



While litigation will always remain an option, hedge fund investors can limit their agony and suffering in the case of fund mismanagement by negotiating up front for transparency, redemption, and liquidity rights.

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Getting your legal ducks in a row

It may be tempting to pawn off dysfunctional limited partnership situations or fraudulent hedge funds as just the occasional hiccup within an otherwise healthy alternative investment industry. But legal experts say that investor complaints about perceived hedge funds improprieties are more common than one might initially expect. "Over the course of any month, I receive several phone calls related to losses incurred through investments in hedge funds, where the investors are concerned about whether those losses were the result of any impropriety," says Ron Geffner, a former SEC enforcement attorney and current partner for New York-based law firm Sadis & Goldberg. The typical abuses can be varied, with Geffner saying that he most often sees problems related to the "allocation of securities, use of soft dollars, misappropriation of assets, and misrepresentation in connection with past performance."

Certainly, in one recent high-profile instance, the Art Institute of Chicago found the maneuverings of a Texas-based hedge fund manager to be anything but pleasant. In this case, the Art Institute's endowment managers placed \$43 million, or more than 6% of the Institute's endowment assets, into two hedge funds—Integral Hedging LP and Integral Arbitrage LP. Then, post the September 11th World Trade Center attack, the Integral funds suffered a precipitous decline in value—perhaps by as much as 90%. Worse yet, obfuscation ruled the day, with the investment manager offering only the most shallow of explanations as to how the losses had been incurred. As a result, the Institute felt forced to turn to a Dallas court and ask for a temporary restraining order against the Integral funds' General Partner. Early this year, the court granted this motion, and appointed a special master to determine the status of the funds' remaining assets.

But according to Geffner, very few cases actually end up being filed in court. "Based upon the number of matters that come across our radar, we would estimate that less than 5% of those matters result in litigation," says Geffner. "Hedge fund managers are loathe to see their names in the press related to any dispute with an investor, and will typically negotiate with an investor to avoid such public scrutiny. At the same time, investors seldom have the stomach to actually litigate. If fraud has occurred, an investor needs to conduct an economic analysis concerning the cost of litigation versus the prospect of eventual recovery."

So what is the process that an investor should follow once burned on a hedge fund foray? The path that Geffner would propose for a potentially defrauded investor is simply to put as much negotiation pressure on the manager as possible. "Your first step is to get legal counsel involved as soon as possible, and after the review of all partnership documentation, send written correspondence to the General Partner's counsel expressing concern about any material misrepresentations. Depending upon the circumstances, the aggrieved investor should contact the firm's auditor and prime broker, and make both aware in writing of the potential fraud."

As a second step, dependent upon the factual circumstances, Geffner suggests determining whether the General Partner is subject to regulation by a state regulatory body or the SEC as a Registered Investment Advisor, or if the General Partner is subject to regulation by the National Futures Association. Should this be the case, the investor is in good shape. The General Partner can be put under immediate regulatory scrutiny. It is only when this is not the case, and a Limited Partnership has been issued as a Regulation D security by a non-registered manager, that regulatory authorities may be slower to take action. "In this latter instance, the SEC certainly still has jurisdiction to investigate," says another New York-based hedge fund lawyer, "but it may not be a top priority. Reg. D securities are, by definition, riskier investments that are privately placed, so when one happens to go awry—which happens all the time, of course—the SEC may not feel compelled to jump into action."

No whining

Wesley Nissen, a partner with Chicago-based Katten Muchin Zavis, stresses that professional fund-of-funds

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managers and other institutional asset allocators should go into hedge fund investments with their eyes open, and shouldn't resort to "whining" when one of these investments unfortunately turns sour.

"There are different products for different needs," says Nissen. "If you want better oversight, transparency, and liquidity, there is a product that affords this: It's called a mutual fund. By definition, hedge funds are less regulated and more secretive, so the only way to avoid nasty back-end problems is to provide for as many of these problems as possible on the front end of an investment."

Along these lines, Nissen suggests asking for special transparency, liquidation, and redemption rights before investing. "It is often possible to get a stop-loss provision within an LP agreement or within a side letter whereby a fund must shut down if it loses 20% or more," says Nissen. "In my extensive work with fund of funds managers, when I have seen them ask for something special in a side letter, they may not get all of that they ask for, but they will usually get something."

Nissen admits that in the case of a \$500,000 investment, it may not be possible to negotiate any special terms, unless the hedge fund is a nascent one, but he says that he has seen many bigger investors ask for and receive a "Most Favored Nation Provision." This clause guarantees an investor the best rights given to any other investor in the fund.

Establishing a separately managed account is also a way to increase transparency and liquidity rights for a larger investor. In this instance, a simple phone call to the prime broker can shut an account down. But a separately managed account also increases an investor's potential liability beyond a finite amount of the initial investment. For this reason, many hedge funds eager for capital may agree to open a completely separate stand-alone Limited Partnership for a large enough institutional investor.

Another New York-based hedge fund lawyer further suggests that the inclusion of an Arbitration Agreement in Limited Partnership agreements, or in initial side letters thereto, can be an attractive clause investors should strive to see included. "Dispute resolution via arbitration is far more cost-effective than litigation. It also offers a defined timetable to resolve a given matter. More investors should look for the inclusion of such terms or demand them. Unfortunately, you likely won't get a hedge fund manager to agree to arbitration in advance unless you are a big investor," says this attorney.

"In general, thinking ahead about contingencies can save a lot of headaches later on if a hedge fund subsequently runs aground," concludes Nissen. "The simple difference of having pre-negotiated monthly liquidity as opposed to quarterly or annual liquidity can serve to avoid many further problems."

No matter what advance steps are taken to avoid future problems, nasty situations will, of course, still arise from time to time. When they do, it is important to realize that "All Limited Partnerships, whether managed by a Registered Investment Adviser or not, are still subject to certain anti-fraud provisions of the Investment Advisers Act of 1940," according to Geffner.

"There are certain standards of care that need to be adhered to," agrees Nissen. "If fraud or gross negligence can ever be established, a General Partner won't be able to source his own legal expenses from the partnership, and will need to make restitution to the fund of earlier legal advances."

According to Nissen, Delaware law—under which many Limited Partnership agreements are written—also "specifically provides that upon demand, any Limited Partner shall be provided with a list of other Limited Partners. Failure of a General Partner to do so could be adequate grounds for a judge to mandate compliance, or even issue a temporary restraining order against a General Partner."

"But, in most instances, a judge is not going to do more than the minimum required," continues Nissen. "To get a temporary restraining order with any teeth to it, you must demonstrate that there are further problems that money alone won't solve. The General Partner must be deemed to have abrogated some specific responsibility. If the General Partner is simply losing money, but without willful neglect of his responsibilities to the investor, then a judge may rule that any damages related to this loss of funds can await the award process at the end of a case."

Chicken?

There is little doubt that the decision whether or not to move to a litigation stance often resembles a huge game of "Chicken."

"You always expect people to be honorable," says a source closely involved in the Art Institute situation. "But when people are not honorable, it still takes a bit of time and nerve to actually push the 'litigate' button. You are always hopeful that the General Partner will shortly bend to your demands."

In addition, no one likes to effectively be suing oneself. "Suing your own Limited Partnership is a bit like paying for the cost of litigation twice," says a New York-based hedge fund attorney, acknowledging that in most instances a General Partner may reserve legal expenses directly out of investor funds. "There is always a tradeoff between the cost of taking this path and the fact that it may be the right thing to do. In addition, even if a suit is successful, there is always the issue as to what is truly collectable in damages—what the assets of the General Partner really are."

The bottom line legal advice many experts would thus proffer on hedge funds is: Don't be too afraid or too shy to pre-negotiate. It can save many problems later. But if "later" does arrive, legal pressure and the risk of bad publicity for a hedge fund manager can often result in manager capitulation to investor demands. Only when a manager fails to capitulate, must an investor weigh whether litigation is worth it, and often it is not.

At that point, according to Nissen, "an investor can still get a pound of flesh from the manager by speaking with the media. This is a small industry. Any investor complaint publicly aired may mean that the offending hedge fund manager will never work in this industry again." ♦