

## Hedge Funds and Mediation

**Josephine Chung, Director, CompliancePlus Consulting**

**Tom Ng, Research Assistant**

**Calvin Ng, Research Assistant**

**July 2010**

Much attention has been caught by a recent court case when San Diego County Employees Retirement Association (“SDCERA”), a pension fund providing benefits for more than 34,000 public employees in the US, sued Amaranth Advisors (“Amaranth”) in March 2010 for damages after the hedge fund had lost all the investment of SDCERA in a financial collapse in 2006. SDCERA tried to argue that the hedge fund should be responsible for misleading them into investing \$175 million US dollars in a multi-strategy fund, which was later found a natural gas fund run by trader Brian Hunter.

The case exposed the weaknesses of traditional adversarial litigation process in confidentiality and preserving business relationships. In any case, as to be seen, this article argues that mediation as a form of Alternative Dispute Resolution (“ADR”) processes provides a better mechanism to resolve disputes for business entities including hedge funds.

Generally, mediation is defined as the process by which the involved parties, with the assistance of a neutral third party, “systematically isolate disputed issues in order to develop options, consider alternatives, and reach a consensual settlement that will accommodate their needs.” Following the revolutionary steps in England<sup>1</sup>, the Judiciary of Hong Kong has taken steps to encourage voluntary Mediation in the recent Civil Justice Reform.<sup>2</sup> Clear instruction has been provided in Practice Direction 31 to assist the

---

<sup>1</sup> Lord Chancellor’s Department *Modernising Justice: The Government’s Plans for Reforming Legal Services and the Courts* Lord Chancellor’s Department Great Britain 1998 at 3.

<sup>2</sup> The Judiciary *Civil Justice Reform Final Report Chief Justice’s Working Party on Civil Justice Reform* The Judiciary of the Hong Kong Special Administrative Region 2009 at 826.

Court in discharging its duty to encourage the parties to use Mediation in appropriate cases.<sup>3</sup> To achieve this, the Court would take all relevant circumstances into account in exercising its discretion on costs. Legal representatives are now under the obligation to advise their clients of the possibility of the Court making an adverse costs order if they unreasonably fail to engage in Mediation.<sup>4</sup>

The Government has also put forward a number of pilot schemes as a precursor to the future development of Mediation in Hong Kong. As early as May 2000, a 3-year pilot scheme on Family Mediation was launched by the Judiciary to subsidize the Mediation fees of the parties in dispute during the test period. The pilot scheme was proved successful with high satisfaction and agreement rate in saving the time of the Court.<sup>5</sup> For commercial disputes, a pilot scheme was also implemented by the Mediation Council from July 2007 to December 2008. This has now been maintained as the Commercial Mediation Scheme “to provide a general, standardized scheme to assist parties in commercial disputes to come to a negotiated settlement of their disputes amicably, economically and objectively through Mediation.”<sup>6</sup> As a step to further the use of Mediation, another pilot scheme for voluntary construction Mediation is proposed.<sup>7</sup> These pilot schemes have reflected the increasing support from the Government in building Hong Kong as the regional centre for Mediation in Asia.

Particularly for hedge funds, the merits of mediation primarily rest on confidentiality and preserving amicable and sustainable relationship between the parties.

## Confidentiality

One important hallmark of mediation lies in its confidentiality. For the hedge fund industry, the performance of funds is usually defined by their respective investment strategies. Confidentiality has topped every hedge fund manager’s agenda in this day and age. However, in the case of dispute between the investors and hedge funds, the traditional adversarial court process will necessitate the disclosure of relevant information in the courtroom rendering the process a less desirable option for hedge funds.

Contrasting the traditional process, the parties can avoid the disclosure of confidential information in the courtroom in the case of successful mediation. After the process of communication and negotiation, the parties involved would sign a privilege agreement in their settlement agreement so that important information can remain between the parties. The agitation caused by the dispute can be brought to the minimum with the privilege

---

<sup>3</sup> The Judiciary of the Hong Kong Special Administrative Region *PD 31 Practice Direction on Mediation* <http://legalref.judiciary.gov.hk/lrs/common/pd/pdcontent.jsp?pdn=PD31.htm&lang=EN> (20 May 2010).

<sup>4</sup> *Ibid.*

<sup>5</sup> Hong Kong International Arbitration Centre *Lehman-Brothers-related Investment Products Dispute* Press Release 31 October 2008 at 4.

<sup>6</sup> The Hong Kong Mediation Council (A Division of the Hong Kong International Arbitration Centre) *Commercial Mediation Scheme Terms of Reference* 2009 at 1.

<sup>7</sup> Above 5 at 3.

under the mediation agreement making it the more popular option for most professional industries in recent decades.

## **Preserving Business Relationships**

In modern business world, preserving good business relationships is also essential to business successes. Different businesses are inherently interdependent on each other in the food-chain of a business society and good relationships would definitely create convenience to the businesses amid keen competition in their respective industries.

Business relationships, once established, should always be maintained and only under very rare circumstances should such relationships be allowed to deteriorate.

Investment in hedge funds is usually limited to professional investors in many jurisdictions of the world. These professional investors are the special group of investors vested with significantly greater investing capacity than traditional retail investors. As both reputation and business considerations, maintaining good business relationships is essential to the success of every hedge fund, even in the case of dispute between the hedge funds and their investors.

Considering the significance of good business relationships, mediation provides an excellent mechanism to resolve disputes by avoiding tension and conflict in the adversarial system. As ruled in the English case *Dunnett v. Railtrack*, the sustainable relationship can be maintained by the mutual compromise between the parties in reaching the settlement agreement without finding fault on either of them. Unlike proceedings in the Court, mediation does not rule out the possibility of future co-operation between the parties in dispute.

## **Potential Lack of Professional Mediator?**

One potential problem with mediation as the most suitable mechanism to handle disputes between hedge funds and investors is the lack of professional mediator having full knowledge about the disputes. From one perspective, in most cases, disputes about hedge fund investment involve highly technical issues about finances and investment strategies within the hedge funds. It may be difficult to nominate a mediator having full professional knowledge about the operation of the industry to mediate in every dispute which may concern a variety of issues.

From another perspective, as the problem is viewed through a more analytical lens, the potential lack of mediator having profound professional understanding of financial issues may not be too great an obstacle in the mediation process. Through a well-trained mediator, the parties in dispute are enabled to communicate, negotiate and bring their dispute to an end without confronting each other and establishing legal liability on a specific party. With the expertise of identifying the most viable settlement options for the parties, the mediator would help the parties prepare detailed agreements which set out the particulars of the resolution.

As such, the more important question has become whether the mediator, with sound fundamental knowledge about investment strategies and hedge funds, have the necessary skills and expertise to bring the parties together to communicate and agree on terms acceptable to them – Full knowledge about the operation of hedge funds has become a sufficient, but not necessary, criterion.

## **The Madoff Case**

The recent Madoff scandal may serve as an example to illustrate the effectiveness of ADR in financial disputes. The hedge funds, the banks and the victims of the Madoff's Ponzi scheme successfully arrived at a settlement. Some 720,000 investors have recovered \$15.5 Billion from the banks. From the banks' point of view, they have avoided a painful lawsuit. For instance, Spanish giant Santander, one of the largest banks in Europe, was willing to pay \$235 million to the victims so as to settle their claims against two hedge funds operated by the bank. The investors, on the other hand, were able to recover 85% of their claims.

These settlement arrangements are beneficial to both the hedge funds and the investors. In respect of the banks or the hedge funds, they successfully avoid civil lawsuits and minimize the possible adverse impact on their reputation. On the contrary, if the parties decide to resolve the conflict through litigation, other clients may lose confidence in the funds. The fact that the fund is facing a lawsuit can trigger redemption and threaten the very existence of the hedge funds. In contrast, mediation is also a confidential process. This means that the confidential information of the hedge funds can be protected. With regard to the investors, they need not go through the lengthy, stressful and risky litigation process and secure the recovery of their initial investment.

Most important of all, mediation can on the one hand resolve the dispute, and on the other hand preserve the relationship between the hedge funds and their clients. This is of paramount significance to the hedge funds. Given that a considerable number of middle-size hedge funds only serve a handful of clients, preserving the business relationship between them is vital to the very survival of the fund itself.

## **Mediation in other countries**

In the Asia-Pacific Region, mediation and ADR are also gaining popularity. In Hong Kong, the Hong Kong Monetary Authority initiated the Lehman Brothers Related Investment products Dispute Mediation and Arbitration Scheme in order to resolve the Lehman Brothers mini-bond saga. Similar scheme was introduced in Taiwan by the Financial Supervisory Commission. The authority has specified 9 typical scenarios, and the banks must endeavor to settle with their clients if their cases fell into one of these scenarios. Although the Financial Supervisory Commission did not specify mediation as the only means, it was clear that the spirit of the scheme was to avoid litigation and encourage settlement between the banks and the investors. According to the report of the Liberties Times on 24<sup>th</sup> May, 2010, 20892 cases were settled.

In Singapore, PricewaterhouseCoopers, the receivers of the Lehman Brothers minibond, has also offered settlement with the investors. It is worth noting that the HKMA is the only authorities which specified mediation as a means to settle the Lehman Brothers disputes. This may be a reflection of the increasing popularity of mediation in Hong Kong.

In many respects, mediation is the ideal means of dispute resolution. This is particularly true in commercial or financial disputes. In many countries a centralized financial dispute resolution scheme has been established. The Financial Service Ombudsman in Australia as well as The United Kingdom and the Financial Industry Disputes Resolution Centre in Singapore are some examples. In Hong Kong, the government is proposing the establishment of a Financial Dispute Resolution Centre. According to the Consultation Paper on the Establishment of an Investor Education Council and Financial Dispute Resolution Centre (P.57-58), these centralized schemes were quite effective in resolving disputes. The Financial Industry Disputes Resolution Centre in Singapore has successfully mediated 485 cases. In the United Kingdom, more than 55,000 was resolved through mediation or recommended settlement.

Nevertheless, these centralized schemes usually target disputes at the retail level. Take Hong Kong as an example, according to the Consultation Paper on the Establishment of an Investor Education Council and Financial Dispute Resolution Centre (P.43), the proposed Financial Dispute Resolution Centre does not cover disputes between funds and institutional investors. Only individual clients or a sole proprietor can make use of the services of the centre. Given that hedge funds mainly serve institutional investors, it is envisaged that the proposed Financial Dispute Resolution Centre may not play a very important role in the hedge fund industry. It is hoped that the scheme would also cover institutional investors as long as they agree to settle the disputes through mediation.

In the premise, the other way to promote mediation in the hedge fund industry is to educate the hedge fund managers. A possible means is to incorporate mediation into the code of conduct. For instance, in Hong Kong, the Fund Manager Code of Conduct provides that the fund managers must maintain an efficient procedure to handle complaint. The relevant authority can encourage mediation by providing that the managers should refer the disputes to a mediator before the parties consider other dispute resolution methods.

## Conclusion

It should also be emphasized that mediation is no substitute to the disciplinary action brought by the supervisory authorities. In the case of fund managers' misconduct, the managers may also face disciplinary actions, even though their clients are willing to settle the civil cases. Admittedly this may reduce the attractiveness of mediation as a means of dispute resolution. Nevertheless, it is of paramount importance that the managers should maintain the highest level of integrity. A balance has to be drawn between efficient dispute resolution and the integrity of the entire financial service industry.

Mediation has a number of advantages than the traditional litigation process before the Bench. Despite the possible lack of professional mediator in financial matters, the advantages in confidentiality and preserving business relationships would definitely prevail. It is no question that mediation can potentially become the most suitable mechanism of resolution for commercial and financial disputes. Coupled with the potential support of the government, it is more likely that the sphere of influence of mediation may continue to expand alongside other traditional means of resolving disputes.

**END**