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Seventh Circuit Holds Equity Receivers Not Bound by State Law Priorities in Liquidating Hedge Funds

BY FAYE B. FEINSTEIN AND CHRISTOPHER COMBEST

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The song tells us that "money changes everything."[1] Lack of it does as well: where an insolvent investment fund has insufficient assets to pay all of its investors in full, the law and policy governing distribution of those limited assets may change the state-law entitlements of the fund's investors. At a time when billions of dollars of assets are under the supervision of federal receivers and bankruptcy trustees, the Court of Appeals for the Seventh Circuit recently ruled, in *SEC v. Wealth Management LLC*[2], that an equity receiver, in proposing her plan of distribution to investors, was not bound by the requirements of state law when establishing priorities for, and making distributions to, those investors. Along the way, the Seventh Circuit made new circuit law on procedural and substantive matters directly affecting the rights of all parties to federal receivership and liquidating bankruptcy proceedings.

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I. Introduction – The Extraordinary Power of a Federal Equity Receiver

The use of court-appointed fiduciaries to protect assets from waste is at least as old as the time of Queen Elizabeth I.[3] In the United States, equity receiverships flourished in the 19th Century, as the preferred device for achieving the financial reorganization of railroads, the country's first great corporations, whose failures were also the country's first great insolvencies – the *General Motors* and *United Air Lines* cases of their day. At a time when there was no national bankruptcy law, the equitable authority of receivership courts proved a powerful and flexible tool: the courts valued assets, authorized their sale, approved the categorization of claims and interests, and blessed distribution schemes,

[1] Cyndi Lauper, *Money Changes Everything*, *on* She's So Unusual (Epic Records 1984).

[2] 628 F.3d 323 (7th Cir. 2010) (hereinafter, "*Wealth Management*").

[3] For further detail on the history of equity receiverships, *see*, Douglas G. Baird, *The Elements of Bankruptcy* 61-72 (5th ed. 2010) and John D. Ayer, *Rethinking Absolute Priority after* Ahlers, 87 Mich. L. Rev. 963, 970-71 (1989).

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all based, not on the commands of a statute, but on the courts' views as to what was reasonable and fair.

As federal bankruptcy law later came to dominate corporate reorganizations, the purpose of equity receiverships reverted to the more narrow one of safeguarding an insolvent entity's property, ''especially . . . in cases involving fraud and the possible dissipation of assets[,] since the primary consideration in determining whether to appoint a receiver is the necessity to protect, conserve and administer property pending final disposition of a suit.''[4] Within that narrower scope, however, federal district courts are no less powerful than when they were supervising equity receiverships in the 1800s.

Federal law[5] authorizes the Securities and Exchange Commission (''SEC'') to seek appointment of a receiver to protect an entity's assets pending the resolution of an SEC action to restrain violations of federal securities laws. However, the ''*power* of a district court to impose [that] receivership . . . does not in the first instance depend on a statutory grant of power . . . [r]ather, the authority derives from the inherent power of a court of equity to fashion effective relief''.[6] A federal receiver exercises the district court's power pursuant to the court's order of appointment. When using that power to craft a plan for the allocation of the assets of the receivership entities, the receiver, similarly, is not limited by specific statute or rule; her plan may suspend or override rights and remedies available under state law or contract ''as inimical to receivership purposes even though they are or might be warranted under controlling law''[7]; she may categorize claims in any ''sensible'' way[8] for the purposes of determining percentage distributions, which distributions may vary among the classes for appropriate reasons – she is limited only by what the supervising district court determines is ''equitable and fair in the eyes of a reasonable judge.''[9]

In *Wealth Management*, the Seventh Circuit agreed with that sweeping description of a receiver's power to propose, and a district court's discretion to approve, the allocation of the property of six insolvent hedge funds on a strict *pro rata* basis to all investors, according to their net cash invested in each fund. The appellate court held that such allocations are not controlled by state law, even if applicable state law would have required an allocation different from that proposed by the receiver and would have resulted in more favorable treatment for certain objecting investors who had, pre-receivership, requested, but not received, redemption of their equity interests.

II. Factual Background of the *Wealth Management* Decision

A. The Wealth Management Investment Funds

The receivership at issue arose out of an enforcement action filed by the SEC against Wealth Management LLC (''WM''), James Putman (''Putman'') – WM's founder, majority owner, and Chief Executive Officer – and Simone Fevola (''Fevola'') – WM's former President and Chief Investment Officer – seeking to enjoin them from violating the federal securities laws.[10]

WM operated as a financial planning firm for families and individuals. Beginning in 2003, it established six unregistered pooled investment funds (*i.e.*, hedge funds), each structured as a limited liability company or a limited partnership. WM served as general partner or managing member of each of the WM Funds. WM placed approximately $102 million of its clients' money, representing over 300 client accounts, in the six WM Funds. Many of those clients sought relatively safe, low-risk investments to fund their retirements, and they believed that their interests in the WM Funds were stable and appreciating in value, a belief WM encouraged through regular communications to its clients. The WM Funds, however, had invested that $102 million in a variety of illiquid and speculative vehicles, including, among others, life insurance premium financing vehicles, real estate development funds, and water parks. The values reported to investors were based, at least in part, on reports from the managers of those various alternative investments, without independent due diligence or verification by WM.

The illusion of ''nothing but blue skies''[11] began to evaporate in February 2008, when WM sent letters to investors, informing them that there was not enough money to pay redemptions in full, and as a result, redemptions were to be limited to two percent of an investor's equity per calendar quarter. Some investors followed this directive and asked for their two-percent redemptions; others ignored the limitation and requested full redemption of their equity, some of which requests were honored by WM and some of which were not; still other investors simply did not make redemption requests.

The skies darkened further in June 2008, when Putman and Fevola disclosed to WM's advisory board that they had each taken $1.24 million in undisclosed compensation from insurance brokers, allegedly in exchange for steering certain WM Funds toward investments in life insurance premium financing vehicles. In December 2008, WM sent notices to investors in all six WM Funds, stating that the Funds could not satisfy redemption requests, would be liquidating their portfolios, and would likely be unable to pay all investors' capital accounts in full.

[4] *In re McGaughey*, 24 F.3d 904, 907 (7th Cir. 1994).

[5] Section 27 of the Securities and Exchange Act of 1934, 15 U.S.C. § 78aa(a); *see also, e.g.*, *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1103-05 (2d Cir. 1972); *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1307 (2d Cir. 1971).

[6] *SEC v. Wencke*, 622 F.2d 1363, 1369 (9th Cir. 1980) (emphasis added); *see also SEC v. Basic Energy & Affiliated Res., Inc.*, 273 F.3d 657, 668 (6th Cir. 2001); *McGaughey*, 24 F.3d at 907; *SEC v. Elliott*, 953 F.2d 1560, 1566 (11th Cir. 1992) (same).

[7] *United States v. Vanguard Inv. Co., Inc.*, 6 F.3d 222, 226 (4th Cir. 1993) (though equity holder claimed rights as creditor based on state contract law, when in receivership, district court may deny such state law remedies).

[8] *SEC v. Enterprise Trust Co.*, 559 F.3d 649, 652 (7th Cir. 2009).

[9] *SEC v. Enterprise Trust Co.*, No. 08 C 1260, 2008 WL 4534154, at *3 (N.D. Ill. Oct. 7, 2008), *aff'd* 559 F.3d 649 (7th Cir. 2009).

[10] The authors note that Fevola consented to entry of final judgment in the SEC action, without admitting or denying the substantive allegations of the complaint, while the SEC's action against Putman is scheduled for trial this year.

[11] WM's trademarked slogan.

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B. The SEC Enforcement Action

In May 2009, after months of investigation, the SEC filed an enforcement action in the United States District Court for the Eastern District of Wisconsin (the ''District Court'') against defendants WM, Putman, and Fevola, seeking to enjoin them from violations of various federal securities laws and rules. Each of the WM Funds was named as a ''relief defendant,'' that is, as a party holding assets generated by the defendants' illegal actions, but who are not themselves accused of wrongdoing. At the SEC's request, the District Court appointed Faye B. Feinstein of Quarles & Brady LLP, as Receiver for WM and the WM Funds. Among other things, the District Court's order of appointment (a) found that appointing the Receiver was necessary to prevent the misuse of the WM Funds' assets and to provide and implement a plan for the equitable distribution of those assets to their investors, and (b) authorized the Receiver to administer and manage the business affairs, funds, assets, causes of action, and any other property of WM and the WM Funds.

C. The Receiver's Asset Allocation Plan and the Appellants' Objections

Having determined that the six WM Funds would be unable to repay investors more than a small fraction of the $102 million invested and outstanding at the time of her appointment, the Receiver proposed a plan (''Plan'') for the equitable allocation of the WM Funds' assets to creditors and equity holders, according to their appropriate priorities. It was uncontroversial that secured creditors should be paid first out of the value of their collateral and that unsecured creditors – *i.e.*, secured creditors with deficiency claims; unsecured lenders; companies that provided goods or services on credit – should come next. The issue that led to the appeal was how to treat the claims of those equity investors who had requested redemption of their equity interests before the receivership, but had not been fully paid on those requests. The Receiver proposed a plan to allocate the Funds' assets *pro rata* to their respective investors, based on their net cash invested in each WM Fund as of a date certain, with no special priority afforded to those investors who had requested redemption, as opposed to those who had not.

1. The Appellants' Arguments: Redeeming investors come first under state law, and the Receiver has no discretion to alter that result.

The objecting investors who became the appellants at the Seventh Circuit – the Edwin Wilson M.D. IRA and the James P. and Sandra J. Verhoeven Revocable Trust (''Appellants'') – had sought, pre-receivership, to withdraw their investments from the relevant WM Funds. As is typical, the subscription agreements for the Funds provided that, upon a request for redemption and acceptance of that request by the managing member/general partner, investors would be treated as ''creditors'' of the relevant WM Fund, an ''account payable'' would be noted in that Fund's books and records, and redeemers, would be paid, in full, before any payments to non-redeeming investors. The Appellants argued to the District Court and, afterwards, to the Seventh Circuit, that, under their agreements with the relevant WM Funds and under Wisconsin law (Delaware law, which governed others of the hedge funds, is substantially similar), their requests to redeem had transformed their ordinary equity investments into higher-priority unsecured debt, thereby making them ''creditors'' of the funds, whose rights to payment trumped those of non-redeeming investors.

The Appellants also argued that *federal* law bound the Receiver to strictly honor their state-law contractual priorities. The Appellants relied upon 28 U.S.C. § 959(b) (''Section 959(b)''), which provides that:

> . . . a trustee, receiver or manager appointed in any cause pending in any court of the United States . . . shall manage and operate the property in his possession . . . according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

The Appellants argued that applicable Wisconsin law gives redeeming investors priority as creditors, and Section 959(b) deprived the Receiver of discretion to modify that priority.

2. The Receiver's Arguments: Among investors in a failed hedge fund, equality is equity, and federal courts are not bound by state law to the contrary.

The Receiver took the position that each investor's right to payment arose from the same underlying fact – the investor's equity investments in one or more of the WM Funds. With those investments, the Appellants accepted the same risk as all other investors: the risk that their equity interests would not generate profit and that redemption requests would not be honored. Referring to potential future distributions as ''payables'' could not obscure the economic substance of the Appellants' interests, or the fact that the rights and claims of redeeming equity holders are fundamentally different from those of creditors who provided goods or services to WM or the WM Funds.[12] The Receiver also pointed out that objections to receivership plans are often ''made by investors attempting to assert a superior claim to the receivership *res* so that they can recoup their entire investment''[13] and that, ''[w]hile a *pro rata* distribution is not necessarily a plan that everyone will like,'' it is favored as the most equitable means of treating investors of a defunct investment company.[14]

As for Section 959(b), the Receiver argued that Appellants' reading was severely at odds with the broad

[12] The District Court's order approving the Receiver's Plan captured this idea with a citation to *In re Envirodyne Indus., Inc.*, 79 F.3d 579, 582-83 (7th Cir. 1996): ''Because the stock redemption is a transaction by which a corporation acquires its own stock from stockholders, it is simply a method of distributing a proportion of the assets to the stockholders. [Citation omitted]. In substance, the former stockholders become equity holders rather than creditors on par with the corporation's other creditors.'' (The order itself is unreported and not available on Westlaw; it is entered as item 161 on the District Court's docket for Case No. 09-CV-506.)

[13] *SEC v. Byers*, 637 F. Supp. 2d 166, 176 (S.D.N.Y. 2009).

[14] *See, e.g.*, *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 89 (2d Cir. 2002) (courts favor *pro rata* distribution when victims' funds are commingled); *SEC v. Reserve Mgmt. Co. (In re The Reserve Fund Sec. & Derivative Litig.*), 673 F. Supp. 2d 182, 195-96 (S.D.N.Y. 2009); *Byers*, 637 F. Supp. 2d at 177.

equitable discretion that courts have repeatedly identified as the core of equity receiverships. The Receiver's position, therefore, was that Section 959(b) does not apply to liquidations, where, because all ongoing business has ceased, the receiver is not ''operating or managing'' the insolvent company's property, so long as she does not interfere with the state's police or regulatory powers or act to the detriment of public health and safety.[15] The reordering of private economic arrangements in pursuit of an equitable distribution of too few assets to too many claimants – even those arrangements that are based upon, and enforceable under, state law – is the essence of equity receiverships, and a federal statute like Section 959(b) should not be read to compromise the federal court's ability to accomplish that essential task.

The District Court approved the Receiver's Plan, finding, among other things, that the Plan's treatment of investors was equitable and reasonable and that Section 959(b) does not compel a federal equity receiver to comply with state limited liability company or limited partnership law in structuring a plan to allocate receivership assets.

III. The Seventh Circuit's Opinion and New Circuit Law

The Seventh Circuit unanimously affirmed the District Court, making new circuit law regarding appellate jurisdiction and Section 959(b).

A. Appellate Jurisdiction over Plan Approval Orders in Receivership Cases

While agreeing with the Receiver, that the District Court's Plan approval order was interlocutory, as it did not completely dispose of the SEC action below, the panel further held – as a matter of first impression in the circuit – that the ''collateral order doctrine'' confers appellate jurisdiction over orders in receivership proceedings approving distribution plans.[16]

Adopting the positions of the Fifth and Sixth Circuits, the Seventh Circuit held that the order met all of the criteria for review as an appealable collateral order: (a) it conclusively determined how the assets of the WM Funds will be distributed; (b) the issue is both important to all investors and separate from the merits of the SEC's enforcement action against Putman, and (c) the order would be effectively unreviewable on appeal from a final judgment in the enforcement action, because, by that time, all the receivership assets would likely have been distributed.[17]

B. Seventh Circuit Determines that 28 U.S.C. § 959(b) Does Not Apply in Liquidation Proceedings, and the Receiver Need Not Follow State Partnership or Limited Liability Company Statutes

The Seventh Circuit began its substantive analysis by acknowledging the District Court's ''broad equitable power'' to accomplish its ''primary job . . . to ensure that [a] proposed plan of distribution is fair and equitable.''[18] Adopting the Receiver's position that ''equality is equity'', the Seventh Circuit found that giving unpaid redemption requests the same priority as any other equity interest ''promotes fairness by preventing a redeeming investor from jumping to the head of the line . . . while similarly situated non-redeeming investors receive substantially less.''[19]

The court then considered the argument that – notwithstanding the enormous power of district courts to ensure equitable outcomes in receivership proceedings – Section 959(b) straitjacketed that discretion and compelled the District Court to give the Appellants ''first dibs'' on what would have been nearly all of the distributable assets of the WM Funds at issue. In another matter of first impression for the Seventh Circuit, the panel joined the Courts of Appeals for the Second, Eleventh, and District of Columbia Circuits[20] and held that Section 959(b) does not apply where an entity's business operations have ceased and its assets are being liquidated. Therefore, federal equity receivers (and bankruptcy trustees, as well) need *not* follow the requirements of state law when distributing assets under their control.[21]

The appellate court also found that, even if Section 959(b) were to apply to the Wealth Management receivership, the relevant state statutes and WM Fund operating agreements did not confer upon the Appellants their asserted priority to the Funds' assets.[22] Wisconsin limited liability company law confers upon a member the status and priority of an unsecured creditor for distributions owed to the member only at such time as the member ''becomes entitled to receive'' such distribution.[23] The company's operating agreement, in turn, determined when and if that moment of entitlement occurred, and, as the court noted, the operating agreement authorized the managing member to restrict entitlements to distributions. After WM did so in February 2008, the Appellants were not entitled to full redemption payments and, therefore, could not be ''creditors'' under Wisconsin law for the amount of their full redemption payments.

IV. Lessons from the *Wealth Management* Decision

For receivers and their counsel, the *Wealth Management* decision is a reminder that allocating the financial assets of an insolvent company necessarily means allocating the damage caused by the company's failure, and

[15] *See, e.g.*, *Alabama Surface Mining Comm'n v. N.P. Mining Co., Inc. (In re N.P. Mining Co., Inc.)*, 963 F.2d 1449, 1460-61 (11th Cir. 1992); *Saravia v. 1736 18th St., N.W., Ltd.*, 844 F.2d 823, 827 (D.C. Cir. 1988); *Vass v. Conron Bros. Co.*, 59 F.2d 969 (2d Cir. 1932) (interpreting predecessor to Section 959(b)); *In re Old Carco, LLC*, 424 B.R. 650, 658-59 (Bankr. S.D.N.Y. 2010) (holding that ''the plain language of section 959(b)'' means that ''once a trustee . . . ceases business operations, section 959(b) does not apply'').

[16] *Wealth Management*, 628 F.3d at 330-31.

[17] *Id.*

[18] *Id.* at 332.

[19] *Id.* at 333-34.

[20] See authorities cited *supra* note 15.

[21] *Wealth Management*, 628 F.3d at 334.

[22] *Id.* at 335.

[23] Wis. Stat. § 183.0606.

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that granting priority to some claimants necessarily means shifting a greater share of the damage to the rest. By ruling conclusively on the scope of Section 959(b), the Seventh Circuit has assured receivers that their ingenuity in crafting fair ways to spread that pain is limited – not by private contract with the persons who took the company into insolvency or by state statutes aimed at enabling and protecting private economic and commercial interests – but solely by what the receiver's appointing court determines is ''equitable and fair in the eyes of a reasonable judge.''[24]

[24] *Enterprise Trust*, *supra* note 9.

For investors, there are also lessons to be learned from the *Wealth Management* decision: (a) actively monitor all investments; (b) ask questions and understand the substance of the documents executed and the discretion given to fund managers, including the circumstances under which the fund manager can limit or refuse to honor redemption requests, and (c) understand that, even if a request to redeem and exit from a fund has been accepted by the fund manager, a court-appointed receiver or trustee will have the power to treat the redeeming investor as though it were still invested in the fund, with no greater rights than other non-redeeming investors.