



# FOCUSING ON LEGAL STRATEGY

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Margot MacInnis and Mathew Clingerman provide insights into preparing for a hedge fund litigation strategy.

On March 6, 2008, the SPhinX liquidators of the SPhinX Group of Companies (the SPhinX liquidators) filed two complaints, one in New York and one in New Jersey, against various defendants. The SPhinX liquidators allege, among other things, that certain third parties were responsible for a \$263 million loss that SPhinX suffered from maintaining funds on deposit in an unregulated and non-segregated account.

In preparing and investigating potential third-party claims, the SPhinX liquidators considered a number of issues that investors, creditors, insolvency practitioners and litigators may find beneficial if considering a litigation strategy. Because the complaints are the subject of ongoing litigation, this article does not attempt to discuss the merits of the cases. It is also not intended to provide or be construed as legal advice.

## ATTORNEY SELECTION

Selecting the attorney to lead your investigation, and possibly the litigation strategy, is one of the most important and crucial steps in preparing for a hedge fund litigation strategy. Great care should be taken to ensure that the attorney selected has the capabilities, experience and resources to undertake such a significant project. In SPhinX, the liquidators undertook a comprehensive interview and due diligence exercise, and met with eight firms with differing backgrounds and remuneration packages. Factors that we considered in assessing the attorneys were:

- Does the attorney have experience in litigating hedge fund matters?
- Does the attorney have prior experience pursuing the types of defendants?
- Does the attorney have a track record of successful results in major litigation, both in trial and on appeal?
- Does the attorney have experience in third-party plaintiff litigation?
- What is the overall depth and reputation of the litigation department of the firm?
- Does the attorney or firm have a conflict?

Where the case involves a Cayman Islands fund, there is a need to ensure that the attorney retained has experience dealing outside the US, preferably addressing issues that may arise from a multi-jurisdictional litigation strategy. Additional features that the SPhinX liquidators looked at when contemplating which attorney would best suit their needs included:

- Experience in multi-jurisdictional litigation and recovering assets outside of the United States
- Experience working with insolvency practitioners outside the United States
- Willingness to assist the insolvency practitioner in its reporting and consultation duties, and
- Willingness to communicate and co-ordinate with the liquidators and the other attorneys that may be working on related matters.

Interesting insights can be gained by observing the way in which the firms prepared themselves for the interview process. Some came into the process with little knowledge of the funds, and the interview process served as a fact-finding exercise. Others had done considerable research and came to the meeting with ideas and views. It is not surprising that those without thought insights and observations were not considered as favourably as those that had done a significant amount of advance preparation. While not every firm of attorneys interviewed met or exceeded every criteria, the firm that was ultimately engaged demonstrated a great appreciation of the issues and complexities in the case, and successfully embodied many important factors.

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## UNDERSTANDING THE FUND STRUCTURE

Another important consideration for the liquidator is to invest sufficient time and effort to develop a full understanding of the fund structure, the parties involved and their interrelationships. In SPhinX, the liquidators were dealing with 22 hedge funds, which contained hundreds of share classes in a feeder, master and portfolio strategy fund matrix. As with any case, there are issues and circumstances peculiar to it that require consideration. In the case of SPhinX, a key aspect was researching and attempting to understand the rationale for SPhinX placing the funds in an unregulated and non-segregated account. In the ensuing investigation, the liquidators attended depositions and interviews with various parties that were involved in the events leading up to the collapse of the fund. The liquidators were able to gain an insight into the decision-making processes of individuals and place into context the information uncovered during the investigation. The process afforded the liquidators an opportunity to re-evaluate and reconsider any predeterminations or judgements that had been formed. This process enabled the liquidators to compile a detailed organisation/relationship chart that further enhanced their understanding of relationships and events.

Unique to the Sphinx case was the purchase of the third-party claims of SPhinX's investment advisor, PlusFunds Group Inc. SPhinX was a potentially large creditor in Plusfunds, having filed a claim for the losses it suffered. The decision to purchase the third-party claims from

PlusFunds arose from a number of concerns regarding our recovery in PlusFunds. First, the investment advisor had little in assets, and the projected recovery, even if successful, was minimal. Second, the investment advisor was also considering pursuit of its own third-party litigation strategy. This litigation would be pursuing similar defendants as in SPhinX. Third, the liquidators assessed that gaining access to the investment advisors' documents and information would assist in their own case. The perceived conflicts and risks arising from competing actions caused the SPhinX liquidators to seek an alternative solution. A cost-effective arrangement was reached that resulted in the liquidators purchasing the PlusFunds' causes of action.

## DOCUMENTS AND E-DISCOVERY

A significant undertaking whenever consideration of a third-party litigation strategy is contemplated is gaining access to documents and information. As a hedge fund doesn't have its own books and records, but instead delegates its contractual duties to third-party service providers, this exercise poses many difficulties. There are two primary means of getting this information: voluntarily and involuntarily. The former strategy is of course the easier and less expensive, but may not always work. The SPhinX liquidators used a combination of both and successfully negotiated wind-down agreements with the service providers, which preserved the rights and access to critical documents to assist in the liquidation process. Of particular interest was the recovery of a number of previously deleted files of the principal wrongdoers, which greatly assisted in understanding the frame of mind of the principal parties in the fraud. In addition, the SPhinX liquidators made applications in the US courts for discovery and examination of certain key parties, which provided additional information and documents to support the investigation.

Through these processes, the SPhinX liquidators gained access to more than a million documents and interviewed or deposed more than 30 parties. Having the ability to research this data, and ensuring that it is properly filtered and collated, is a difficult issue. To assist with this investigation, the SPhinX liquidators engaged a third-party service provider to assist in the collection, analysis and processing of this information.

## THE IMPACT OF INDEMNITIES

As is standard in the hedge fund industry, SPhinX provided indemnities to its third-party service providers. Indemnities, and the contingent liability that may arise, are a source of serious consideration for any party contemplating third-party litigation. They have the potential of not only setting off any potential recovery, but to the extent the third-party service provider incurs costs in defending themselves, the fund may be liable, thereby diluting the assets it holds for the benefit of creditors and investors. In reviewing its litigation strategy, the SPhinX liquidators gave significant consideration to indemnities and their impact on the litigation strategy. Among these considerations were:

- Identifying the potential indemnity claimants
- Understanding the thresholds for defeating an indemnity claim
- Assessing whether it was necessary to determine and quantify appropriate reserves or provisions
- Looking at alternative means of defeating indemnity claims, and
- Assessing the impact on the litigation strategy.

Ultimately, the SPhinX liquidators took a two-pronged approach to dealing with indemnities. The litigation filed in the United States will seek a jury to determine whether the indemnities are valid. Further, the SPhinX liquidators are also addressing the indemnity issue in the Cayman proceedings.

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## CONCLUSION

Contemplating a litigation strategy, particularly in the instance of Cayman hedge funds, is a measured process that requires the injured party to pursue various steps to ensure that it has at its disposal all of the facts and personnel to properly research and, if appropriate, prepare the litigation strategy. Insolvency practitioners with experience in cross-border litigation should ensure that the necessary building blocks are put in place. These include a thorough assessment of: all facts and circumstances; all members of the litigation team, including the attorneys and experts, in terms of their capabilities and resources, to ensure that the issues have been properly researched and that the matter gets sufficient attention; the consequences of all remedies and defences being considered; and, above all, whether the steps being considered are cost-effective, efficient and sufficient, and whether there may be better means of getting the same result ■

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