

## Hedge Fund Hell: These Funds Sue You

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The U.S. is a litigious place in ordinary times, but the combination of massive wealth destruction, disgruntled investors and potential fraud has set the stage for a perfect legal storm.

Lawyers are already pouncing on investment firms and banks that handed over clients' money to alleged con artist [Bernard Madoff](#), accused of running a giant Ponzi scheme that swindled as much as \$50 billion.

Others have filed suits over Lehman Brothers' bankruptcy, the money market fund Reserve Primary Fund's breaking the buck, and losses related to the government bailouts of **Fannie Mae** ([FNM Quote - Cramer on FNM - Stock Picks](#)), **Freddie Mac** ([FRE Quote - Cramer on FRE - Stock Picks](#)) and **AIG** ([AIG Quote - Cramer on AIG - Stock Picks](#)).

Besides those high-profile cases, there is potential for more legal carnage for real estate appraisers who approved inflated home values; mortgage lenders who didn't perform due diligence on borrowers; and advisers who misled clients about investments and risk.

Essentially, the little guys who have been hammered throughout the financial crisis are intent on recouping some of their losses. Law firms are jumping in to assist on the legal end, hoping to profit from attractive class-action opportunities.

In an interesting twist, alternative asset managers are exploring this development as an investment opportunity that is shielded from the rocky markets.

The investment firms can provide financing to cover legal bills and court fees for a fee and a share of potential profits at the end. At least two hedge funds have been prominent in this area, MKM Longboat since 2005, and Juridica Capital Management since the start of 2008.

Juridica, an arm of London-based **Juridica Investments** ([JIL.L Quote - Cramer on JIL.L - Stock Picks](#)), chose 17 cases out of 122 last year. The selection involves a rigorous, two-month due diligence process that examines credit risk, potential profit and expenditure, defendants' financial status and other players involved in the case.

Eventually, the fund deployed more than \$100 million in cases that ranged among intellectual property, monopoly, price-fixing, minority-shareholder disputes and an expropriation claim against a sovereign nation.

Juridica structures each deal differently, sometimes as a loan secured by a contingency fee, while each "cut-up of profit is customized." But in its first year of operations, Juridica booked a \$5.25 million profit and its net asset value gained 25%.

"[Lawsuits are] relatively uncorrelated to everything else that's going on -- it's unrelated to equities and derivatives and bonds," says Juridica Capital Management CEO Richard Fields, a former partner at several major law firms. "You don't want to profit at the misfortune of everybody else, but we've seen a serious increase in interest in light of the economy."

Fields says 90% of cases are settled without a lengthy trial or resolved through motions, allowing for a quick turnaround on profit when the right case is selected. The fund's first win involved a case in which Juridica extended a \$5 million line of credit to a plaintiff and booked a \$3.5 million profit within six weeks, when the case was resolved. Another involved a \$25 million credit line with a 7% fee for a case that was settled before it reached the floor.

Paul Fisher, an independent lawyer based in California, specializes in challenging the constitutionality of zoning codes, which is often backed by investors who want to share in the increased value of a development project.

Fisher characterizes the notion of investing in litigation as "nothing new," because lawyers have always placed such bets via contingency fees, and purchasing judgments as an investment is commonplace. But he also notes that there is both a good and bad aspect to disinterested parties financing litigation: It can either support a legitimate complaint that lacks funding or encourage spurious lawsuits.

"From a public policy standpoint, it's very problematic, and seems to be encouraging litigation," says Fisher. "But on the other hand, if you have a litigant with very just cause and valuable claim, who is drowned out because it's far too daunting to pursue a claim against a very moneyed defendant, it might encourage more justice."

Discussions with several hedge fund managers suggest that others are exploring the idea or interested in learning more about it. One said he was "very familiar" with the strategy, though not pursuing it at the moment. Two others called it "very interesting" or "very curious," adding that they would like to learn more. Another said the Madoff scandal was rife with opportunity for such investments.

"It does sound really interesting, and hedge funds tend to be the first to identify those kinds of opportunities in the market," says Nadia Papagiannis, a hedge fund analyst with Morningstar. "That's where the skill and the alpha comes in -- predicting the outcome of the lawsuit and setting up the financing for it. That skill is what hedge funds are known for, but it's not been what hedge funds have been doing recently."

Still, with the trauma the hedge fund world has sustained and the planning, development and resources required for such a strategy, few are apparently plunging into litigation investments.

Ezra Zask, who worked in the hedge fund industry for two decades and is now a director at the consulting firm LECG, says opportunities will not be as abundant as some believe because "deep pockets are disappearing through bankruptcy and M&A or settling." Papagiannis also notes that if too many funds get involved, with too much money chasing winnable suits, the strategy's profitability will diminish.

One irony of hedge funds betting on suits stemming from the financial crisis is that it may become cannibalistic: There are plenty of angry clients, and it's not a stretch to assume that some of them may be filing suit --especially those who lost money on [hedge fund](#) investments, and whose remaining capital has been locked up.

Navigant Consulting has rolled out services to act as an arbitrator of sorts, helping funds ease tensions with disgruntled clients. Mitchell Kaye, who oversees Navigant's hedge fund restructuring group, says business has ticked up quite a bit as the industry seeks to avoid further stress from litigation.

"Yes, they're very concerned," he says. "They're less likely to be sued if they hire an independent adviser to make sure [all investors] are being treated fairly, and it helps their brand."

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