Hedge Funds Become Latest Target for Whistleblowers: $40 Million Settlement in Tax Case Demonstrates Broad Reach of New York's False Claims Act

Fittingly, on "Tax Day" 2017, the New York Attorney General announced a $40 million settlement based on taxes allegedly avoided by members of Harbinger Capital Partners Offshore Manager LLC ("Harbinger"), a hedge fund investment manager operating in New York City. While the settlement amount itself was record breaking, the underlying source of liability – New York's state false claims act, N.Y. State Finance Law §§ 187 *et seq.* ("NYFCA") – was highly unusual as well. Until now, most civil enforcement actions extracting massive settlements from financial industry companies for fraud allegations unrelated to the securities laws have been the exclusive province of the United States Department of Justice and whistleblowers – referred to as "*qui tam* relators" – using the federal False Claims Act ("FCA"), 31 U.S.C. §§ 3729–3733, and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), 12 U.S.C. § 1833a. This latest action, which relied on state tax laws as the basis for the fraud claim, may usher in a whole new wave of potential liability against hedge funds and similar businesses.

Background of Federal and State False Claims Acts

The federal FCA creates liability for businesses and individuals who make (or cause to be made) false claims for payment of government funds or who make false statements in order to avoid an obligation to pay the government. Strengthened by its *qui tam* provision, which allows and incentivizes private parties to sue in the name of the United States by rewarding them with a percentage of the overall recovery, the Justice Department has recovered more than $22.8 billion in FCA cases over the past five years. But, for all of its power, the federal FCA does not authorize actions to enforce the tax laws. Likewise, the majority of states and municipalities with false claims acts – many of which enacted their own laws patterned after the federal FCA – have the same tax liability carve-out as the federal FCA (although a handful of states do not include an express carve-out and a few additional states have only a partial carve-out). However, New York is a notable outlier, having amended the NYFCA in 2010 to specifically allow actions based on state tax liability. *See* Fried Frank FraudMail Alert No. 10-08-26. And other jurisdictions have taken notice of New York's success with its amended statute, as earlier this year both Michigan and the District of Columbia had bills introduced that specifically would allow for false claims act tax liability. While the NYFCA places some modest limitations on tax-based false claims suits – such as requiring (1) the defendant to have at least $1 million in net income for the tax year in question and (2) alleged damages in excess of $350,000 – these gatekeeping standards (which were included in the Michigan and the District of Columbia bills as well) are not likely to hinder state *qui tam* enforcement actions against most hedge funds, financial institutions, and their principals.

A finding of liability under either the federal or most state/municipal false claims acts imposes mandatory treble damages – *i.e.*, three times the losses sustained because of the violation – plus civil penalties (currently $10,957 – $21,916 for each false claim under the federal FCA). In both federal and state/municipal false claims act jurisdictions, private enforcement by *qui tam* relators is the norm, with relators filing suit under seal in the hopes that a government investigation will lead to government intervention in the suit, a substantial monetary recovery, and a hefty bounty for the relator. Even if the government does not intervene, the relator can continue to pursue the action in the name of the government, in pursuit of an even higher percentage recovery in the event of judgment or settlement. The *Harbinger* settlement, for example, provides for a relator award of $8.8 million (plus attorneys' fees and costs), representing more than 20% of the total settlement proceeds.

The *Harbinger* Suit and Settlement

In *State ex rel. Doe v. Harbinger Capital Partners Offshore Manager LLC*, No. 100416/2015 (N.Y. Sup. Ct.), a *qui tam* relator (not yet publicly identified) brought suit under the NYFCA alleging that the members of the investment manager for the hedge fund Harbinger Capital Partners Master Fund I Limited failed to pay New York state and city taxes on a portion of their income. *See* Stipulation & Settlement Agreement (Apr. 3, 2017).

According to the complaint, an investment management company headquartered in Alabama, Harbert Management Corporation, sponsored and organized the Harbinger hedge fund, which focused on "distressed investments." The hedge fund had separate "feeder funds" for onshore and offshore investments, and Harbinger – a Delaware limited liability company – was the investment manager of both the hedge fund and its offshore feeder fund. Harbinger, which acted as a pass-through entity for performance fee income earned based on the profits of the feeder fund, had several members resident in Alabama and an office in Alabama that provided middle and back office support. But Harbinger's primary decision-maker for the hedge fund's investment strategy was resident in New York City, and Harbinger conducted all significant trading activity out of offices in New York City, the location identified as the "principal office" of Harbinger in its founding documents. Based on these allegations, the suit claimed that the members of Harbinger should have paid New York taxes on performance fee income, which would not have been earned but for this New York activity.

According to the allegations, Harbinger's chief administrative officer, resident in Alabama, disregarded accounting advice that New York taxes would be due, including by not apportioning any income to New York, listing only the Alabama office address on Harbinger's "partnership" returns, and failing to file other state returns over a six-year period. In this way, Harbinger allowed its individual members to take advantage of Alabama's lower tax rate and avoid New York taxes.

The settlement resolves civil claims against Harbert Management Corporation, Harbinger's chief administrative officer, and the Alabama-based members of Harbinger. However, no claims against Harbinger or non-Alabama-based members of Harbinger have been released as part of this settlement. The New York Attorney General's investigation is ongoing, and the settlement requires each of these settling entities and individuals to cooperate in that investigation. As is common in federal and state FCA settlements, there is no release of criminal liability.

Key Takeaways

First, while the *Harbinger* settlement is notable for its substantial recovery on a tax evasion theory, it should be seen as a continuation of the recent trend in enforcement actions against financial companies. In the years since the financial crisis, federal and state governments increasingly have used the tools available to them under civil fraud statutes to investigate and extract large recoveries for alleged financial fraud. For example, the Justice Department has used the federal FCA to pursue a variety of financial industry defendants, from mortgage lenders to recipients of federal bailout monies. In addition, the Justice Department began using the civil penalties provisions of FIRREA – after years of dormancy – to pursue large recoveries from banks, credit rating agencies, and others for conduct "affect[ing] a federally insured financial institution." *See, e.g.*, Douglas W. Baruch et al., FIRREA Enforcement Trends, 31 Rev. of Banking & Fin. Servs. 131 (Dec. 2015).

Second, the cooperation provision in the *Harbinger* settlement is similar to the cooperation provisions incorporated into federal FCA and FIRREA settlements as a result of recently adopted Justice Department policies for holding individuals accountable, "particularly in the aftermath of the financial crisis." *See* Deputy Att'y Gen. Sally Quillian Yates Memorandum for Dep't of Justice, Individual Accountability for Corporate Wrongdoing (Sept. 9, 2015).

Third, entities and individuals alike may not previously have considered the prospect of federal or state/municipal false claims act or FIRREA liability for their activities, but now, more than ever before, should educate themselves, including about the lengthy statutes of limitations associated with these potential sources of liability, and ensure that their compliance policies and programs are both current and broad enough to cover such potential liability.

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