HOW TO LIQUIDATE A HEDGE FUND

AKRAM & ASSOCIATES LIVE WEBINAR

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DETERMINING WHETHER TO LIQUIDATE

WHETHER TO LIQUIDATE

To determine a fund's long-term viability, a fund manager facing a slew of redemptions must determine whether redemptions will drain the liquid assets of the fund. If the pending redemptions would adversely affect what the manager believes is a prudent balance between liquid and illiquid assets, or if the amount of the redemptions in fact exceeds the amount of liquid assets available in the fund, a manager has several choices.

Most hedge fund governing documents allow the manager to suspend or limit redemptions or to delay the payment of redemption proceeds under certain circumstances. Where permitted and assuming prevailing market conditions allow, such actions may provide the manager additional time to liquidate illiquid assets at market prices and not be forced to sell assets at "fire sale" prices.

Another option that may exist in the hedge fund investment agreement permits the manager to pay a portion of redemption proceeds in kind with illiquid assets, either by transferring the assets directly to the redeeming investors or by transferring the assets indirectly by means of a "synthetic side pocket." A "synthetic side pocket" is accomplished by sequestering illiquid assets in a newly created subsidiary and granting an ownership interest in the subsidiary to the redeeming investor with a value equivalent to the investor's share in the fund as of the redemption date Over time, the manager will liquidate the illiquid assets in the synthetic side pocket for the benefit of redeemed investors, but it is the investor who accepts market risk in that scenario. The fund is protected from a run on its cash by the placement of illiquid assets into the synthetic side pocket as it allows redemption claims to be satisfied with illiquid assets.

HOW TO LIQUIDATE A FUND

1. TALK WITH HEDGE FUND SERVICE PROVIDERS

A manager should first contact his hedge fund attorney to inform him of the plans to close down the fund. The lawyer will be able to help guide the manager through the process and will be able to help with any issues which may arise. The auditor, broker and administrator should also be contacted so that these service providers can begin their own processes for winding the fund down. During the wind down process, the manager should expect to talk with each of the service providers a few times.

2. INFORM YOUR INVESTORS

A manager will need to inform the investors that the fund will be winding down. The manager will probably want to do this through some sort of letter. After the manager has discussed the wind down with the attorney, the attorney can help the manager draft the letter. The letter should inform the investors that the fund will be closing and also let the investors know what steps are being taken before the final liquidation is complete. The manager may also ask the investor how the final proceeds should be sent to the investor – either through wire or through a check. Additionally, if the manager is going to be starting a new hedge fund, he may want to mention this in the letter. (However, the manager will need to be careful that the mention of the new fund does not rise to the level of a public offering – the attorney can discuss this with the manager.)

3. MAKE THE FINAL WINDOWN AND DISTRIBUTIONS

The final wind down is the process of liquidating all of the fund's positions to cash and then transferring the fund's assets to the fund's bank account. From the bank account, the manager will then be able to distribute the assets to the investors pursuant to the final accounting by the administrator and/or auditor.

4. PROVIDE THE FINAL AUDIT

The auditor will provide final audited financial statements to the manager who will then provide these statements to all of the investors in the fund. Usually the final audit will be completed prior to the actual distribution of the assets to the investors in the fund.

5. CLOSE DOWN THE ENTITIES

After the final audit and distribution to the investors, the manager will want to close down, or cancel, the fund entity. To do this the attorney will:

1. Submit articles of cancellation to the Delaware Secretary of State to close down the entity. The filing fees for this are typically $200-$300 dollars payable to Delaware.
2. Pay any outstanding Delaware franchise taxes. Generally these are going to be less than $200, but it will depend on the fund. The attorney will be able to contact Delaware to determine the amount of the taxes owed.
3. Provide the manager with an explanation of how to contact the IRS about the canceled entity.
4. Contact the registered agent in Delaware to cancel registered agent services with them.

Additionally, the hedge fund manager should also decide whether the hedge fund management company will also need to be wound down. In many cases, the entity will be kept alive in order to serve a future purpose for the manager; in some cases the management company will serve as the general partner to a new hedge fund.

6. POTENTIAL ROLL OVER ISSUES

For mangers who are simultaneously closing one hedge fund and starting another, a common practice is to simply roll the assets from the old fund to the new fund. In such instances the manager will definitely need to have close contact with all of the service providers to ensure a smooth transition. Additionally, there may be some issues which the manager will need to discuss with counsel if there are tax-exempt entities in the old fund.

CONCLUSION

IN CONLUSION…

Hedge fund liquidations and dissolutions form an evolving area of law with limited precedent. As hedge funds face rapidly declining asset values combined with historically high redemptions, fund managers are being forced to evaluate whether to continue operating.

Once the specter of liquidation is raised, the manager should promptly provide the fund more time and control by taking advantage of options that may exist under its fund documents, such as suspending redemptions or creating synthetic side pockets. If these options do not exist, the fund manager should focus his attention on the timing of redemptions to try to ensure the most equitable outcome among investors—if for no other reason than that it will reduce the risk of costly litigation. As a less attractive option, the fund manager can avail itself of the bankruptcy process to create judicial oversight of the liquidation process.

THANK YOU FOR LISTENING

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