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Three Key Considerations for Fund Sponsors when Participating in Bankruptcy Proceedings

The Capital Commitment Blog on **July 6, 2021**

We anticipate a more assertive regulatory enforcement program under the Biden administration, particularly focused on fund managers' conflicts of interest, advisers' codes of ethics, and related policies and procedures relating to material nonpublic information. These concerns may be heightened for fund managers participating in bankruptcy proceedings, where competing fiduciary obligations arise, particularly in the context of serving on creditors committees. Outlined below are three primary concerns.

1. **Fiduciary Concerns**

Members of an unsecured creditors committee or other committee in bankruptcy proceedings have fiduciary obligations to other bankruptcy creditors. Because of this, members of bankruptcy committees face greater risks of being charged with fraud. Wherever a fiduciary duty exists, a breach of such duty in connection with a securities transaction may form the basis for criminal charges by the DOJ or an enforcement action by the SEC. The antifraud provisions of the securities laws prohibit devices, schemes, and artifices to defraud in the offer or sale, or in connection with the purchase or sale, of securities. The DOJ can prosecute similar theories under mail fraud, wire fraud, other specific securities fraud statutes or bankruptcy-specific statutes. A breach of a duty, particularly a fiduciary duty, can provide the hook for securities fraud charges under a scheme liability theory; *e.g.,* when an individual acts for personal gain contrary to his or her fiduciary obligation to others.

This situation came to the fore in a matter prosecuted last year, where the portfolio manager of a fund allegedly exploited his position as a co-chair of the unsecured creditors committee in Neiman Marcus's bankruptcy proceedings. As a representative of the unsecured creditors, the portfolio manager had fiduciary obligations to all unsecured creditors, not just the interests of his fund. The DOJ and SEC alleged that the fund manager used his position to attempt to suppress another bidder for securities he sought to acquire for the fund he managed, acting to his own benefit and to the detriment of the other unsecured creditors to whom he owed a duty. This was an extreme case, but one that highlights the importance of, and risks arising from, fiduciary obligations.

2. **Conflicts – Different Parts of Capital Structure**

Conflicts of interest can arise when a fund manager has separate funds that invest in different parts of a single company's capital structure. Such conflicts are more likely to arise in connection with a bankruptcy proceeding where a fund manager may find itself in a position where a forced liquidation or some other bankruptcy action may serve its interest as a creditor, but may disadvantage its position as an equity holder. Taking any action that disproportionately disadvantages one fund while benefiting another can potentially result in a breach of fiduciary obligations. These obligations are heightened when the decision maker manages one fund with debt interests as well as another fund with equity interests in the same company. If a fund manager does not have a separate decision-making structure for each fund (as well as information barriers), it might not be able to take action without risking its fiduciary obligations. Managing the conflicts that accompany investments across a capital structure is an important consideration in the bankruptcy context.

3. **Potential Misuse of Material Non-Public Information ("MNPI")**

During bankruptcy proceedings, circumstances exist that that could give rise to potential claims of insider trading or other misuse of MNPI. When fund manager representatives serve on a creditors committee, the firm typically creates a wall between the person who serves on the committee and others who may make trading decisions. However, breakdowns in controls may lead to misuse of that information and potential liability. A number of years ago the SEC successfully brought an action alleging that a representative on various creditors committees engaged in a pattern of insider trading of fixed-income securities using information he obtained through those committees.

A separate but related question is whether a fund manager's existing compliance policies are effectively implemented to prevent misuse of information. Registered investment advisers are subject to Rule 204A of the Investment Advisers Act, which requires them to establish, maintain, and enforce written policies and procedures to prevent the misuse of MNPI, particularly in circumstances where the risk of obtaining MNPI is heightened – such as when a fund manager representative is a committee member. The SEC continues to pursue actions against investment advisers for failures to maintain robust policies and procedures relating to the handling of MNPI. The effectiveness of information barriers is an area on which regulators are likely to focus, particularly as they increase scrutiny of private fund managers.

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