Court and Sparks

In the wake of the subprime mortgage meltdown, troubled hedge funds litigate.

OVER RECENT MONTHS, unprecedented and enormous losses resulting from the subprime mortgage meltdown have focused increased scrutiny on hedge funds, the unregulated investment pools that have become increasingly popular as a result of their above-market returns. According to a report last August by the law firm Morrison & Foerster, of the roughly 9,000 hedge funds, which combined hold at least $1.7 trillion in assets, an estimated 2,000 are perceived as vulnerable to subprime market woes. Fears that the last to exit will suffer the greatest losses have in a few instances fueled a "run on the bank," resulting in margin calls, forced sales and losses now exceeding $1 billion.

This meltdown has already sparked a host of investigations and lawsuits. Courts and arbitration panels will be asked to apportion losses and determine whether they resulted from fraud and conflicts of interest or from market risk.

The at-risk hedge funds invested heavily in highly leveraged instruments such as credit default swaps, collateralized debt obligations and collateralized mortgage obligations. According to media reports, the SEC is investigating the way hedge funds valued these exotic instruments. The SEC is also looking at the bond-rating agencies for awarding high ratings to bonds that have since lost a large measure of their value and for failing to timely downgrade ratings—in some instances not until after the bonds had collapsed. The investigations focus on whether bond ratings were tainted by the large fees the agencies received from issuers. If the ratings turn out to have been influenced improperly, hedge funds, banks and pension funds that bought bonds in reliance on the ratings are likely to have claims against the agencies.

I SUE YOU, YOU SUE ME

The mortgage meltdown has also hit investors hard. Many suffered losses in the millions. In the past, hedge fund investing was limited to deca-millionaires and institutions that could afford the risks. In recent years, however, hedge funds working with brokerage firms opened their doors to retail customers by lowering their investment minimums to as little as $100,000. Concerned about this trend, the National Association of Securities Dealers in February 2003 warned brokers that they were obligated to make sure that their clients understood and could withstand the risks before putting them into hedge funds. Indeed, investors have started to bring claims alleging that their brokers ignored the warning, failed to fully disclose the risks, and gave bad advice because of a tangled web of conflicts of interest between the hedge funds and the broker-dealers.

The hedge funds, in turn, have sued underwriters, issuers and others involved in creating and selling subprime mortgage pools. For example, in April, Bankers Life Insurance sued the underwriter, seller and servicer of subprime mortgages it purchased in the secondary market, alleging that the prospectus misrepresented and understated the risks of the investment and that the defendants failed to disclose bad news as it unfolded. Bankers Life asserted that the defendants failed to disclose that a large portion of the portfolio was in default and had been denied insurance coverage, and that the trustee failed to enforce its rights under the pooling-and-servicing agreement. Had this been disclosed, Bankers Life alleges, it would never have purchased the mortgage pools.

In anticipation of litigation, hedge funds with mortgage-based losses have begun taking defensive measures. In July, two Bear Stearns hedge funds that sustained considerable losses from subprime mortgages filed for bankruptcy protection. In all likelihood, investors will assert claims against the funds' lenders for calling loans and selling collateral at fire-sale prices, precipitating the funds' collapse.

The case also has sparked a novel jurisdictional dispute. The funds filed for bankruptcy protection in the Cayman Islands, where they were incorporated, hoping that the Cayman court would be more debtor-friendly than U.S. courts. However, U.S. Bankruptcy Court Judge Burton Lifland in New York recently denied a request by the funds' trustees to recognize the Cayman Islands proceeding. If the ruling stands, it will force the fund to refile its bankruptcy in a U.S. court. This issue of first impression will be critical in other cases because many hedge funds are incorporated in offshore jurisdictions such as the Cayman Islands.

Those who invested in mortgage-backed securities directly or through a hedge fund should scrutinize their portfolios and investments carefully. We have entered a new chapter in the history of hedge fund investing whose end has yet to be written.

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