investors' funds.[10]

These cases lead to either the appointment of a receiver or the institution of bankruptcy proceedings with a trustee charged with the duty to unravel the affairs of the hedge fund.[11]

When a hedge fund fails, two issues arise regarding the prior distributions. First, whether and to what extent an investor should be permitted to retain the previously received redemptions. Second, how should such redemptions be treated for the purpose of calculating post-failure distributions?

There are two key issues which habitually arise in the administration of a failed hedge fund. The first is the treatment of investors who redeemed their interests in the fund prior to its failure and, as a result, received a greater return than those who remained invested until the fund failed. The second is the calculation of investor distributions upon the liquidation of the fund's remaining assets. Courts and interested parties have wrestled with determining the appropriate approach to these issues but there is no consensus on the best way to address them. This article discusses the various approaches undertaken by different courts and suggests a template for the fair treatment of investors.

The Hedge Fund Structure. Modern hedge funds began as an investment vehicle that allowed qualified investors to place money in less conventional spaces in the market as a ''hedge'' to protect the remainder of their investment portfolio. As the relative ease of using the model to raise money became apparent, more and more investment vehicles were opened as ''hedge funds.'' Because these funds limit participation to ''qualified investors,'' there is minimal SEC oversight of their activities.[12] Only after violations of securities laws have been alleged, does the SEC become actively involved through enforcement activities. But as more and more individuals and institutions attain the status of a ''qualified investor,'' the assumption that hedge fund investors are sophisticated enough to protect themselves may not be

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[3] By soliciting certain wealthy individuals, hedge funds fall within the exemption of the Investment Company Act of 1940. The Act directs the SEC to regulate investment companies but excludes from its purview issuers of securities owned exclusively by persons who, at the time of acquisition of the securities are ''qualified purchasers.'' A qualified purchaser is any natural person or family-owned company owning more than $5 million in investments. 15 U.S.C. § 80a-2(a)(51)(A); Sue Ann Mora, *Hedge Funds: Their Advisers do not have to Register with the SEC, but More Information and Other Alternatives are Recommended* 67 La. L. Rev. 61 (2006).

[4] Implications of the Growth of Hedge Funds, *supra* note 1 at 7, 82.

[5] *Id.*

[6] The SEC notes that funds of hedge funds represent approximately 20 percent of hedge fund capital and are the fastest growing source of capital for hedge funds today. 69 Fed. Reg. at 72057.

[7] Most hedge funds charge management fees of 1 to 2 percent of net assets and 20 percent of the profits and extra fees for account administration, audits and trader bonuses. BusinessWeek cites a study by LJH Global Investments concluding that the average investor pays fees as high as 3.5 percent of assets a year. Anne Tergesen, *A Fee Frenzy at Hedge Funds; As Investors File in, Managers are Tacking on Extra Fees*, Business Week, June 6, 2005 at 126. A hedge fund manager of a $10 billion fund would earn $200 million based on a 2 percent management fee.

[8] Adam Shell, *$363M is Average Pay for Top Hedge Fund Managers*, USA Today, May 26, 2006, at 1B (citing rankings released by Institutional Investor's Alpha magazine).

[9] *See* Jim McWhinney, *Massive Hedge Fund Failures*, Investopedia.com (Nov. 17, 2005) available at http://www.investopedia.com/articles/mutualfund/05/HedgeFundFailure.asp (describing the recent failures of Bailey Coates Cromwell Fund, Marin Capital, Aman Capital, Tiger Funds and Long-Term Capital Management).

[10] Hedge funds are considered ''unregulated'' because they avoid registration under the federal securities laws. For example, hedge funds avoid regulation under the Investment Company Act of 1940, 15 U.S.C. § 80a-1 et seq. because they do not offer their securities to the public or because their investors are qualified high net-worth individuals or institutions. Similarly, hedge fund advisers avoid registration under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 et seq. because they have fewer than 15 clients and do not hold themselves out to the public as an investment adviser. *See Goldstein*, 451 F.3d at 875-77 (rejecting the SEC's proposed rule to require hedge fund registration under the Investment Advisers Act). In 2005, the SEC proposed rules that had the effect of requiring hedge fund managers to register as investment advisers under the Investment Advisers Act of 1940 and, in response, numerous hedge fund managers registered with the SEC. The registration rules, however, were abandoned by the SEC in 2006 and the registrations, to the extent they were not withdrawn, have little practical effect now. Of course, hedge funds and hedge fund advisers nonetheless are fiduciaries and are subject to securities laws including the antifraud and insider-information statutes and regulations.

[11] For purposes of this article, the term receiver will be used in reference to Receivers and Trustees.

[12] Implications of the Growth of Hedge Funds, *supra* note 1.

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accurate. Nonetheless, today, a hedge fund is best described as a largely unregulated investment vehicle that solicits funds from qualified investors and invests in mostly easily liquefiable assets.[13] The concept of their use as a "hedge" is only coincidental on a case by case basis.

The Nature of Hedge Fund Failures. While each failed hedge fund has facts and circumstances that make its demise somewhat unique, the failures can be grouped into three general categories.

1. *Business Failures*. Put simply, some hedge funds fail because they make bad investments and lose too much money to survive. This may be the result of bad initial strategy or the poor execution of a viable investment plan. An example of the latter problem occurred in Amaranth where a single trader determined that the price of natural gas was about to undergo a significant adjustment. In contravention of internal guidelines of the fund, he proceeded to risk a large percentage of the fund's capital in investments predicated on that analysis. When the hoped-for adjustment in price did not materialize, the losses were unsustainable and the fund was closed.[14]

2. *Outright Fraud*. A number of hedge fund failures are attributable to intentional fraud by the fund's principal or manager which commenced at or near the inception of the fund. Several have been classic Ponzi schemes in which funds collected from new investors were used to pay dividends to earlier investors creating the appearance of a profitable entity while, in fact, investor monies were misdirected and used for a variety of improper purposes, including payments to the fund managers.[15] In those cases, little or none of the money invested was ever put into investments. Classic Ponzi and other fraud cases include the Bayou Hedge Funds[16] and Manhattan Investment Fund Limited[17] among others.

3. *Hybrid Cases*. The last general category includes cases in which the fund managers invested funds as advertised and also diverted money in excess of approved fees. In these cases, the collapse of the fund is often attributable to both bad investments and diversion of funds.

[13] Hedge funds are distinguishable from other types of unregistered investment vehicles based on their investment strategies, i.e. seeking an absolute return, and their unregistered status.

[14] *See, e.g., Hedge Funds: Flare-up,* Economist, Sept. 23, 2006.

[15] The Second Circuit has described a Ponzi scheme as "a scheme whereby a corporation operates and continues to operate at a loss. The corporation gives the appearance of being profitable by obtaining new investors and using those investments to pay for the high premiums promised to earlier investors. The effect of such a scheme is to put the corporation farther and farther into debt by incurring more and more liability and to give the corporation the false appearance of profitability in order to obtain new investors." *Hirsch v. Arthur Andersen & Co.,* 72 F.3d 1085, 1088 n.3 (2d Cir. 1995).

[16] *See Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P. (In re Bayou Grp.)*, 360 B.R. 624 (Bankr. S.D.N.Y. Feb. 23, 2007).

[17] *See Gredd v. Bear Stearns Sec. Corp. (In re Manhattan Inv. Fund Ltd.)*, 359 B.R. 510 (Bankr. S.D.N.Y. Jan. 9, 2007).

Redemptions. When a declining hedge fund reports diminishing returns, investors often seek to redeem their investments (i.e. withdraw). Typically, fund documents take one of two general approaches to redemptions. Either the documents require investors to leave their funds in for an agreed upon period, absent special circumstances, or the documents permit investors to redeem all or a portion of the funds invested on a periodic basis. In the second example, an investor who wishes to redeem gives notice, the value of its investment is calculated, and funds are returned.

In the cases of hedge funds that are troubled or even worse, fraudulently managed, the promoters often allow redemptions calculated upon either the original amount invested or upon some other invented amount unrelated to the value of the fund but intended to create the impression that the fund is doing well.

When the funds subsequently fail, two issues arise regarding the prior distributions. First, whether and to what extent an investor should be permitted to retain the previously received redemptions. Second, how should such redemptions be treated for the purpose of calculating post-failure distributions?

Recovery of Redemptions. The principal legal theory utilized to recover improperly paid redemptions is that of fraudulent conveyance. Fraudulent conveyance laws date back to Elizabethan England commencing with the Statute of Elizabeth.[18] Such actions seek to recover property improperly transferred in order to preserve assets for the benefit of creditors. The right to such recoveries is currently codified as section 548 of the United States Bankruptcy Code and most states have adopted either the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfers Act.[19] Although there are some minor differences among the various statutes, they have the same theoretical underpinnings and can be taken together for the purpose of this discussion.

[18] The Statute of Elizabeth, 13 Eliz., ch. 5 (1570), provides that "covinous and fraudulent feoffments, gifts, grants, alienations, conveyances, bonds, suits, judgments and executions, as well of lands of tenements as of goods and chattels . . . devised and contrived of malice, fraud, covin, collusion or guile, to the end, purpose and intent, to delay, hinder or defraud creditors and others . . . shall be utterly void, frustrate and of no effect. . . ." This statute was read to mean that conveyances made with the intent to hinder, delay, or defraud creditors are not actually void, but rather are only voidable as to creditors who were hindered, delayed, or defrauded, the conveyance remaining valid as between grantor and grantee.

13 Eliz., ch. 5 § 2 provided further that "[p]arties who knowingly participated in the conveyance 'incurr[ed] the penalty and forfeiture of one years value of the said lands and in tenements . . . and the whole value of the said goods . . . .' Of this amount, 'one moitie whereof'—that is, one-half—went to the crown and the other half went to the "party or parties aggrieved." *see* Bruce A. Marrell, *Following Zaretsky: Fraudulent Transfers and Unfair Risk*, 75 Am. Bankr. L.J. 317, 332 n.36 (2001) (citing 13 Eliz., ch. 5 § 2 (1571)).

The fraudulent-conveyance statutes in many states are essentially modernized versions of the Statute of Elizabeth, providing creditors with the ability to avoid transfers made by debtors with the intent to hinder, delay, or defraud creditors' collection efforts. W. Brown, *The Law of Debtors and Creditors* § 6:76 (2007).

[19] 11 U.S.C. § 548(a)(1) codifies fraudulent conveyance under the Bankruptcy Code. For an example of a state fraudulent-conveyance statute see N.Y. Debt. & Cred. Law §§ 272 to 276-a (McKinney 2007).

If a receiver chooses to seek recovery of redemptions under a fraudulent conveyance theory, he may proceed under . . . the theory of actual fraud. . . . Alternatively, if the receiver proceeds under a constructive fraudulent conveyance theory, he will seek the difference between the value of the property received by the estate and the value of the property conveyed.

The purpose behind the fraudulent conveyance statutes is self-evident. In an effort to allow creditors to receive the largest dividend possible under the circumstances and to prevent debtors from ''selling'' property at less than fair prices either through greed or desperation, transfers by an insolvent transferor are scrutinized to make certain that the estate has not been depleted by fraudulent or ill-considered transactions.

Fraudulent conveyances fall into one of two categories. The first requires intentional fraud. In such cases property is transferred for little or no value with the actual intent on transferor's part to defraud, hinder or delay creditors. This form of fraudulent conveyance is readily understandable.

Less obvious is the second form of fraudulent conveyance: constructive fraud. Here, actual intent of the transferor is not required. Instead, a transfer is deemed to be a fraudulent conveyance if it is made while the transferor is insolvent (or about to become insolvent) and the value received is less than ''fair'' or does not constitute ''reasonably equivalent value.'' In order to determine whether a ''constructive'' fraudulent conveyance occurred, the Court must retrospectively determine the value of the asset transferred and then compare it to the consideration received at the time the transferred occurred.[20]

Under either form, a recipient of a fraudulent conveyance who takes in good faith and for value retains a lien on property received up to the value of the property which they exchanged in return for the fraudulent conveyance. Experience teaches that most investors who receive redemptions take them in good faith. Therefore, a receiver's challenge is almost always based on a dispute over the value of the investment at the time of the redemption.

If a receiver chooses to seek recovery of redemptions under a fraudulent conveyance theory, he may proceed under either of the two theories. A receiver can proceed under the theory of actual fraud. If the fund operator was operating a Ponzi scheme or was otherwise engaged in an actual fraud at the time of the redemption in question, and if the redemption was made in an effort to conceal the fraud or to encourage others to invest, then the receiver may seek recovery of all of the funds transferred as a result of the redemption subject only to the good faith defense.[21] Alternatively, if the receiver proceeds under a constructive fraudulent conveyance theory, he will seek the difference between the value of the property received by the estate and the value of the property conveyed.

Actions to Recover Redemptions. Almost all of the judicial analysis related to the propriety of a receiver's action to recover funds paid as distributions in advance of the collapse of a hedge fund has arisen out of cases in which the failed hedge fund was deemed to be a Ponzi scheme. In those cases, there was never a time when the enterprise was operated legitimately and there were no real earnings. New investors were lured by the false promise of large returns and older investors were kept placated by payments from newly raised funds. The

[20] *See, e.g., Rubin v. Mfrs. Hanover Trust Co.*, 661 F.2d 979, 993-94 (2d Cir. 1981).

[21] *See Sharp Int'l Corp. v. State St. Bank and Trust Co. (In re Sharp Int'l Corp.)*, 403 F.3d 43, 56 (2d Cir. 2005) (citing *United States v. McCombs*, 30 F.3d 310, 328 (2d Cir. 1994)) (''[W]here actual intent to defraud creditors is proven, the conveyance will be set aside regardless of the adequacy of consideration given.''); *see also Scholes v. Lehmann*, 56 F.3d 750, 757 (7th Cir. 1995), *reh'g en banc denied*, 1995 U.S.App. LEXIS 17088 (7th Cir. 1995), *cert. denied sub nom. African Enter., Inc. v. Scholes*, 516 U.S. 1028, 116 S.Ct. 673, 133 L.Ed.2d 522 (1995) (under analogous Illinois fraudulent conveyance statute, ''if fraudulent intent is proved, then . . . the defendant, unless he had no knowledge of the transferor's fraudulent intent, must return the entire payment that he received rather than just the amount by which it exceeded the consideration that he gave in exchange for the payment''); *Hayes v. Palm Seedlings Partners-A (In re Agric. Research and Tech. Group, Inc.)*, 916 F.2d 528, 538 (9th Cir. 1990) (under Section 548(a)(1)(A), ''the entire transfer may be avoided, even if reasonably equivalent value was given, so long as the transferor actually intended to hinder, delay or defraud its creditors and the transferee accepted the transfer without good faith''); *Kendall v. Turner (In re Turner)*, 335 B.R. 140, 145 (Bankr. N.D. Cal. 2005), *modified on reconsideration by*, 345 B.R. 674 (Bankr. N.D. Cal. 2006) (''the entire transfer is avoided'' under Section 548(a)(1)(A) of the Bankruptcy Code); 5 *Collier on Bankruptcy* ¶ 548.01[1] at 548-11 (15th ed. 2006) (''[I]f the transaction is fraudulent within the rules set forth in section 548, the trustee may avoid it in its entirety without any limitation on the extent of the recovery other than those imposed by § 548(c) to protect transferees and obligees in good faith.''

promoter misused funds until demands for redemptions became too great and the scheme collapsed.[22]

Almost all of the judicial analysis related to the propriety of a receiver's action to recover funds paid as distributions in advance of the collapse of a hedge fund has arisen out of cases in which the failed hedge fund was deemed to be a Ponzi scheme.

Courts faced with claims by receivers for the return of amounts paid to investors prior to the collapse of the fund generally have been required to undertake their analysis in the context of fraudulent conveyance law. Receivers have argued that the redemptions constituted intentional fraudulent transfers because they were made in furtherance of the Ponzi scheme and constructive fraudulent transfers because the redeeming investors received more than they were entitled to as the value of their investments were less than the amount received.

Courts generally have sided with the redeeming investors in the Ponzi scheme context. They have reasoned that since the Ponzi scheme was a fraud from its inception, the original investment was void *ab initio* giving rise to a claim for rescission. Thus, the courts reason, an investor has given fair value by exchanging a valid rescission claim for the redemption.[23] The extinguishment of a valuable rescission claim, therefore, is deemed a good faith exchange for value and accordingly is immune from attack as a fraudulent conveyance. The value of the rescission claim is deemed to equal the amount initially invested. Under this approach, however, funds received in excess of the initial investment (i.e. profits) must be returned because the amount of the valid rescission claim is limited to the original investment.[24]

In analyzing this judicial reasoning, it should be noted that, in cases of this type, the investors have not asserted a rescission claim at the time of the redemptions.[25] The ''exchange'' which they intended to make was merely a redemption of their interests in an investment. Releases that would be expected in the case of a settlement of a rescission claim were not exchanged. In fact, the investors likely had no knowledge of any basis for rescission. Therefore, the extinguishment of a rescission claim as the basis for a fair value exchange is a legal construct created to justify the result of allowing a redeeming investor to keep money received. The investor sought to redeem its investment, not to rescind its original transaction. Thus, in order to determine whether the exchange was proper, the value of the investment should be calculated in accordance with the operative documents governing the hedge fund and then compared to the amount received.

These documents can take one of two forms. The first form treats the investment as a loan with a promised return of principal plus interest. Here, if the amount returned is equal to the contractual amount, it can be fairly argued that the exchange is for reasonably equivalent value. But under such circumstances, it should be unnecessary for the court to involve the fictional ''rescission claim'' analysis to protect the transfer. Moreover, even under these circumstances, where the contract is clear, courts have been unwilling to allow the investor to keep the interest component. Thus, it appears that the Court, in utilizing the rescission theory, is attempting to achieve a form of rough justice regardless of the provisions of the parties' agreement.

This conclusion is further supported by the courts' treatment of the second and more prevalent arrangement in the hedge fund cases. Under this argument, the investor is assigned a percentage interest in the fund which fluctuates as new investors contribute to the fund and as the value of investments rise and fall. In the ordinary course, at the time of a requested redemption, the value of the investor's share is calculated and it is entitled to withdraw an amount up to the value of its investment.

In the typical fraud case, whether Ponzi or hybrid, the value of the enterprise has been diminished by the fraud and, therefore, the value of the shares redeemed also has been reduced. Thus, any payment in response to a redemption request exceeding this reduced value is by definition a constructive fraudulent conveyance.

Some have argued that the prevailing judicial view holding that the release of a rescission right constitutes value sufficient to support the redemption in the Ponzi scheme context is flawed because it places an unrealistic value on the rescission claim. While the courts may be correct that the investor has a valid claim for rescission in the full amount of its investment, they fail to consider the *value* of that claim in the context of an insolvent entity, nor do they consider the impact of this decision on the underlying rationale of the fraudulent conveyance statutes.

[22] While a number of the cases appear to be hybrids, as discussed previously, courts have consistently treated enterprises as true Ponzi schemes even when there are some elements of legitimate investing.

[23] *See, e.g.*, *Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 596 (9th Cir. 1991); *Warfield v. Carnie*, 2007 U.S. Dist. LEXIS 27610 (N.D. Tex. Apr. 13, 2007).

[24] *See Commodity Futures Trading Comm'n v. Equity Fin. Group, LLC*, 2005 U.S. Dist. LEXIS 20001, at 85-87 (D.N.J. Sept. 2, 2005), *aff'd* 2005 U.S. Dist. LEXIS 26847 (Sept. 26, 2005); *Commodity Futures Trading Comm'n v. Skorupskas*, 1988 U.S. Dist. LEXIS 18649, at 4-9 (E.D. Mich. Aug. 22, 1988); *Commodity Futures Trading Comm'n v. Hoffberg*, 1993 U.S. Dist. LEXIS 15173, at 8-9 (N.D. Ill. Oct. 28, 1993); *Sender v. Buchanan (In re Hedged-Investments Assocs.)*, 84 F.3d 1286, 1290 (10th Cir. 1996); *Scholes v. Lehmann*, 56 F.3d 750, 757-58 (7th Cir. 1995); *In re Taubman*, 160 B.R. 964, 987-88 (Bankr. S.D. Ohio 1993); *Eby v. Ashley*, 1 F.2d 971, 973 (4th Cir. 1924).

[25] Rescission is an equitable remedy where a court may rescind a contract or unwind a transaction based on a defendant's misconduct. A court may rescind a contract if a party alleges fraud in the inducement of the agreement, lack of consideration, impossibility of performance, breach of the contract, mistake of law or fact or illegality. A party seeking rescission must also show that damages are not an adequate remedy. *New Paradigm Software Corp. v. New Era of Networks, Inc.*, 107 F. Supp. 2d 325, 328-29 (S.D.N.Y. 2000).

Courts have suggested that the use of fraudulent conveyance law to redistribute losses among investors is really a disguised preference analysis, which is only available under the Bankruptcy Code.[26] In a preference recovery, payments on account of an antecedent debt within a prescribed period are subject to recovery where such payments allow the recipient to receive more than it would receive if the insolvent payor were liquidated.[27] Since legislators have not extended preference liability beyond bankruptcies, the courts further suggest an extension of this form of analysis really is a veiled attempt to create a cause of action not yet approved by the legislature.[28] Instead, the courts have focused on a transaction by transaction analysis ignoring the comparative recovery aspect mandated by a preference analysis. The clear conclusion is that if the redemption is valid and proper under the governing documents, then the redemption is supported by fair consideration. It appears that the prevailing view is correct, at least with regard to any argument based upon comparative recovery among claimants.

But, to the extent courts create the fiction of a rescission claim to support the redeeming investor over those left behind, the courts have committed the very wrong they criticized in rejecting comparative recovery arguments; they have effectively made a policy decision better left to the legislature. At the time of the redemptions in question, every investor in the scheme held an equally valid unasserted rescission claim. It is only by fortuity that some investors sought redemption prior to the collapse of the scheme while others did not. Moreover, the redeeming investor did not even assert a rescission claim. By recharacterizing the nature of the redemption, the courts have chosen to ignore the transaction which actually took place. The only possible purpose for such analysis is to achieve a goal not mandated by the legislature.

If such transfers are viewed for what they were intended to be, redemptions of interests in the enterprise, the redeeming creditor has received far more than the value exchanged. The recharacterization of redemptions as rescission settlements only serves to benefit those who through luck avoided the consequences of the fraud by receiving money taken from subsequent investors. While those who received the funds did so innocently, their innocence should not create sufficient reason to allow them to receive a better result than other victims of the same scheme.

When viewed in this context, it appears that the majority rule in cases of this type appears to be a legal construct designed to achieve a goal of allowing those who managed to extricate themselves from a fraudulent scheme to retain ''their'' money against the claims of a receiver. But that construct is based on a skewed view of the facts surrounding the redemptions in question and is contrary to legislative policy as expressed in the fraudulent conveyance statutes.

[26] *See, e.g., In re Unified Comm. Capital, Inc.*, 260 B.R. 343, 353-54 (Bankr. W.D.N.Y. 2001). But note UFTA § 5(b) provides a limited ability to recover preferences provided that the recipient is an insider of the transferor. This limitation makes the use of § 5(b) rare.

[27] *See* 11 U.S.C. § 547(b).

[28] *See United Commercial*, 260 B.R. at 352, n. 10; *In re Carrozzela & Richardson*, 286 B.R. 480, 489 (D. Conn. 2002).

Distributions to Investors. In contrast to the courts limited consideration of the various theories of recovery from redeeming investors, courts have developed numerous theories to guide the distribution of recovered funds.

Four distribution methods are generally discussed.

The first method is the Pro Rata Distribution method.[29] This method ignores redemptions. A receiver returns to each investor the amount invested by that investor divided by the total amount invested multiplied by the dollars to be distributed.

While this method is often discussed by courts, its failure to make allowance for previous distributions has led to its universal rejection.

A second distribution method is commonly known as the ''Net Investment,'' ''Net Principal Investment'' or ''Franklin'' method of distribution. Here, redeeming investors are allowed to retain all funds distributed to them but those amounts are deducted from the investor's initial investment before calculating its recovery. The ''net investment'' then is used to calculate the investor's share of the pool of recovered funds. This method is best explored in *CFTC v. Franklin*, 625 F. Supp. 163 (W.D. Va. 1986) *rev'd on other grounds sub nom. Anderson v. Stephens*, 875 F.2d 76 (4th Cir. 1989).[30]

The ''Rising Tide'' method is a third approach to distribution. Pursuant to this distribution methodology, the investor is entitled to retain previously received funds, but they are deducted from the amount which he would have received under the distribution plan, not from his original investment. The formula to be applied under this method is dollars invested multiplied by proposed distribution percentage minus amount redeemed.

By way of example, under the ''Rising Tide'' theory, an investor who redeems half of his investment prior to the fund's collapse would receive a distribution from the estate only after non-redeeming investors receive a fifty percent distribution. After the non-redeeming in-

[29] The Supreme Court was one of the earliest proponents of the principle of pro rata distribution. In *Cunningham v. Brown*, 265 U.S. 1, 9, 44 S.Ct. 424, 68 L.Ed. 873 (1924), defendant Charles Ponzi operated a classic Ponzi scheme. During the liquidation proceedings, certain defrauded investors argued for application of the traditional rule, the ''first in, first out'' method. *Id.* at 11. Under that method the first funds invested in a Ponzi scheme are deemed the first funds converted. In rejecting this argument, the Supreme Court announced the principle of pro rata distribution—''[a]fter [termination of the scheme] the victims of Ponzi were not to be divided into two classes . . . They were all of one class, actuated by the same purpose to save themselves from the effect of Ponzi's insolvency . . . It is a case the circumstances of which call strongly for the principle that equality is equity.'' *Id.* at 13.

[30] Courts rejecting the Net Investment Method have found that it results in certain investors receiving more than their proportionate share of recovered funds at the expense of the other, less fortunate, investors thereby violating the principle of unjust enrichment. That is, the Net Investment Method permits an investor who previously received a withdrawal or redemption to retain the full amount of that withdrawal in addition to a distribution calculated on the basis of net funds invested. *Hoffberg*, 1993 U.S. Dist. LEXIS 15173, at 8-9; *Equity Fin. Group*, 2005 U.S. Dist. LEXIS 20001, at 85-87; *Skorupskas*, 1988 U.S. Dist. LEXIS 18649, at 6-7 (''By permitting an investor to reap more than the proportionate share of his investment [the Net Investment Method] permits the investor to in effect reap a 'profit' on the scheme . . . '').

vestors receive a distribution commensurate on a percentage basis with the redeeming investors, the redeeming investors will share in all future distributions.

Courts adopting this method suggest that it is more equitable for those who did not redeem or only redeemed small amounts. See *Equity Fin. Group* 2005 U.S. Dist. Lexis 2001, *Skorupakus* 1988 U.S. Dist. Lexis 18649, *Hoffberg* 93 C 3106, 1993 U.S. Dist. Lexis 15173. They suggest that by directing all funds remaining in the pool to non-redeeming investors until cash payouts are equalized, the Rising Tide method comes closer to equality than the others previously discussed.

Regardless of the distribution theory adopted, its fairness is clearly compromised in cases where the fund commences and operates as a legitimate enterprise and fraud or malfeasance occurs at a later date. Under any distribution theory, courts should make a distinction in calculating losses for investors depending on the value of their interests at the time the fraud commenced.

A fourth distribution method discussed is the ''Redemption Recapture'' method. Under this methodology, the receiver seeks to recover all redemptions, place them back in the distribution pool and redistribute the funds based on the investor's original investment. The Receiver in the Bayou Hedge Funds bankruptcy cases proposed to adopt this method.[31] In that case, Bayou's principals operated a massive Ponzi scheme, and upon collapse, the sole remaining estate assets consisted of investor redemptions. Recognizing the substantial costs involved in litigating over one hundred redemption adversaries, the Receiver devised a distribution process which contemplated the return of prior redemption payments and the distribution of such recoveries to all investors.[32] Notwithstanding the actions of the receiver in Bayou, to date, no court has adopted the ''Redemption Recapture'' method.

An Alternative Distribution Method. The methods discussed above are based on the presumption that the hedge fund in question must be treated as a blind pool. That is, every dollar contributed, regardless of timing, is treated the same as every other dollar. This concept was developed in the context of true Ponzi schemes, where funds were never invested and every investor was a victim separated only by the fortuity of when they unknowingly invested in the fraudulent enterprise and if they requested redemptions prior to the scheme's collapse. The flaws in these distribution methods were analyzed in the previous sections.

Regardless of the distribution theory adopted, its fairness is clearly compromised in cases where the fund commences and operates as a legitimate enterprise and fraud or malfeasance occurs at a later date. Under any distribution theory, courts should make a distinction in calculating losses for investors depending on the value of their interests at the time the fraud commenced.

By way of illustration, consider the following simple example: Investor A contributes $100,000 to a $1,000,000 fund. Thus at the time of his initial investment he owns 10 percent of the fund. Over the first year, the fund increases in value to $10,000,000. Investor A's 10 percent interest is now worth $1,000,000. At the end of the fund's first year, Investor B contributes $100,000, the same investment as Investor A. Should he now have the same 10 percent interest as Investor A? Clearly not. Instead he owns .09 percent of the fund. The value of his investment equals the $100,000 he contributed as opposed to $1,000,000.

If a fraudulent scheme later commences at the hypothetical fund and the fund is liquidated, the distribution plan should consider the investor's percentage interest in the fund as opposed to the raw dollars invested.

Similarly, if the value of the fund had decreased due to unsuccessful investing, the value of each investor's investment should be adjusted downward. Thus, if we modify the prior example to reflect performance in which the initial market value of the investments had decreased from $1,000,000 to $500,000 at the end of year one, Investor A's investment would be worth only $50,000. If Investor B then contributed $100,000, his percentage interest would equal 16.67 percent. Simply

[31] *In re Bayou Grp., LLC*, Case No. 06-2206 (ASH) (Bankr. S.D.N.Y. June 13, 2007). To date, the Receiver's proposed plan is pending confirmation.

[32] The Bayou distribution plan is as follows: First, the Receiver divided all redeeming investors into two classes: those who received redemption payments equal to their principal investments (''Complete Redeemer Investors'') and those who received redemptions in amounts less than the amount of their principal investments (''Partial Redeemer Investors''). Second, all redeeming investors could litigate their right to retain their redemptions or settle. As an incentive to settle and preserve estate assets, settling redeeming investors would realize a 60 percent recovery of their allowed claims. In order to hold an allowed claim, a Complete Redeemer Investor electing to settle would pay the Receiver 100 percent of the portion of the redemption payment consisting of fictitious profits and 50 percent of the portion representing principal. Similarly, a Partial Redeemer Investor would pay 50 percent of the redemption payment consisting of principal. Finally, investors electing to litigate faced the prospect of 100 percent recovery (minus litigation expenses estimated at 10 percent of the principal investment) if they prevailed in the litigation. On the other hand, if the Receiver prevailed, an investor would recover only 20 percent.

put, the value of an investor's percentage interest in the fund should rise and fall with the value of the fund.

The most difficult question is whether and how to factor in the losses at a fund that are caused by fraud. As in the examples pertaining to investment loss, a person contributing $100,000 to a $1,000,000 fund owns 10 percent. If a half of the fund is stolen and a new $100,000 investor comes in, a strict percentage approach would suggest that he would own one-sixth of the fund or 16.67 percent and the original investor would own one-twelfth or 8.34 percent. This result may seem inequitable to some, given that the fund made no real investments. Moreover, it could be argued that both investors were equally the victims of a fraud and should be treated the same. The methodology suggested herein, however, measures the actual losses suffered by each investor based upon the timing of their investment and the timing and extent of the thefts. Accordingly, it most accurately reflects the actual experience of each investor in accordance with the terms of their investment.

On the surface, the most difficult case is the hybrid situation where some losses (or gains) were caused by investments and other losses were the result of theft. But, if one is attempting to measure the economic impact of the fund's losses on each investor to determine the fairest distribution method, then the cause of the loss is irrelevant. The proposed methodology best measures each investor's loss.

Conclusion. The rise in importance of hedge funds along with their increased rate of failure has exposed the lack of rigor in the prior legal analysis of the claims of investors in failed hedge funds. Applying the principles of fraudulent conveyance law while respecting the structure of the hedge funds leads to a fairer and more consistent distribution of the assets regardless of the cause of the hedge fund's failure. Accordingly, whether it is for the purpose of determining the validity of redemptions or developing a plan of distribution, courts should analyze the position of each investor based on the value of its investment as of the fraud's occurrence (and thereafter if needed). Applying this overriding principle will result in more equitable treatment for investors.

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