

Stop Press - Surviving the collapse of a hedge fund

20 FEBRUARY 2008

CATEGORY:
ARTICLE

Introduction

Hedge funds are reporting steep losses and falling asset values. This will no doubt prompt a rush to exit by their stakeholders and investors, forcing fire sales of assets to raise cash to meet redemption requests. This in turn will cause a number of investors to seek to redeem their interests in the funds. The funds can either suspend redemptions or sell assets at depressed prices to meet these redemption requests.

Therefore, stakeholders, creditors, directors, fund managers, and functionaries of the funds – such as the administrator, prime broker and custodians – should be considering their position. This requirement applies equally to trustees who have made investments either directly or through an investment manager into such an investment scheme.

Usually hedge funds have the right to restrict redemptions to ensure their survival and to avoid a collapse, but such action is likely to have an adverse affect on stakeholders who need to be aware of their rights in such situations.

Tension often arises between the hedge fund manager's interests and those of investors. The way in which hedge funds remunerate the managers may encourage extreme risk taking in order to recover the losses or in some extreme cases cheating or fraud.

As this paper explains, stakeholders and functionaries alike need to be fully aware of their rights and remedies.

Structure and regulation

London is the leading centre of fund expertise in Europe and according to Hedge Fund Intelligence the value of assets managed by UK fund managers exceeds US\$316billion. It is estimated that there are over 300 specialist hedge fund managers and over 79 mainstream asset managers who are managing funds and using hedge fund style strategies.

Three out of four hedge funds globally are incorporated in the western Caribbean Islands.

Common hedge fund structures involve a combination of entities, of varying legal forms, located in a mixture of onshore major financial centres and offshore low tax jurisdictions with light regulatory regimes.

The optimal location and form of each entity within the structure are often determined by factors such as tax efficiency, proximity to the markets, and the appropriate regulatory regime. In the case of a typical UK managed hedge fund the structure usually comprises:

- The fund manager or adviser located in the UK and authorised and supervised by the Financial Services Authority (" FSA") (commonly there will be an offshore manager which delegates the fund management to a UK manager);
- Prime Brokers based in London to execute the trades, for financing, stock lending, repo and derivative transactions;
- Funds often in non-UK territories such as Cayman, British Virgin Islands or Bermuda;
- Administrators often based offshore mainly in Ireland, Luxembourg, Cayman or British Virgin Islands.

However, the UK's regulatory system in effect precludes the sale of hedge fund products directly to retail clients, and they can only be sold to sophisticated investors. Consequently, hedge funds and their managers are generally subject to a light-touch regulatory framework. They may not have detailed compliance procedures in place, which could give rise to competing interests of the managers, directors and the investors. In addition there may not be adequate reporting of trades and provision of financial information in place. This is a significant concern for all investors, creditors and stakeholders.

In addition, the FSA does not currently regulate the hedge funds themselves in the UK; most of them are domiciled overseas. It is therefore incumbent upon the investors in turbulent times to monitor their investments in hedge funds carefully and to seek the appropriate legal and regulatory advice in a timely manner.

In the event of market instability where a fund, or quite often a group of highly geared hedge funds, finds itself in a distressed situation the managers or lenders may seek to limit their losses, which will result in immediate large-scale realisations. If the realisations are in an illiquid sector this could have a knock-on effect and drive down the net asset values in that sector. As seen recently, this causes market disruption and a loss of market confidence.

Creditors and stakeholders of the same standing need to ensure that the strict principle of pari passu sharing is observed. This ensures that all investors are treated equally and have available the same information, with no one investor being afforded preferential redemption terms compared with others in the same share class. The employment of “side letters” by some hedge funds (often to the larger investors) may have eroded this fundamental principle.

Recent events

As we have all seen in the financial press, the collapse of hedge funds and the resulting fallout are becoming more frequent, affecting not only large financial institutions but all other stakeholders, functionaries, directors and employees. We are clearly not out of the woods yet. It is important at such times to be able to call upon the right people who can advise and act quickly to protect your interests and interact with other professionals, especially insolvency practitioners.

Issues

The most common claims made by investors are:

- having been deceived about the value of assets;
- inaccurate industry specific data which influenced their decision to invest and skewed the rates of return;
- allegations against a fund manager that he misled them about exposure to the mortgage-backed securities market or to another type of investment which has failed or under-performed.

Material mis-statements in the offering documents may give rise to claims against the fund manager.

It may be possible to hold investment banks that securitised the mortgages or other receivables at least partially responsible, in the case of a major collapse of the market, for failure to disclose material facts about the credit quality of the mortgages or assets receivable.

Possible actions by the liquidator on behalf of the stakeholders against the directors may include breach of fiduciary duties, fraudulent preference, trading whilst insolvent, misfeasance, fraud and theft. Often the actions of the directors, managers and functionaries give rise to tracing claims against third parties for recovery of money belonging to the fund which has been wrongfully paid away.

When a fund encounters financial difficulties, solutions may include:

- Independent Business Reviews – critical appraisal of the fund’s ongoing viability on behalf of its investors, prime brokers and lenders, to determine the cause of underperformance.
- Crisis Stabilisation – critical appraisal of the fund’s investment portfolio, to preserve and protect the fund’s assets, and review of reporting and management procedures to determine the context of actual and impending payment defaults.
- Debt Advisory – advising;
- - fund managers on their duties and responsibilities for meeting impending margin calls;
 - stakeholders on negotiations centred on refinancing banking facilities and covenants; and
 - restructuring capital structures.
- Stakeholder Protection – ensuring stakeholders’ rights are dealt with consistently and fairly.
- Financial Restructuring – integrating tax advice, stakeholder analysis and intermediation, to advise stakeholders on the restructuring of the fund’s capital and financial structure.

How we can help

At Withers we can help address these challenges. Whether our clients are the fund managers, directors of the funds, investors, stakeholders, prime brokers or lenders, we establish and help implement key legal and organisational solutions.

Our team is fully integrated with our offices in London, New York, Greenwich Connecticut, Geneva and Milan.

By combining its funds practice with its litigation and insolvency team Withers has significant expertise not only in establishing hedge fund structures but also in advising in distressed situations following trading losses, illiquidity or credit events. We often advise the funds, their directors, investment managers, administrators, prime brokers and investors, whether institutional, fund of funds, trustees or individuals, on issues affecting their rights, obligations and duties. We often advise insolvency practitioners pre and post appointment. We also advise funds and fund managers on their employment rights.

Expertise at Withers is not limited to UK and US failures. It also includes Cayman Islands, British Virgin Islands, Anguilla, Bermuda and Switzerland.

We are able to advise quickly and effectively and take action on restructuring a distressed fund, and advise on the most appropriate corporate restructuring procedure to be implemented in order to maximise returns for stakeholders or to preserve the fund as a going concern. We can obtain the appropriate form of injunction and orders to freeze assets which have been wrongfully paid away, and obtain orders to compel information about the fund from its directors and functionaries in any part of the world.

We also advise the insolvency practitioners who are to be appointed to the distressed or collapsed fund on the options available to them in a wide range of jurisdictions, and as to the most effective jurisdiction for the conduct of the insolvency proceedings or the most appropriate forum for

restructuring the fund.

All of our funds and insolvency professionals augment their technical knowledge with in-depth financial services sector experience, so they understand the specific issues faced by stakeholders, functionaries and the officeholders of hedge funds and alternative investment structures.

Often, due to the structure of a hedge fund, monies and assets will be held in or have been paid away to a diverse number of jurisdictions. We are a leading law firm in fraud and asset tracing, and have considerable experience in using liquidation as a fraud busting tool, obtaining injunctions and disclosure orders to preserve and protect the assets of the funds for the benefit of the stakeholders and creditors.

Trustees

It is an important time for trustees to be aware of any investments they have made into these types of arrangements, looking to conduct an audit of their investments, and dusting off the offering documents, subscription agreements and the investment vehicles' constitutive documents. They should be seeking to engage the fund manager in an open dialogue and obtaining as much information about the fund and its portfolio and obligations to third parties, from the manager, the directors, administrator or prime broker.

Here too Withers can help.


Our Funds, Insolvency and Restructuring team draws on its wealth of experience and knowledge to develop innovative solutions for the stakeholders, fund managers, and creditors, and to help them deal with all the complex problems surrounding a distressed or failed investment fund. We are particularly well versed in advising holders of distressed debt as to their rights attaching to the debt and how they are able best to use those rights when being asked to consider implementation of an insolvency procedure, such as a Creditors' Voluntary Arrangement, Administration, Schemes of Arrangement, or Liquidation.

Authors

Christopher Coffin

CONSULTANT | LONDON, BRITISH VIRGIN ISLANDS

Litigation and arbitration


 +44 20 7597 6101


 christopher.coffin@withersworldwide.com

Peter Wood

PARTNER | LONDON

Litigation and arbitration

 +44 20 7597 6106

 peter.wood@withersworldwide.com