HEDGE

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Beacon Hill investors raise thorny questions

By Elise Coroneos

Former investors in Beacon Hill's Safe Harbor and Bristol funds have finally asked for their day in court. In a law suit filed in mid-April, they make allegations claiming liability against Beacon Hill, its majority stakeholder Asset Alliance and its administrator ATC Trustees.

The suit also raises knotty—and very interesting—questions about whether financial incentives offered by Asset Alliance motivated Beacon Hill to purposely overstate returns.

The law suit is investors' first attempt to tell the story of how their investment in Safe Harbor and Bristol went badly astray. It begins with allegations that Beacon Hill did not execute the strategy investors had understood they were allocating to, namely, investment in mortgage-backed securities on a low leverage and fully hedged basis.

Instead, the plaintiffs charge, Beacon took a large, highly leveraged short position in US Treasuries as early as July 2002, apparently betting that interest rates would rise.

When interest rates continued to fall, losses went unreported to investors until October when the firm announced a loss of 25% dating back to August, a number that it revised later in the month to 54% and revised again in November to 61%.

Most important, the complaint alleges that the Beacon defendants John Barry, Thomas Daniels, John Irwin and Mark Miszkiewicz "did not act alone—and could not have acted alone—in perpetrating this scheme to the detriment of plaintiffs."

The suit alleges that Asset Alliance knew or should have known that the Beacon defendants were not managing the funds according to the agreed investment strategy, that they were overleveraged and that they had reported artificially inflated returns for at least July, August and September 2002.

As such, the plaintiffs allege that not only did Asset Alliance possess the power to direct management decisions by virtue of its majority stakeholding, but also "controlled Beacon Hill and culpably participated in the fraud."

The suit alleges that around the time of its buying a 50% equity interest in Beacon in September 1999, Asset Alliance filed an S-1 with the SEC explaining that it provided expert advice to its "affiliates" in regard to "marketing and distribution services, strategic plan-

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HEDGE UPDATE

Ivy rolls out registered fund

New York-based **Ivy Asset Management Corp** launched its first registered fund of funds on April 1 with nearly $26 million and some 150 investors. **The Ivy Multi-Strategy Hedge Fund LLC**, which is registered with the **SEC** under the Securities Act of 1933 and the Investment Company Act of 1940, has a minimum investment of

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Investors' suit against Beacon Hill, Asset Alliance and ATC Trustees raises some knotty issues.
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◄1 ning and administration, as well as back-office support and systems."

Furthermore, the plaintiffs say it was their understanding that "Asset Alliance regularly reviewed and examined portfolio reports from the Funds' prime broker and met frequently with the Beacon Defendants to discuss, among other things, risk management issues."

Asset Alliance will be found liable whether it is determined that it either knew or should have known about the losses, says Scott Berman, the attorney from Brown Rudnick Berlack Israels who filed the complaint on behalf of investors. "You need to bear in mind that you can be held liable for something even if you just act recklessly," he says.

The complaint indirectly casts doubt on the law suit Asset Alliance filed against Beacon Hill in January this year. In that suit, Asset Alliance alleges that misrepresentations regarding the value of the funds' assets and investment strategy constituted a fraud upon itself—thereby creating murky waters in regards to its own liability.

In the case against ATC Trustees, Beacon's Caymans-based administrator, the complaint concludes that had the firm carried out its contractual and fiduciary duties, it would have known, or should have known, that the numbers it received from Beacon Hill were false. Its duties included verifying that the portfolio was accurately marked and performing an independent valuation.

The complaint states that "instead, ATC ignored the prime broker's statements and simply used the marks supplied by the Beacon Defendants to calculate the NAV of the Funds and distribute the monthly NAV statements to the investors."

"You can be held liable for something even if you just act recklessly"

An incentive to lie?

The investors' suit also suggests that a previously undisclosed financial motive may have influenced the Beacon defendants to overstate returns. A Statement of Claim filed in arbitration by Asset Alliance reveals that the purchase price it paid for 50% of Beacon Hill was subject to "certain annual adjustments based on Beacon Hill's performance during specified periods."

Specifically, Beacon Hill was required to meet certain thresholds based on the asset and performance levels of the funds. If Beacon Hill met those thresholds by September 30, 2002—that is, after the relevant losses were accrued—the individual defendants stood to receive an additional $26.4 million from Asset Alliance for the sale of the firm.

However, if Beacon Hill failed to meet the thresholds, it stood to forfeit approximately $7.1 million, according to the suit.

The plaintiffs' claim that they would not have invested in Beacon if this arrangement had been disclosed. Perhaps, but according to legal sources contacted in relation to this article, the adjustment of the purchase price of an advisory business based on performance and asset levels is a typical contractual arrangement.

Furthermore, these experts says, such an arrangement is not required to be disclosed, a fact that might prompt some investors to reconsider investing in hedge funds that have undergone a change in their majority shareholder.

"When people buy advisory businesses, they are buying a contingent cashless stream that is going to depend on how many assets stay under management for how long and also how the portfolio does," says Stephanie Breslow, a partner at Schulte Roth & Zabel LLP.

In a summary of the finer points of buying and selling an advisory business, Breslow says that adjustments in the purchase price of an advisory business may be "dollar for dollar, or based on thresholds (e.g. a reduction if aggregate amounts lost are more than X% of total amounts under management)."

The period within which the purchase price can be adjusted varies from one negotiation to another, says Breslow. The factors determining its duration are twofold.

"Firstly, there will be a fairly short time fuse on whether or not assets fled because of the sale of the business. So for instance, it might be a condition preceding the buyers obligation to go forward that a fund manager doesn't lose more than a specified percentage of the assets from when the transaction was announced.

"The second factor," she says, "is the length of the 'earn out' period, which is driven by a variety of considerations including tax. It could be a longer window, in the vicinity of five years."

Incentive to raise assets?

A commonsense argument throws up another challenge to the allegation that a change in the purchase price provides incentive for firms such as Beacon Hill to cover up their losses: Surely all hedge fund managers have incentives to produce spectacular returns.

"Hedge fund managers can always be very highly compensated based on performance-based fees," says Christopher Wells of Coudert Brothers, who represented Ellington Capital Management in its negotiations to replace Beacon Hill as the manager of Beacon's funds.

"Why is the incentive any different if they have some kind of arrangement with a shareholder to receive more for their interest in the firm? A hedge fund manager always has an incentive to produce better performance rather than worse."

In response to this argument, Berman, the plaintiffs' attorney, challenges the very notion that such arrangements should be considered material to, and therefore disclosed to, potential investors.

"This is an additional incentive that the investors were never told about," says Berman. "It also created a huge incentive for Beacon Hill to go out and try to bring in new money, which was not necessarily in the interests of existing investors."

It is Breslow's belief that all hedge fund managers have an incentive to attract further capital. "If anything, once you have sold a piece of the business to someone else, you theoretically have less incentive to raise assets than before because you have already pocketed part of the money," she says. ■