RECEIVER/TRUSTEE AND INVESTOR CLAIMS AND REMEDIES AFTER HEDGE FUND FAILURES

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I. Introduction

A. There is a long history of spectacular hedge fund blow-ups beginning most notably with the failure in 1994 of the Granite Funds managed by David Askin.

B. There are a number of common themes that arise in many of these hedge fund failures.

C. This presentation will survey some of the most spectacular hedge fund blow-ups, including the recent 2005 and 2006 blow-ups.

D. We will then use these disasters to discuss claims and remedies Receivers/Trustees and defrauded investors can pursue.

II. Spectacular Blow-Ups

A. Granite – 1994

1. CMO fund represented to be market neutral with low leverage. Represented that had state of the art analytics. Represented that portfolio would be marked in good faith using dealer prices.

2. Valuation fraud, aided and abetted by certain counterparty dealers. Dealers revised initial marks to marks requested by Askin.

3. Also made interest rate bets (not market neutral), had crude analytics and was overleveraged.

B. Manhattan – 2000

1. Strategy to short sell technology stocks.

2. With the complicity of its introducing broker, manager fabricated a set of account statements that differed tremendously from the account statements produced by the Fund's custodian/prime broker.

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3. Manager persuaded the auditor and administrator to use the bogus account statements to calculate and distribute NAV statements and year-end audits.

C. Lipper – 2001

1. Portfolio manager artificially inflated the value of the portfolio. Clean audit reports negligently issued by the auditor. Principal of the investment manager failed to adequately supervise the portfolio manager.

D. Beacon Hill – 2002

1. Valuation fraud allegedly committed by managers of CMO funds. Smoothing and inflating the value of the portfolio. Administrators and auditors allegedly used bogus values despite access to contrary information on values that they were provided and other red flags.

2. Aiding and abetting allegations against certain broker dealers who provided marks sought by the manager.

E. Lancer – 2003

1. Strategy to invest in mid-cap "fallen angels."

2. Beginning in 2002, acquired large quantities of unregistered stock and warrants of micro-cap companies and marked the value of all the stock at prices from small volume "market" transactions in the registered stock of the same company. Many of these "market" trades were allegedly manipulated by the manager and the counter party.

3. Auditor and administrator allegedly ignored red flags including two different position reports — one created by Lauer using computer system of prime broker and the other generated by the prime broker. Allegation that prime broker provided the tool to commit fraud. Its clerks entered obviously false info into the computer system.

F. Dobbins - 2003

1. Valuation fraud. Manager allegedly inflated the value of thinly traded and non-publicly traded stock. Allegations that administrator and auditor recklessly and negligently failed to independently value.

G. Wood River - 2005

1. Beginning in February 2003, manager invested virtually all of the funds' assets in one small-cap stock--Endwave Corporation. This was in direct contradiction to the manager's promises that the fund would be broadly diversified with the maximum concentration of one stock capped at ten percent of total assets.

2. The manager reported false valuations, stating that the fund had out-performed that Standard & Poor's 500 stock index, while its investment in Endwave Corporation decreased significantly.

H. Bayou - 2005

1. Shortly after Bayou funds set up, they began to sustain large losses. The managers concealed these losses by knowingly misrepresenting the value and performance of the funds in monthly statements.

2. The managers created a fictitious accounting firm--"Richmond-Fairfield Associates" and fabricated "independent" audit reports to perpetuate the fraud.

3. In July of 2004, the managers fraudulently diverted more than $120 million to a bank account in Germany, purportedly to invest in high-yield investment programs. After eight months tied up in European banks, the money was wired back to a U.S. bank account where the money was subsequently seized and frozen.

I. Portus - 2005

1. Marketed to small investors in Canada (26,000 investors).

2. The manager lied to investors about how their assets were invested and about fund returns. Fictitious trading records. He diverted more than $87.6 million in funds to commissions, referral fees and other expenses.

J. KL Financial - 2005

1. From 1999 through February of 2005, the manager misrepresented trading returns in growth stocks. In fact, the manager lost virtually everything through aggressive trading.

K. Philadelphia Alternative Asset Management - 2005

1. The manager reported false performance and trading results.

2. Man Group, the prime broker for PAAM, allegedly allowed the manager to hide losing trades in an undisclosed account.

L. Durus - 2005

1. The manager manipulated the stock price of two biotechnology companies by concealing regular and massive purchases of them--Esperion Therapeutics Inc. (33%) and Aksys Inc. (80%). When the scandal was exposed the companies' stock fell by more than $300 million causing huge losses to the fund.

2. The manager also failed to make the required filings with the SEC, made false statements to prevent others from selling their stock in the companies, and made false statements to the companies to prevent them from implementing their "poison pill" provisions.

M. International Management Associates - 2006

1. From 1997 to 2006 International Management Associates provided investors (including several current and former NFL players) with statements that misrepresented performance. Fund were diverted for the manager's use and otherwise dissipated.

III. Investor Remedies.

A. Culpable Third Parties.

1. Auditors

2. Administrators

3. Counter Party Dealers

4. Prime Brokers

5. Principals and Owners of Investment Manager

6. Lawyers

7. Middle back office and risk management providers.

B. Liability and Collectibility.

C. Jurisdiction and Venue.

D. Arbitratibility.

E. Class versus Group.

F. State versus Federal.

IV. <u>Receiver/Trustee Remedies</u>

A. Actions against redeemers at inflated amounts.

1. Unjust Enrichment

2. Fraudulent Conveyance

3. Might be limited to amounts exceeding invested capital

B. Claims Against Service Providers and Fund Managers.

1. Breach of Fiduciary Duty

2. Negligence

C. Beware of <u>In Pari Delicto</u> Defense

1. Step Into Wrongdoer's Shoes

2. Adverse Interest Exception

3. Sole Actor Exception to Exception

4. Law Differs by Jurisdiction

(a) <u>Second Circuit</u> - Bennett Funding

(b) <u>Seventh Circuit</u> - Scholes

5. Same courts treat Receivers differently from Trustees