UNITED STATES DISTRICT COURT
DISTRICT OF CONNECTICUT

SECURITIES AND EXCHANGE COMMISSION, *Plaintiff*, *v.* FRANCISCO ILLARRAMENDI *et al.*, *Defendants.*	Civil No. 3:11cv78 (JBA) March 27, 2014

POST-HEARING ORDER ON MOTIONS FOR ADVANCEMENT OF ATTORNEYS' FEES

Movants Christopher Luth, Victor Chong, and Frank Lopez, former principals and officers of Highview Point Partners, LLC (the "HVP Defendants" or "Movants"), have each filed motions [Doc. ## 700, 703, and 705, respectively] seeking an order from this Court requiring the Receiver to advance payment of legal fees for their defense in an action that the Receiver has filed against them, *Carney v. Lopez, et al.*, No. 3:12-cv-00182 (SRU) (the "HVP Lawsuit").[1] The Receiver has opposed these motions, contending that advancement is not warranted given the limited funds available to compensate defrauded investors and because Movants have acted inequitably and engaged in self-help. In the February 10, 2014 Order on Motions For Advancement Of Attorney's Fees (the "Preliminary Order") [Doc. # 821], the Court concluded that Movants made a *prima facie* showing of contractual entitlement to advancement of their attorneys' fees but that an evidentiary hearing was needed to determine whether this relief should be barred on the

[1] Since filing his motion for advancement, Chong has reached a settlement with the Receiver of the claims against him in the HVP Lawsuit, and thus moves [Doc. # 842] to withdraw his motion for advancement. Chong's motion [Doc. # 842] to withdraw is granted, and his motion [Doc. # 703] for advancement is denied as moot.

equitable grounds of unclean hands. The Court held a three-day hearing March 10 through March 12, 2014. For the reasons that follow, the Court concludes that Movants' contractual entitlement to advancement is barred by the doctrine of unclean hands.

I. Facts

The relevant background is set forth in the Court's Preliminary Order and incorporated by reference here. The Court asked the parties to address the following four issues at the evidentiary hearing:

1. The circumstances surrounding the May 2011 transfers that the Receiver contends demonstrate unclean hands.
2. The circumstances surrounding the February 18, 2011 Offshore Fund board resolution, and Movants' contention that this resolution provided authorization for their $2.9 million transfer.
3. Any other communications or transactions that Movants contend demonstrate that the May 2011 transfers were done with consent of fund directors, the Receiver, and/or the SEC.
4. Undertakings and limits on the funds to be advanced, if any, should the Court grant Movants' motions and modify the Asset Freeze Order to provide for such payments.

A. February 2011 Offshore Board Resolution

The February 18, 2011 resolution of the Offshore Fund occurred as Defendant Francisco Illarramendi's fraud was starting to unravel.[2] On January 14, 2011, the SEC commenced this enforcement action against Illarramendi, and the Receiver was appointed on February 3, 2011. After the two largest investors in the Offshore Fund provided notice of their intention to redeem their shares in the capital of the company, HVP Partners was forced to begin the process of winding down the operations of the fund. The February 18, 2011 board resolution provided that the remaining investor shares of the Offshore Fund would be compulsorily redeemed. (*See* Receiver Ex. 5 § 1.1.) The resolution also provided that the Offshore Fund would retain a reserve consisting of 1.5% of the fund's assets to provide for "the Company's liabilities and other contingencies," and which would be returned to investors once the directors determined that it was "no longer required (in whole or part) by the Company." (*Id.* § 3.3.)

The resolution was signed by the Offshore Fund's four directors: Lopez, and three directors from Ogier Fund Services in the Cayman Islands—Evan Burrton, Thomas Parson, and Scott Dakers. Dakers testified that there was never any discussion among the

[2] Highview Point Partners, LLC ("HVP Partners"), was founded in 2004 by Lopez, Luth, and Illarramendi, who also served as its principals and managing members. Chong was the Chief Financial and Chief Compliance Officer. HVP Partners was the investment manager of the Offshore Fund, a hedge fund nominally based in the Cayman Islands (which the Receiver alleges was completely dominated and controlled by HVP Partners, with Lopez as one of its directors). By January 2006, HVP Partners controlled more than $72 million in assets in the Offshore Fund and decided to establish a "master-feeder" structure. To do so, they created the Master Fund, which was incorporated in the Cayman Islands, turned the Offshore Fund into an offshore feeder fund, and created Highview Point L.P., a domestic feeder fund. Lopez was made a director of the Master Fund. (*See* Preliminary Order at 2–3.)

directors of this reserve being used for indemnification and/or advancement of legal fees for HVP Partners and its principals. If Lopez intended that this reserve could be used for such purpose, he did not disclose to his fellow board members his personal interest in the resolution that he voted to approve. In fact, Dakers was not even aware that Lopez and Luth had already retained their own individual counsel.[3] Knowing that the SEC had already commenced an examination of the Funds, Dakers testified that to the extent the reserve would be used to pay for legal fees it would be those of the Funds only, not HVP Partners, in connection with the SEC examination underway.[4]

On the same day that the board resolution was passed, Lopez and Luth wrote a letter to the investors of the Offshore Fund, Master Fund, and Highview Point L.P. (*See* Receiver Ex. 4.) The letter notified investors of the compulsory redemption and explained that 75% of the redeemed assets would be returned to investors by March 2011, and the remaining assets would be liquidated over the course of several additional months in order to maximize investor returns. The letter also explained that the 1.5%

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[3] Dakers was also not aware prior to the attorney retainer and fee transfers that on April 26, 2011 and May 4, 2011 respectively, the Receiver had subpoenaed Lopez and Luth to appear for depositions (in which they both invoked their Fifth Amendment rights and refused to answer questions). (*See* Lopez Dep. Tr. [Receiver Ex. 13]; Luth Dep. Tr. [Receiver Ex. 20].)

[4] A draft of the board resolution initially stated that the reserve would be $3 million, but Dakers suggested that the reserve should instead be expressed as a percentage "as it sounds better." (Luth Ex. 1 at 3.) In a later email Dakers asked about how the $3 million—or 1.5%—reserve had been calculated. Lopez responded that "it seemed like a rational amount to ask from investors based upon potential legal, audit, and other liabilities and contingencies." (*Id.* at 1–2.) In fact, $2.9 million was transferred to law firms for HVP Partners, Luth, Lopez, and Chong.

reserve would be retained "for audit, legal and other potential fees, liabilities and/or contingencies (as provided by the Funds' governing documents)." (*Id.* at 1.)

Dakers testified that the directors reviewed and approved this letter to investors, but he understood the reserve to provide only for the administrative expenses required to wind down the Funds and would only provide for the Funds' legal expenses, not those of HVP Partners or any individuals.

Ultimately, the redemption contemplated by the February 2011 board resolution did not occur. Carl H. Loewenson, Jr. of Morrison & Foerster LLP, counsel for HVP Partners, testified that on March 11, 2011 he notified the SEC of the planned redemption. Within hours he received calls from the SEC and U.S. Attorney's Office objecting to the redemption. On April 11, 2011, HVP Partners entered into a "standstill agreement" with the SEC and the Receiver, which was signed by Loewenson, Luth, and Lopez, in which HVP Partners agreed to suspend its planned redemption and the Funds' assets would remain with their current custodian for thirty days. (Receiver Ex. 12.) Thereafter, the agreement provided that "certain ordinary business expenses will . . . be paid from the Funds." (*Id.*)

Loewenson testified that although the agreement did not specifically reference attorneys' fees, he had telephone conversations with the SEC and Receiver in which he confirmed that "ordinary business expenses" would include Morrison & Foerster's legal fees. Loewenson did not discuss legal expenses for Movants' individual counsel, but believed that at this point the Receiver and SEC were aware that they had each retained individual counsel because the SEC and Receiver were in the process of conducting a thorough onsite examination of HVP Partners and would have seen some of the early

payments of legal fees to Movants' attorneys. Additionally, the Receiver had sent deposition notices to Movants in early April 2011 and had engaged in discussions with their counsel in this time period.

In the intervening months between the board resolution and the May 4 through May 6, 2011 transfers several key events occurred. On March 7, 2011, Illarramendi had pled guilty to criminal charges in the criminal indictment arising out of his fraud. On May 2, 2011, at 1:54 p.m., the SEC emailed a Wells Notice to Loewenson, giving notice to counsel for HVP Partners that the staff of the SEC intended to recommend that the Commission bring an enforcement action against HVP Partners. (*See* Receiver Exs. 15, 25 at 4.) The SEC stated its intent to seek emergency injunctive relief, including an order freezing the assets of HVP Partners and the appointment of a receiver. (Receiver Ex. 25 at 4.) The Wells Notice permitted HVP Partners to make a Wells Submission by May 4, 2011, setting forth its case to the Commission for why proceedings should not be initiated. (*Id.* at 5.)

However, the Funds' directors were not informed of the Wells Notice until 6:57 p.m. on May 4, 2011—after the Wells Submission deadline had passed—when Loewenson emailed them a copy. (*See id.*; Stipulation [Receiver Ex. 51] ¶ 36.) At 7:15 p.m. that same day, Lopez emailed a letter to the other directors of the Funds (Receiver Ex. 23), notifying them that he was resigning effective immediately without explanation.

Loewenson excused his delay in transmitting the Wells Notice to the board because he needed to research an unspecific and privileged legal issue, and he retained the

Cayman Islands-based Appleby law firm for this purpose.[5] Appleby provided Loewenson with the answer to his legal question on May 4, 2011 at 6:40 p.m. and he forwarded the Wells Notice to the directors less than twenty minutes later.

Dakers testified that he did not see Loewenson's email until the morning of the next business day, May 5, 2011, and was shocked and surprised to learn of the Wells Notice. Dakers met with his fellow directors in the Cayman Islands, Parsons and Burtton, and they left a voicemail for Lopez, the remaining director. The following morning, Lopez returned the call with attorneys from Morrison & Foerster on the line. Dakers asked why the directors had not been informed of the Wells Notice until two days after it had been issued but did not recall if Lopez or the attorneys responded. He also asked Lopez why he had just resigned as a director, but Lopez did not respond.

Also on May 6, 2011, HVP Partners filed for bankruptcy (*see* Bankruptcy Petition [Receiver Ex. 35]), which Lopez and Morrison & Foerster did not disclose on the call with Dakers. Dakers only later learned of the bankruptcy via a Google news alert that he had set up for HVP Partners. Lopez also made no mention of the ongoing financial transfers during this call.

B. May 2011 Fund Transfers

Although the parties dispute the propriety of the May 2011 fund transfers, there is no dispute regarding the timing and sequence of the May 2011 transfers, and the parties have entered into a Stipulation of Facts [Receiver Ex. 51] outlining how from May 4, 2011

[5] On May 6, 2011, Luth directed GlobeOp to pay Appleby $10,000 from the Funds, which Loewenson testified was for the services it rendered in connection with this research. (*See* Stipulation ¶ 24; Receiver Ex. 33.)

to May 6, 2011, approximately $2.9 million was transferred from the Amsterdam-based bank account of the Master Fund to HVP Partners' New York-based account and used to reimburse HVP Partners for the payment of various invoices for professional services paid on behalf of Luth, Lopez, Chong, and HVP Partners.

On May 2, 2011, while still a director of the Funds, Lopez received an invoice from Brune & Richard LLP, his counsel at the time which has since been replaced by Robinson & Cole, seeking a balance due of approximately $75,000 and a $100,000 "retainer replenishment." (Receiver Ex. 17; Stipulation ¶ 5.) At 7:17 p.m. that night, Lopez forwarded this invoice to Chong and Luth and directed Chong to process the invoice for payment the following day. (*See* Receiver Ex. 16; Stipulation ¶ 6.) On May 3, 2011, these funds were wired to Brune & Richard from HVP Partners' bank account in two separate transactions. (*See* Receiver Ex. 14; Stipulation ¶¶ 7–8.)

On May 4, 2011, Lopez received another invoice from Brune & Richard, seeking $300,000 as an "advance retainer for legal representation," which was transferred to the firm from HVP Partners' bank account the following day. (Receiver Exs. 26, 14; Stipulation ¶¶ 20–21.)

On May 3, 2011, there were two transfers made from HVP Partners to Luth's counsel at Finn Dixon & Herling LLP: one for $10,417 for an April 14, 2011 invoice, and another for $36,935.52 for a May 3, 2011 invoice. (*See* Receiver Ex. 14; Receiver Ex. 37 at 2.) On May 4, 2011, Finn Dixon sent Luth an invoice, seeking $200,000 as an "additional retainer for legal services," which was paid the following day from HVP Partners' account. (Receiver Exs. 28, 14; Stipulation ¶¶ 18–19.)

On May 4, 2011, HVP Partners transferred $656,803.88 from its bank account to its counsel Morrison & Foerster. (Receiver Ex. 14; Stipulation ¶ 13.) On that same day, Morrison & Foerster sent HVP Partners an invoice for $1.3 million as an "Advance retainer for legal fees" (Receiver Ex. 29; Stipulation ¶ 22), which HVP Partners transferred to the firm on May 5, 2011 (Receiver Ex. 14; Stipulation ¶ 23.) On May 6, 2011, an additional $1,065,000 was transferred to Morrison & Foerster for a May 5, 2011 invoice. (Receiver Exs. 14, 37; Stipulation ¶ 27.)

On May 4, 2011, Luth sent an email to GlobeOp Financial Services—the Funds' administrator—copying Lopez and Chong in which he instructed the Master Fund to reimburse HVP Partners for $466,153.84, which was 50% of the professional fees paid that day. (Receiver Ex. 24; Stipulation ¶ 14.) Later that morning Luth emailed a wire authorization form for $466,154.17 to GlobeOp, copying Lopez and Chong, approving the transfer of funds from the Master Fund to HVP Partners. (Receiver Ex. 22; Stipulation ¶ 15.) Luth sent additional wire authorizations to GlobeOp for transfers from the Master Fund to HVP Partners—copying Lopez and Chong in each instance—on May 5, 2011 for $1,050,000 (Receiver Ex. 31; Stipulation ¶ 16) and May 6, 2011 for $1,400,000 (Receiver Exs. 33–34; Stipulation ¶¶ 24–25.)

From May 4 to May 6, 2011, the total transfers for legal fees from HVP Funds was: $475,275.08 to Lopez's counsel at Brune & Richard; $247,352.52 to Luth's counsel at Finn Dixon; $322,473.80 to Chong's counsel at Cowdery, Ecker & Murphy; and $3,021,803 to HVP Funds' counsel at Morrison & Foerster. From February 18, 2011 through May 6, 2011, HVP Funds paid out approximately $5.29 million in professional fees, a total of

approximately $3.16 million from the Master Fund and $2.14 million from existing funds in the HVP Partners' bank account. (Stipulation ¶ 33.)

C. Reaction to the May 2011 Transfers

Dakers testified that he did not learn of the transfers until the end of May or the start of June 2011 and believed that he first heard about them in a court proceeding.[6] Dakers testified that he was very surprised to learn about both the nature of the transfers and their timing—coming in the days just after the SEC issued the Wells Notice but before the board had been informed of it. Dakers believed that under the terms of the Investment Management Agreements ("IMAs") between the Funds and HVP Partners—which provided that "the Fund[s] shall, upon request of an Affiliated Party, advance amounts in connection with its indemnification obligation" (Receiver Exs. 1–2 § 7)—indemnification and advancement would only be paid to HVP Partners after a written request was made to the Funds' directors and their approval was given. Dakers also testified that he did not believe that the language of the IMAs authorized advancement for retainers rather than reimbursement for legal expenses already incurred.

On the afternoon of May 5, 2011—the day on which Dakers first saw the Wells Notice and Lopez's letter of resignation—he called and then emailed the Funds' administrator, GlobeOp, instructing them that no payments were to be made from the Funds' bank accounts without prior approval from the board of directors in order to comply with a possible enforcement action by the SEC. (Receiver Ex. 32.) On May 10, 2011, the remaining directors of the Master Fund passed a resolution revoking HVP

[6] The transfers were discussed during a May 27, 2011 hearing before the Court. (May 27, 2011 Hr'g Tr. [Doc. # 275] at 27.)

Partners' signing authority on the Fund's bank account. (Receiver Ex. 36.) On May 12, 2011, the Court entered a temporary restraining order [Doc. # 200], freezing HVP Partners' assets.

In May 2011, the Funds retained Schulte Roth & Zabel LLP as their U.S.-based counsel. Michael E. Swartz, a partner at Schulte Roth, testified that he first learned of the fund transfers at the end of May or beginning of June during an evidentiary hearing before the Court. On June 17, 2011, the Funds' Cayman Island-based counsel, the Ogier firm, wrote to Loewenson, demanding an explanation for the May 2011 transfers. (Receiver Ex. 37.) The Receiver also questioned Loewenson about the transfers, and on June 21, 2011, Loewenson sent a response to the Receiver and Ogier, outlining the legal basis for the transfers.[7] (Receiver Ex. 38.) On July 6, 2011, the Receiver sent identical letters to counsel for Lopez, Luth, and Chong, informing them that they were not authorized to pay Movants' legal fees by drawing down on the retainers that they had received from the May 2011 transfers. (Receiver Exs. 41–43.)

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[7] In December 2011, the Receiver entered into a confidential settlement with Morrison & Foerster in which the firm was permitted to keep a portion of the funds that it received in the May transfers. (Stipulation ¶ 35.) Movants contend that they are in the same position as Morrison & Foerster, which received money from the disputed transfers and has been permitted to retain a portion of the funds. However, a settlement does not necessarily represent an endorsement of a party's conduct, but can instead be the result of a calculation of litigation risks and costs and a determination that settlement is in a party's best interest. Accordingly, the Court concludes that the Morrison & Foerster settlement has no bearing on the issues to be addressed in this ruling. Further, Morrison & Foerster as counsel to the HVP Partners stood in a different position than individual counsel for Movants, as in addition to the indemnification and advancement provisions, the IMA provided that the legal, audit, and accounting expenses for HVP Partners—without mentioning its principals and employees—would be paid by the Funds. (Receiver Exs. 1–2 § 3.)

On August 12, 2011, Swartz wrote letters to Movants' counsel informing them that the "Funds intend to advance indemnification payments, as appropriate, pursuant to the terms of the IMA," but demanding that each of the firms first "immediately return" all amounts that HVP Partners had advanced to them from the Funds. (Receiver Exs. 46–48.) Swartz testified that he agreed with Movants that the IMAs authorized advancement of legal fees to counsel for HVP Funds and Movants, but the IMAs required that Movants first make a request to the Funds' directors, who had a fiduciary duty to review the claims and non-privileged billing records to determine whether advancement was appropriate. Swartz testified that after sending this letter, he had a telephone conversation with Luth's counsel, Alfred U. Pavlis of Finn Dixon, who said that he would not return the money, because he was concerned that due to the Asset Freeze Order, the Funds would not be able to disburse legal expenses.

After the Receiver filed the HVP Lawsuit in February 2012, Pavlis sent a letter to Swartz, dated February 17, 2012, in which he wrote, "[p]ursuant to our recent conversations, this letter will serve to confirm Mr. Luth's request for indemnification, including ongoing advancement of legal fees." (Receiver Ex. 49 at 1.) Pavlis "propose[d]" that Finn Dixon "continue to bill against the retainer" of $400,000 that it received in April and May of 2011." (*Id.* at 2.) Pavlis wrote that "[b]ased on our recent conversations, I understand that you will review this proposed approach with the [Master Fund] Board and, if it is not acceptable or there are any issues, you will promptly let me know." (*Id.* at 2.) While Swartz testified that Pavlis' letter did not accurately reflected any agreement between them for Finn Dixon to continue drawing down against the retainer, he acknowledged that he had never responded to Pavlis to correct any misunderstanding.

Swartz explained that he was frustrated that Movants continued to refuse to return the funds and that Pavlis' letter was so inconsistent with their conversations, but at that time he was focused on proceedings to expand the Receivership to include HVP Partners, which occurred on March 1, 2013 when the Court entered the latest version of the Receiver Order [Doc. # 666].

Loewenson testified that it was his idea to have Luth and Lopez submit the invoices for advancement of their legal expenses to GlobeOp.[8] Pavlis testified that Luth played no role in Finn Dixon's decision to invoice him for an additional retainer in May 2011 and noted that Finn Dixon received its first retainer of $200,000 in April 2011 well before the disputed transfers.[9] After the Receiver and the Funds started to dispute the

[8] Movants have expressly declined to advance an advice-of-counsel defense, which would trigger a partial waiver of the attorney-client privilege. Accordingly, there is no evidence in the record regarding the critical questions of whether Loewenson's "idea" was communicated to Luth and Lopez, if they acted in good-faith reliance on it, why he had this "idea" for Lopez and Luth, and the timing of his "idea" in relation to the Wells Notice. Although Movants ask the Court to infer that Movants did not make the decision to transfer the funds, doing so would allow them to "unfairly use [their] privilege as a sword and a shield by relying on advice provided by counsel while simultaneously refusing to disclose the full content of this advice to an adversary." *Aristocrat Leisure Ltd. v. Deutsche Bank Trust Co. Americas*, No. 04cv10014 (PKL), 2009 WL 3111766, at *16 (S.D.N.Y. Sept. 28, 2009). As Movants have declined to advance this defense with its resulting waiver of privilege, the Court declines to speculate regarding what advice Loewenson provided to Movants regarding their individual counsel and why. As to the transfers to Morrison & Foerster, Loewenson testified that they were made in anticipation of HVP Partners filing for bankruptcy, because he had been advised by bankruptcy practitioners that it was advisable to avoid becoming a creditor of his client, potentially creating a conflict of interest.

[9] Neither Lopez nor his counsel testified regarding any efforts to request advancement or to negotiate whether counsel could draw down upon the funds received in the May 2011 transfers.

transfers in June 2011, Pavlis wrote a letter to the Receiver, dated June 30, 2011 "to advise" that he "will continue to draw down on" the retainer paid to Finn Dixon "until such time as Mr. Luth no longer requires representation" in "the ongoing investigations of [HVP Partners] and related parties." (Luth Ex. 11.) On July 6, 2011, the Receiver responded that he did "not authorize" the use of the retainer to pay Luth's legal expenses. (Receiver Ex. 41.)

Pavlis acknowledged that he did not respond to this letter by the Receiver and never sought specific authorization from the SEC or the Court to draw down against the retainer beyond his disclosure that he intended to do so. From December 2012 through March 2013, Pavlis did make repeated requests to the Receiver and Schulte Roth for advancement pursuant to the terms of the IMAs, but they either "ignored or deflected" the prior requests. (Luth Ex. 5 at 1; *see also* Luth Exs. 2–4, 6–11.) Pavlis testified that he was willing to comply with Swartz's August 2011 letter demanding repayment to the Funds of the retainer (Receiver Ex. 48), but only if there was a stipulation signed by the Receiver and the SEC and approved by the Court confirming that Luth's attorneys' fees could be paid under the Asset Freeze Order—similar to that entered by the Court [Doc. # 284] in June 2011 authorizing the payment of fees to Schulte Roth. Despite his repeated efforts to effect such an agreement, the SEC and Receiver would not consent.[10]

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[10] In a November 22, 2011 email Pavlis asked Swartz if he had "made any progress with the SEC and the receiver on the advancement/stip we discussed?" (Luth Ex. 8.) Swartz did not respond until one month later, reporting that the SEC was unwilling to consent to amending the Asset Freeze Order. (*Id.*)

II. Discussion

As set forth in the Preliminary Order, the Court has already determined that under the IMAs, Movants have a contractual right to receive advancement of their legal expenses. The question remaining is whether despite this qualified contractual entitlement, advancement should be barred due to Movants' inequitable conduct "in making the advancement claim itself" by engaging in self-help or other inequitable conduct. *Tafeen v. Homestore, Inc.*, No. 023-N, 2004 WL 556733, at *6 (Del. Ch. Mar. 22, 2004); *see also Nakahara v. NS 1991 Amer. Trust*, 739 A.2d 770, 791 (Del. Ch. 1998).

A. Unclean Hands

The doctrine of unclean hands is "a self-imposed ordinance that closes the doors of a court of equity to one tainted with inequitableness or bad faith relative to the matter in which he seeks relief, however improper may have been the behavior of the defendant. That doctrine is rooted in the historical concept of [the] court of equity as a vehicle for affirmatively enforcing the requirements of conscience and good faith." *Precision Instrument Mfg. Co. v. Auto. Maint. Mach. Co.*, 324 U.S. 806, 814 (1945) (internal quotation marks omitted). The doctrine is intended in part to protect the integrity of the judicial process and is applied against "a litigant whose acts threaten to tarnish the Court's good name." *Nakahara*, 718 A.2d at 522. "It is undisputed that an unclean hands defense requires a finding of bad faith." *Obabueki v. Int'l Bus. Machines Corp.*, 145 F. Supp. 2d 371, 401 (S.D.N.Y. 2001). As "an unclean hands defense is an affirmative defense," the Receiver bears "the burden of proof." *Tafeen v. Homestore, Inc.*, CIV.A. 023-N, 2004 WL 1043721, at *1 (Del. Ch. Apr. 27, 2004).

The overall purpose of the unclean hands doctrine is to secure justice and equity and avoid rewarding inequitable conduct; it is not intended as a punishment for wrongful conduct. *See Keystone Driller Co. v. Gen. Excavator Co.*, 290 U.S. 240, 245 (1933) ("[Courts] apply the maxim, not by way of punishment for extraneous transgressions, but upon considerations that make for the advancement of right and justice."). Accordingly, courts have broad discretion in their application of the unclean hands doctrine, and "are not bound by formula or restrained by any limitation that tends to trammel the free and just exercise of discretion." *Id.* at 245–46; *see also Nakahara*, 718 A.2d at 522 ("[T]he decisional authority is almost universal in its acceptance that courts of equity have extraordinarily broad discretion in application of the doctrine."); 27A Am. Jur. 2d Equity § 98. In determining whether to apply the unclean hands doctrine, the Court may also consider whether doing so would frustrate other public policy considerations. *See S.E.C. v. Electronics Warehouse, Inc.*, 689 F. Supp. 53, 73 (D. Conn. 1988) (citing *Pan American Co. v. United States,* 273 U.S. 456, 506 (1927)).

Here such considerations include the strong public policy of Delaware law, which governs the IMAs, in favor of indemnification and the advancement of attorney's fees. *See VonFeldt v. Stifel Fin. Corp.*, 714 A.2d 79, 84 (Del. 1998) ("We have long recognized that Section 145 serves the dual policies of: (a) allowing corporate officials to resist unjustified lawsuits, secure in the knowledge that, if vindicated, the corporation will bear the expense of litigation; and (b) encouraging capable women and men to serve as corporate directors and officers, secure in the knowledge that the corporation will absorb the costs of defending their honesty and integrity.").

However, a countervailing consideration is the goal of this equity Receivership to maximize recovery for the victims of Illarramendi's fraud, and the Court has broad discretion in determining whether in light of this goal it is appropriate to modify the Asset Freeze Order. *See S.E.C. v. Prater*, 296 F. Supp. 2d 210, 218–19 (D. Conn. 2003) ("The Second Circuit has established that in considering whether to unfreeze assets frozen in securities fraud proceedings, 'the disadvantages and possible deleterious effect of a freeze must be weighed against the considerations indicating the need for such relief.'" (quoting *S.E.C. v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1106 (2d Cir. 1972))).

Counsel for the Receiver argues that it has met its burden of demonstrating that Luth and Lopez should be barred from relief due to their bad faith and misconduct. He contends that the evidence demonstrates that Movants surreptitiously rushed to provide for their own personal legal defense as the SEC and the Receiver were closing in on HVP Partners. The Receiver illustrates its proof of the haste, noting that the transfers largely occurred during the two-day period between when HVP Partners received the SEC's Wells Notice and when the Funds' directors, other than Lopez, were notified. The Receiver also points to what he calls a deliberate choice of Luth and Lopez not to make a request for advancement as was contractually required, because doing so would raise red flags and such requests would likely be denied since the SEC and Receiver were poised to freeze the assets of and take over administration of the HVP entities.

Lopez and Luth generally advance identical arguments to each other in favor of advancement. They contend that the evidence demonstrates that they acted in good faith under a well-established course of dealings with the directors in which HVP Partners as

the investment manager was delegated plenary authority for day-to-day operations of the Funds, and GlobeOp had day-to-day authority over administrative matters, such as paying invoices that HVP Partners submitted. They contend that the Cayman Islands-based directors from Ogier were merely "professional fiduciaries," who as Dakers testified, at any given moment might be serving as directors for up to fifty different hedge funds, and who acquiesced in allowing HVP Partners to assume governance functions that might normally belong to the board.

Movants also contend that these directors failed in their duty of inquiry despite ample signs of problems at the Funds and HVP Partners. In support of this argument, Movants note that the directors did not contact GlobeOp to reassert director control over the Funds' accounts until May 5, 2011, well after a number of events occurred which should have raised concerns: the SEC complaint against Illarramendi in January 2011, the February 2011 appointment of the Receiver, Illarramendi's March 2011 guilty plea to criminal fraud charges, and the April 2011 standstill agreement between the SEC and HVP Partners. Finally, Movants contend that given that the IMAs provide for an unconditional contractual right of advancement, they acted in good faith in believing that they were authorized to make such payments under the terms of the February 2011 board resolutions and the standstill agreement with the SEC.

The plain language of the Funds' IMAs makes clear both that Movants have a right to advancement of their legal fees, but that in order to exercise this right they had to make a "request" to the Funds. The Receiver, Dakers, and Swartz contend that this "request" had to be to the Funds' directors. Movants contend that the directors delegated this authority to them or alternatively that the February 2011 board resolution authorized

the payments or that the wire authorizations submitted to GlobeOp were sufficient to comply with the "request" requirement.

Even assuming that Movants' litigation defense expenses qualify under the February 2011 board resolution as legal fees or contractual liabilities of the Funds (*see* Receiver Ex. 4 at 1; Receiver Ex. 5 at 2), nothing in the board resolution purported to authorize the payment of such expenses to Movants, without a separate request to the Funds' board, much less permitted them to unilaterally "advance" amounts from the Funds for themselves. Each of the IMAs provides that the "Fund *shall*, upon *request* of an Affiliated Party, advance amounts in connection with its indemnification obligation . . . ." (Receiver Exs. 1–2 § 7 (emphasis added).) Movants' contention that advancement does not require any board notice or approval is untenable. The broad language in the IMAs that seemingly leaves no room for director discretion in providing Movants advancement (*see id.* ("[T]he fund shall . . . .")) is squared with the concurrent need for director approval because despite this broad language there are several limitations on advancement. First, as stated in the IMAs, indemnification and advancement can only be permitted "to the fullest extent legally permissible under the laws of the State of Delaware." (*Id.*) Second, Movants are only entitled to have the Funds advance legal fees for matters arising "in connection with the good faith performance [of their] responsibilities to the Fund." (*Id.*)

Third, although the Delaware Supreme Court has approved of contracts broadly requiring a corporation to advance litigation expenses to corporate officers even in suits brought by the corporation itself, the "corporation's obligation to pay expenses is subject to a reasonableness requirement." *Citadel Holding Corp. v. Roven*, 603 A.2d 818, 823 (Del. 1992). Thus, despite the broad contractual right to advancement accorded to Luth and Lopez, the directors were still required to exercise their business judgment to ensure compliance with the minimal requirements of reasonableness and that the money to be advanced was related to Movants' service to the Funds.[11] *See Pearson v. Exide Corp.*, 157 F. Supp. 2d 429, 437 (E.D. Pa. 2001) ("Delaware courts have consistently found that a corporation may bind itself in advance, through its bylaws or by contract, to advance the costs of litigation incurred by present or former directors or officers," but a proper request must be submitted allowing the corporation "an opportunity to review those invoices and, in the event that [the corporation] finds, in good faith, particular litigation expenses which are unreasonable, they can file objections to those specific unreasonable expenses.").

It defies common sense that good-faith notions of proper corporate governance could have been contemplated by Movants—principals of the Funds' investment manager under investigation by the SEC, federal prosecutors, and the Receiver for complicity in Illarramendi's fraud against the Funds' investors—and that they could have thought that

[11] While Movants contend that the submission of invoices to GlobeOp satisfied the "request" requirement, as Movants acknowledged during the hearing, GlobeOp's role was administrative in nature and there is no evidence that the Funds' directors intended to—or even could have consistent with their fiduciary duties—delegated such substantial responsibility for exercising business judgment to GlobeOp.

they were empowered to transfer the Funds' financial resources to HVP Partners' bank account to defend themselves without any disclosure or permission from the Funds' directors.

Lopez, who was simultaneously serving as a director for the Funds, has a particularly untenable argument in this regard. To the extent that Lopez contends that the February 2011 board resolution authorized the payment of his attorneys' fees without the need for a request or review by the Funds' directors, he provides no explanation for his failure to disclose to the other directors of the Funds that he had a substantial personal stake and thus conflict of interest in voting in favor of that resolution. Although Luth was not a director of the Funds, as a principal of the investment manager to the Funds, he was an agent and likewise owed the Funds a fiduciary duty, *see Sci. Accessories Corp. v. Summagraphics Corp.*, 425 A.2d 957, 962 (Del. 1980) ("[A]n agent owes his principal a duty of good faith, loyalty and fair dealing."), and he never disclosed his conflict of interest in making these transfers for his personal benefit ostensibly during the course of his agency, *see id.* ("Encompassed within such general duties of an agent is a duty to disclose information that is relevant to the affairs of the agency entrusted to him."). Thus, if Movants' contention were to be credited that their course of dealings with the board in combination with the February 18, 2011 resolution led them to the good-faith conclusion that they were authorized to reimburse HVP Partners for contractually mandated expenses and obligations and to stockpile their legal retainers without explicit approval, they provide no explanation for their failure to disclose to the directors their substantial conflict of interest regarding these self-dealing transactions. While the failure to comply with corporate formalities on its own would not necessarily demonstrate unclean hands,

here the undisclosed self-dealing is not consistent with a good-faith misunderstanding particularly under the circumstances of the imminent storm heralded by the Wells Notice.

A related and further troubling factor is the failure of HVP Partners to transmit the Wells Notice to the Funds' directors for two days while these monetary transfers were occurring. Loewenson explained that this delay was due to the need for legal research, although the issue remained privileged and could not be explored. Even if an unresolved legal question justified withholding from the Funds' directors the existence of the Wells Notice, Movants provided no explanation for why the monetary transfers needed to occur before the directors were notified that the Funds' investment manager faced an imminent SEC enforcement action for securities fraud and that the Funds were to be named as relief defendants.[12] (*See* Receiver Ex. 25.)

Finally, Movants argue that even if they should have made requests to the directors before taking advance payments, there is no evidence that they engaged in intentionally deceitful or unconscionable conduct that should bar them from receiving their contractual right to advancement because the paper trail associated with the monetary transfers was transparent, showing that they did not attempt to conceal their

[12] There is no record evidence documenting when Luth and Lopez learned of the Wells Notice. They did not testify at the hearing. Nevertheless, given that HVP Partners largely consisted of just Luth, Lopez, and Chong at this time, it stands to reason that they, as the principals of HVP Partners, were made aware of the Wells Notice as soon as Morrison & Foerster received it even if the information was withheld from the Funds' directors. Lopez and Luth were both copied on Loewenson's May 4, 2011 email in which he finally sent the Wells Notice to the directors (Receiver Ex. 25), and when Lopez responded to Dakers on May 6, 2011, he was joined by attorneys from Morrison & Foerster.

actions.[13] They contend that the requests for transfers were submitted to GlobeOp for payment with supporting documentation showing the nature of the payments and complying with the established delegation of authority from the directors to GlobeOp and HVP Partners. They contend that in applying the unclean hands doctrine, the Court should balance the equities and look to not only their misdeeds but also the evidence of their good faith. In particular, they note that HVP Partners voluntarily disclosed to the SEC the earlier-planned share redemption, and that Loewenson negotiated with the SEC the standstill agreement providing for payment of "ordinary business expenses" (Receiver Ex. 12), which Loewenson testified he orally confirmed included Morrison & Foerster's fees and which the Receiver and SEC should have known also would have included Movants' individual counsel's fees.

Movants' claim of good faith is undermined by the record evidence that they exploited ambiguities in the standstill agreement with the SEC and the February 2011 board resolution to their favor rather than confirming their assumed understanding.[14] While unlike in *Nakahara*, 739 A.2d at 774, there was no court order yet in place that prohibited the transfer of funds, after the Wells Notice, Movants acted with knowledge that an asset freeze was imminent and the record suggests that they raced while they could to engage in undisclosed self-dealing transactions to provide for their own personal

[13] In his closing argument counsel for Lopez invoked the maxim "no harm, no foul," contending that because Movants are entitled to advancement—as determined by the Court in the Preliminary Order—no harm arose from the transfers. In *Nakahara*, the court rejected "the familiar 'no harm, no foul' argument." 739 A.2d at 791.

[14] Their conduct contrasts unfavorably with Schulte Roth & Zabel, which obtained an order [Doc. # 284] from the Court specifically authorizing the payment of their attorneys' fees and the Funds' ordinary business expenses after review by the SEC.

interests without seeking approval from the Funds' directors, the Receiver, the SEC, or the Court (until they had nearly exhausted the $2.9 million reserve).

Further, although Loewenson testified that the transfers were his "idea" and Pavlis testified that Luth played no role in seeking invoices from Finn Dixon, Movants have not advanced the argument that they acted on the advice of counsel and the record is clear that they had ample personal involvement in and knowledge of the transfers. On May 2, 2011, Lopez emailed Chong, copying Luth, the $175,000 invoice from Brune & Richard and directed him to process it for payment on the following day. (Receiver Ex. 16.) Luth requested each of the five transfers in emails to GlobeOp and copied Lopez on each of these communications from May 4 through May 6, 2011. (Receiver Exs. 24, 22, 31, 33, 34.) Additionally, shortly after the transfers were discovered, Movants refused to return the funds once counsel for the Funds and the Receiver dispelled any potential ambiguities and asserted that the transfers were not authorized. Thus, even if the transfers had been the result of a good-faith misunderstanding, once that misunderstanding was corrected, Movants did not act to reverse their actions and drew down those retainers after being expressly told that doing so was not authorized.

Accordingly, the Court concludes that the Receiver has demonstrated by a preponderance of the evidence that Movants lacked clean hands when they transferred the Funds' money to HVP Partners' accounts to reimburse the cost of their individual legal fees, and equity requires that the further advancement that Movants request be barred. The Receiver does not ask the Court to order Movants to return the money that they have already transferred to their attorneys, and at this time, the Court will not require them to return any unused retainers—which by this point are likely exhausted.

While the determination at this time that Movants are not entitled to advancement of their fees does not preclude Movants from seeking indemnification for such expenses in the event that they prevail in *Carney v. Lopez, et al.*, No. 3:12-cv-00182 (SRU), *see Nakahara*, 739 A.2d at 795 ("My determination that plaintiffs are not entitled to *advancement* has no bearing on plaintiffs' ability to seek and obtain *indemnification.*"), but because Movants have come to the Court with unclean hands in the contractual advancement process itself, the Court cannot in good conscience ratify their misdeeds after the fact by authorizing additional advancement of their fees from funds otherwise reserved for payment to investment-fraud victims.

III. Conclusion

For the reasons discussed above, the motions of Luth [Doc. # 700] and Lopez [Doc. #705] for advancement are DENIED. Chong's motion [Doc. # 842] to withdraw his motion [Doc. # 703] for advancement is GRANTED, and his motion [Doc. # 703] for advancement is DENIED as moot.

IT IS SO ORDERED.

/s/

Janet Bond Arterton, U.S.D.J.

Dated at New Haven, Connecticut this 27th day of March, 2014.