

November 2, 2006

MEMORANDUM TO: Clients and Friends of the Firm

FROM: Brian S. Fraser

RE: Civil Litigation Risks Mounting for Hedge Funds?

The hedge fund world has increasingly become a target of both the government and the media. Two Congressional committees are investigating the SEC's handling of an insider trading investigation of a hedge fund. The Treasury Department is investigating the impact of the hedge fund industry on the financial markets. The Department of Justice is examining potential anticompetitive conduct by LBO firms. The New York Stock Exchange reported that referrals of insider trading cases to the SEC rose by 26% this year and told the Senate Judiciary Committee that hedge funds account for a large part of that increase. A New York Times editorial on October 20, 2006 declared "Closing in on Hedge Funds" and cited allegedly overstated returns and rumors of insider trading by fund managers as reasons to call on the SEC and Treasury to commence investigations and enhance "oversight".

Along with the increasing risk of regulatory or (worse) criminal investigations in this environment, there is also increased risk that civil litigants will try to "piggy-back" on the well-publicized investigations. Over 300 civil class actions followed on the heels of the SEC's investigation of "laddering" in IPOs a few years ago, and class action lawyers are undoubtedly looking at the possibilities for litigation against hedge funds.

There is also the risk that competitors, target companies, shareholders, bankruptcy trustees and others will become more litigious against hedge funds given the current environment. For example, an issuer recently sued two hedge funds that were allegedly short-selling its stock, asserting that they had violated various federal securities laws by making false, incomplete and misleading statements in SEC filings regarding their short position, among other things.

It may be time to take stock and consider the ways in which an adversary might attempt to capitalize on the current negative publicity about hedge funds and seek to exploit an issue, real or perceived, to your detriment.

Here are just a few areas where we see mounting risk of civil litigation:

1. *Allegations by debtors, creditors committees, bankruptcy trustees, issuers or shareholders that an investor has relied upon confidential non-public material*

*information obtained through a position as a lender to trade in the public securities of the borrower or profit from positions in another part of the capital structure*

The risk of insider trading allegations is not new. (We wrote about the application of the rules on insider trading to investments in distressed assets back in 1992.) What is new is the atmosphere of distrust. See “As Lenders, Hedge Funds Draw Insider Scrutiny”, New York Times, October 16, 2006, p. A1. Among the questions we are frequently asked are: Will a “Big Boy” provision protect me from a fraud claim by a counterparty? What are the risks to our position if we serve on a bankruptcy committee and still trade? What if I am receiving information as part of a lender group and still want to trade the public securities of the company? What risks, if any, do I incur by acquiring positions in different parts of the capital structure of a company in bankruptcy?

*2. Allegations by sellers, competitors or target companies that funds have “colluded” with one another to dampen competition for a company or an investment*

Hedge funds often partner with other fund managers to secure additional capital and/or lay off risk on a particular investment. In what circumstances could such partnering be viewed as a form of illegal collusion?

*3. Allegations by disgruntled shareholders or other constituents of breach of duty, or even fraud, against a fund that has taken one or more seats on a board*

Are the business benefits of a board position worth the increased legal risk of claims for breach of fiduciary duty, equitable subordination or recharacterization of debt as equity?

*4. Allegations by fund investors that illiquid investments have not been properly valued by the manager*

How much disclosure is necessary or appropriate regarding a fund’s valuation methodology?

At RK&O, we provide a wide range of services for hedge funds. We advise and represent hedge funds and investment banks in connection with their investments and transactions, advise them on compliance and regulatory matters and we have extensive experience – as defense lawyers and as former prosecutors and enforcement officials – in SEC and criminal securities cases.

Our civil litigators have many years of experience counseling hedge funds about litigation risks, evaluating litigations in arbitrage situations and representing hedge funds in contested bankruptcy proceedings and in litigation as plaintiffs and as defendants. If

civil litigation is unavoidable, we have extensive trial, arbitration and bankruptcy experience and provide aggressive representation together with a deep understanding of the business issues.

If you have any questions for our civil litigation partners, please contact:

In New York:	Brian S. Fraser	212-530-1820
	Arthur S. Greenspan	212-530-1816
	Shari Brandt	212-530-1874
	H. Rowan Gaither	212-530-1807
	Patricia C. O'Prey	212-530-1969
	Neil S. Binder	212-530-1809
In Washington:	Lucinda O. McConathy	202-261-2992