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Hedge Fund Failure Predictions and Strategies: How to Catch a Falling Knife and Not Get Cut

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Predictions and Suggestions of Morrison & Foerster's Hedge Recovery/Defense Team.

Morrison & Foerster has formalized its multi-disciplinary team dedicated to responding to client service needs in the coming distress cycle for at-risk hedge funds and structured debt vehicles. Representing "foreign representative" liquidators and investor/creditor committees early in U.S. Chapter 15 bankruptcy cases, following the first round of failed funds' filing of offshore insolvency cases, has helped us appreciate the "game" to come. We are now also helping prime brokers and bank creditors prepare their defensive and recovery strategies for what is coming next, as we enter this serious, crash-risk period. As failed funds begin to liquidate their portfolios, whether in the courts or outside of court and "below the radar," our Team is also there to support the buyers. The cross-border and multi-disciplinary nature of these issues requires a unified Team of lawyers with relevant experience acquired from cross-border bankruptcy/restructuring, M&A, and litigation in prior down-cycles. Also relevant are practices for international tax and hedge fund formation and advisory practices, for distressed M&A, and for other specialties applicable to certain asset categories, such as credit default derivatives.

Vulnerable Hedge Funds at Risk: A Quick Profile

Nine thousand hedge funds exist today, holding roughly $2 trillion in assets. At least 2,000 of such funds are perceived to be vulnerable to "run on the bank" investor redemption pressures. Such redemptions result from fears that the last to exit will suffer greater losses. The concern about financial reporting credibility is particularly focused on the exposed funds' assets that are difficult to value. Suspicions about such valuations are increasing, especially in a falling market with decreased liquidity and that is vulnerable to successive forced sales as a result of margin calls, bankruptcies, excessive redemptions, limited refinancing at far lower valuations, and other factors. Such at-risk hedge fund assets include credit default swaps ("CDS's"), collateralized debt obligations ("CDO's"), collateralized loan obligations ("CLO's"), leveraged buyouts ("LBO's"), and other distressed debt and exotic categories. While the SEC had investigated some asset valuation practices earlier this summer, the recent SEC "mark-to-market" investigation of the "consistency" of valuation methods and results is said already to have increased compliance vigilance by prime brokers, banks, hedge fund accountants, and administrators. Some foresee an increased risk of both margin calls on hedge funds' highly leveraged positions, and consequent distressed sales of such hard-to-value assets, all forcing prices and values even lower. In prior down cycles, such as the Drexel junk bond collapse, such successive, forced sales created both a downward valuation spiral and a credit crunch. The larger and more successful "distressed opportunity funds" of today were the "vultures" that profited previously, and again have raised money for a predictable replay.

The reason this problem is focused on vulnerable hedge funds, as opposed to private equity funds or other investment vehicles, is that hedge funds have both shorter lock-up agreements with investors ranging from 30 days to a year or more and more aggressive valuations on difficult-to-value assets. Lawyers who are regularly involved in these disputes divide the world of private equity funds and hedge funds based on the length of the investors' lock-up commitment of their funds. Funds with lock-up periods of a year or less are generally viewed as "hedge funds," and those with longer lock-up periods are viewed as "private equity." Bankruptcy/restructuring lawyers also divide hedge funds into “vulnerable funds” versus all other funds, based on a variety of factors, one of which is the length of the investors’ lock-up, with those able to redeem on 90 days or less being most vulnerable. While most funds also have other contractual protections against excessive redemptions compared to liquid assets, those protections only delay and cannot overcome the angry investors’ litigation strategies described below. For example, neither Sentinel nor certain other well-known funds were able to resist the temptation to use their bankruptcy-law defenses to investor redemption strategies in recent litigation.

While our analysis of at-risk funds contains many other factors, other vulnerabilities include a strong focus on the types of asset classes held by the fund. Some asset categories are often presumed to be booked far higher than the prices at which they will sell in a falling market or, in the case of the liability side of the balance sheet, to establish a *net* value payout on the credit default derivatives that insure distressed debt, for which the fund reported what may prove to be inadequate reserves. For example, if a hedge fund “insures” $100 million in bonds (whether owned or not by the “insured” hedge fund buyers of the credit default derivatives), that insurer fund may book both a $5 million token reserve and a $15 million theoretical profit. The insurer fund cites both rating opinions and GAAP reporting rules about not recognizing contingent liabilities that are too remote or inestimable. But (like the rating agencies themselves) the funds ignore the predictable market dynamics that will arise once the debt insurers no longer can refinance at par their massive first- and second-lien debt in a falling market. All that the beneficiaries of such credit default derivatives must do in order to profit generously is to cause the debt issuer’s bankruptcy. Often, only more than 25% of any strategic tier of bond debt is required to force a secured debt default that, in turn, forces a defensive bankruptcy in order to stay the lien enforcement. Unfortunately, the hedge fund selling the credit default derivatives then will need to explain to investors how it lost $80 million and now also must reverse the $15 million theoretical profit on which the fund managers paid themselves a generous fee.

Other Illustrative Asset Valuation Concerns

One of the many side-effects of these pressures is the impact of illiquidity in certain relevant falling markets and those others expected to cool and fall. This illiquidity can magnify the classic problem, when many funds risk short-term borrowing to fund investments in illiquid, long-term products. One major bank’s supported funds received $3 billion in support to calm investors in the face of another loss announcement. Many funds do not have similarly powerful support to guard against the risk of a run on the bank by investors. The consequences of failure to provide support are illustrated in another prominent investment bank’s hedge funds’ Cayman insolvency proceedings and U.S. Chapter 15 cases.

In boom times, key economic players focus on buying low and selling high and on other strategies, where, to quote one observer, they hear “one hand clapping.” In the meltdown that is quickly approaching, however, no one is clapping. Instead, to use a contrasting metaphor, the question is how best to catch a falling knife before it lands in your lap. “Vultures” still will provide liquidity, but only at prices that are far lower than where they are presently booked by funds needing liquidity. In a falling market, it can be dangerous to hold onto investments too long. On the other hand, many funds also are worried about losing big investors to redemptions, tempting the rest of the investors to follow the first to leave. Who trusts their aggressive hedge fund’s financials enough to risk being the last to leave with whatever remains? Clearly, there are many credible funds who deserve their investors’ confidence; on the other hand, there are many funds for which investors are understandably nervous about the potential losses resulting from being the last to exit. This is especially true for fiduciary investors, who will face harsh questions from their pension and other beneficiaries for taking such high risks with their money. While the funds will argue that full disclosure was made and that such investors assumed the risks, there will be debates, especially over the valuations of the assets and liabilities.

This problem is illustrated by the attempt of structured investment vehicles (“SIV’s,” “SIV-lites,” or “conduits”) to profit from the gap between short-term borrowing rates and longer-term rates by buying structured product investments, typically rated by the credit-rating agencies now suffering credibility problems. Having misjudged the risks related to subprime mortgage that now seem obvious, many investigators wonder what other risks the rating agencies have misjudged. (The rating agencies defend against such criticism by reminding critics and victims of valuation surprises about the limited nature of their ratings, such as the concept of only predicting the *hold-to-maturity* risk, rather than the interim market problems.) Currently, much of the crisis in the commercial paper market is related to SIV conduits, which invested, for example, in *rated* subprime-mortgage-backed bonds and collateralized debt obligations, creating so-called “asset-backed commercial paper” (“ABCP”). Because of the maturity of a high amount of such paper as of August 15, the market wondered if such paper would be refinanced, given value uncertainties, lack of confidence in ratings-matching market prices, and other risks and uncertainties. Despite generous funding by the Federal Reserve to ensure liquidity, there already have been sales by hedge funds facing redemptions, because their at-risk structured products are driving down prices and scaring off investors. In Europe and, increasingly, the United States, such commercial paper is now being funded on an overnight basis, because of reluctance to risk the usual three-month rollover, even with the Federal Reserve and EU Central Banks intervening to provide tens of billions of dollars of emergency liquidity. The core problem, however, remains unsolved: uncertainty and credibility problems about asset valuations for conduit programs and the structured credit markets.

Similar credibility and valuation issues confront at-risk hedge funds with large credit default derivative "insurance" exposures. The current fear is that many such funds have booked the income to improve apparent fund performance with what in the coming distress cycle may prove to have been inadequate reserves for their much larger liability. The normal risk to distressed debt of the issuer's bankruptcy in a cooling economy is increased now by the risk that the *other hedge fund beneficiaries* of the credit default insurance may use various opportunities in order to recover on the insurance before it expires, such as by forcing debtors into bankruptcy with distressed debt, particularly first- or second-lien debt. Given the massive leverage of first- and second-lien debts that many companies have been refinancing and extending, as soon as the refinancing liquidity at par disappears, the defaults and bankruptcies will be easy to trigger, if a sufficient number of hedge CDS holders maneuver to cash in on their insurance. If a beneficiary of insurance can recover 100% in bankruptcy through its CDS, why should it ever agree to a debt discount compromise in a workout to avoid a bankruptcy? With the notional amount of credit default derivatives approaching $29 trillion, far in excess of the actual insured debt (*i.e.*, naked bets on "credit event" triggers, such as bankruptcy), there appears to be a large faction of the market eager for more bankruptcies. First- or second-lien debt can always cause a bankruptcy, if no refinancing is available at an acceptable price.

Some types of assets will be overvalued because of the misperceptions of many (including rating agencies) about inherent asset values, subprime-mortgage-related securities being one clear example. Other types of assets also will be overvalued, because of fund strategies not succeeding in down markets, such as, for example, distressed debts that were purchased from banks and other creditors at higher prices than creditors reasonably could expect as a possible "traditional" recovery. While fund buyers justified higher prices based on "enterprise value" of the hedge fund's claims against the debtor, which assumes converting the debt (often second-lien debt) into equity control of the debt issuer, such theoretical enterprise value is now disappearing in the down market. When the first lien cannot be refinanced at adequate value in the coming credit crunch, the second lienholder hedge funds will suffer large book losses, regardless of how hard they battle with the first lienholders for salvage. (Indeed, the second lienholders' struggle for salvage typically also will cause losses to both first and second lienholders.)

Losses Inspire Both Litigation and Defensive Maneuvers that Create Little Value for Investors

When refinancing opportunities at aggressive valuations disappear in the cooling markets, the realistic salvage value of the debt issuer often will force big losses to be allocated among many constituencies in such a zero-sum game. Such games are often rough, and many intercreditor battles damage the debtor in the process. Unfortunately, some of the disputing parties in the next round will not be battling merely for minimal losses, but also to reduce litigation exposure of their own investors and others challenging their financial reporting. For example, consider a fund that paid and booked distressed second-lien debt at 70% of par, envisioning a higher "enterprise value" when such holders were to convert that debt into equity control of the debtor in a friendly (to them) Chapter 11 plan of reorganization. Will such a fund be willing to accept an offer of 10% payoff from the first lienholders, who contend that the second liens have lost all value and should just "go away"? Can the second lienholders "cram down" the first liens into a Chapter 11 plan to preserve value for the second liens, to the severe prejudice of the first liens? Can the debtor survive such intercreditor battles? Recent and older history demonstrates the negative answers to these questions, but the bet on the second liens preserving the hedge funds' original book valuations is not a bet that many would consider reasonable.

The Psychology of Panic and Cumulative Bad News

Recent business news has focused on the risk of redemptions at hedge funds vulnerable to "runs on the bank" that overwhelm their liquidity. Beginning on Tuesday, August 14, 2007, headlines focused on Sentinel Management Group attempting to freeze redemptions, concluding within days in a bankruptcy filing. On the Monday before that, the big news was that a major investment bank and its friends were pumping $3 billion into the bank's distressed fund to avoid the kind of squeeze position that resulted in recent Cayman Islands insolvency proceedings for two funds sponsored by another major bank recently in the news, with the usual accompanying Chapter 15 bankruptcy cases in New York to delay and manage the inevitable U.S. litigation. Such news will become a regular event now, despite the best efforts of fund sponsors and the Federal Reserve and EU central banks to provide ample liquidity and to "catch a falling knife."

Since credit ratings focus on holding-to-maturity risk, without regard to the effect of the interim "games" and market "corrections," the ratings do not reassure those who are concerned about the effect on market declines from massive margin calls, CDS-insurance-inspired bankruptcies, and other forced sales for accommodating redemptions by fund investors. Absent reliable asset values, what emboldens the fiduciary money in these funds (*e.g.*, pension funds, university endowments, foundations, etc.) to continue to bet against the risk of a massive exit? Since many larger and safer private equity and hedge funds have been raising money to purchase cheaply the portfolios of these failing funds, the risks are well advertised. (One recent study touted impressive returns from 124 distressed debt and special-situation opportunity funds, even before they begin to implement their planned purchases from other failed hedge funds expected to end in liquidations.) Indeed, the investors in the stronger vulture (pardon the term) or distressed opportunity fund buyers also are often the same investors trying to decide when to exit from the vulnerable funds targeted by the stronger funds. For those planning such an exit from the vulnerable funds just in time, the recent court decision in the *Bayou* fund bankruptcy case is instructive, since the end game for that case is organized, legal recovery actions against all of the redeeming investors for the benefit of those left holding an empty pot.

Those of us who were involved in the prior hedge fund collapses in this cycle know well what will surprise the public, when "war stories" are exposed in litigation. Some hedge practices are not going to sound sympathetic to juries, or even to some judges, who believe that predictable rules should be enforced in these "games." "Side pockets," "side letters," and many other special hedge fund accommodations in this cycle for favored investors eventually will filter into public discourse, much like the terms "Fat Boy," "Get Shorty," "Death Star," and the rest of the lexicon of the strategies of Enron energy traders that eventually came to light. The fact is that litigators will feast on certain practices of failed hedge funds, notwithstanding justifications in the fund partnership agreements and their documents and disclosures. Why? Because at the core of this impending crisis—underneath all the other many things that intelligent people will dispute—is this inescapable truth: from hindsight, failed hedge fund books often will appear to overstate asset values and to understate the value of the liabilities, particularly with respect to credit default derivatives.

Suggestions to Prepare for What's Coming

The single most important piece of advice is to consult relevant experts soon, while there is still time to plan a strategy. Such experts include not only bankruptcy/restructuring lawyers, but other *cross-border* professionals, who know well the relevant players in the Caymans and other applicable jurisdictions. Such experts also should have three other qualifications: (1) deep experience in the prior Drexel junk bond and S&L crises; (2) substantial experience with Chapter 15 bankruptcies; and (3) the experience of working with the other relevant practice specialties on actual hedge fund failures, both in and out of bankruptcy court. Similarly experienced and connected litigators, hedge lawyers, international tax lawyers, and derivative lawyers are also essential to the planning implementation.

The advance planning process should focus on likely patterns that can be predicted and addressed, including the following: (1) a "run on the bank" by investors demanding redemptions in excess of liquid assets; (2) investors focused on book values of assets and liabilities that do not correspond to the legal and market realities; (3) litigation threats and filings against many predictable targets; (4) a Cayman (or other applicable country) insolvency proceeding that is arranged with anticipated support and strategies; (5) a U.S. Chapter 15 to stay litigation, to support sales (and sometimes seek benefits for fund insiders), and otherwise to implement an expected strategy that is often very different from the typical Chapter 11 or 7 strategies; and (6) asset sales, claims administration (including allowance, settlements, and disallowance of claims), and other transactions conducted using the best available integrated strategies under Cayman (or other applicable foreign law) and U.S. laws and rules, *i.e.*, coordinated cross-border "cherry picking". Those making preparations need to act quickly to protect their interests, because these cases will drive toward a quick and pre-arranged end result, unless effective counter-strategies can be implemented timely, likewise using both U.S. and foreign law.

Because many creditors, litigation defendants, investors, and other interested parties will not be fully prepared or well-advised, there will be some early case results where such constituencies are very disappointed. The key is not to learn the hard way. There is a path to achieving acceptable results, but the opportunity to employ such solutions can be lost as quickly as other players in this zero-sum game can arrange. Proper planning and early, proactive responses are critical.

For further information, please feel free to contact any members of the Morrison & Foerster LLP Hedge Recovery/Defense Team. Contact information is attached.

Morrison & Foerster's Hedge Recovery/Defense Team

The Firm has a large, multi-disciplinary Team to address all aspects of client service in the context of failing or failed hedge funds and related problems. During the past 15 months, our team has been actively involved in many fund failures, whether generally visible or "below the radar," including such common situations involving Cayman insolvency proceedings and parallel U.S. Chapter 15 cases, as well as ample litigation, tax problems, and other complex issues. The problem sets at issue require an intimate understanding of both the hedge fund game and the players, particularly in the Cayman Islands and other countries where the funds are registered. When our clients acquire portfolios of failed funds, a seamless team with all of these specialties is essential for quick success.

Rather than list the entire 50-plus lawyer Team, we offer contacts to the Team through any of the following members, who are identified by their respective specialties:

Specialty	Contact
Bankruptcy/Restructuring Practice	Gary Lee G. Larry Engel
Hedge Fund Practice	Kenneth W. Muller Kim Tomsen Budinger
Litigation Practice	Jack C. Auspitz Mark P. Ladner
Derivatives/Capital Markets Practice	Barbara R. Mendelson
Tax Practice	Robert A.N. Cudd Thomas A. Humphreys
M&A Practice	Robert S. Townsend