



## Message from Our Boston Office

Welcome to Pepper Hamilton LLP's *Boston Office Update*. Our clients and friends often ask Pepper attorneys for advice and education on subjects of interest. This newsletter, and its future editions, will not only focus on timely topics relevant to our clients' business needs, but also will discuss industry challenges, changes and innovations – and of course, the many legal issues that arise from such changes.

This edition features an article by Julia D. Corelli of our Corporate and Securities practice area. The article focuses on the obligation that may arise when hedge funds and private equity funds partner.

We're also pleased to announce that we have expanded the Boston office with the addition of several new partners and associates.

We hope that you enjoy the *Boston Office Update* and welcome your suggestions for topics to include in future editions. As always, if you have any questions about any of the information contained in this newsletter, just give us a call or visit us on the Web at [www.pepperlaw.com](http://www.pepperlaw.com) and we'll do our best to help.

Enjoy!

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## When Hedge Funds and Private Equity Funds Partner, Conflicting Obligations May Arise

As more hedge funds seek to maintain high returns, diversify their investment strategies and deploy more capital, they are looking to invest in companies traditionally in the territory of private equity funds. Not only can this hybrid investment strategy create conflicting obligations of hedge fund managers to their investors, but it also fosters tensions with the private equity funds that are co-investing.

So-called "side pocket" investments are portions of hedge funds set aside for opportunistic investing in private companies. The hedge fund's partnership agreement can allow for a certain percentage (up to 25 to 30 percent) to be invested in illiquid investments at the discretion of the hedge fund managers. The offering circular and partnership agreement for the hedge fund generally places minimal restrictions on the terms and conditions of the investment, and rarely requires that the investment be made alongside an experienced private investment firm.

Co-investing can put unexpected pressures on a deal. Consider the following factors of how hedge funds work that are polar opposites of the way private equity firms usually function:

- There is often no coherent investment strategy being pursued when a hedge fund makes a private investment, i.e. the private investments are not limited to a particular industry or life stage of a company or size of investment.
- Hedge fund managers generally have no operational expertise in the portfolio company's area of operation and do not work with portfolio company managers to boost company growth.

- Hedge fund managers are compensated annually on realized and unrealized returns, with returns from private investments excluded until realized, and with no clawback risk.

Driving opportunity for future liquidity is probably the greatest pressure point in a deal involving the co-investment of hedge fund and private equity funds. Even though they move by design from the relatively liquid, short-term investments they have relied upon historically, into the longer-term, less liquid positions more often associated with private equity investment, hedge fund managers frequently want substantially the same liquidity horizon for the private deals. The hedge fund wants the earliest opportunity for liquidity, whereas the private equity fund wants to control the exit timing so it occurs at the peak of the company's value and after the private equity firm has brought all of its operational strategies to bear to maximize value.

If a company with a hedge fund investor is not advancing towards a liquidity event with all deliberate speed and sufficient capital appreciation, the pressure will mount on the portfolio company and the private equity fund investor to find a liquidity event in short order. The hedge fund would rather exit and redeploy the capital in an investment that is appreciating fast enough and with sufficient near-term realization that high water marks will be satisfied and performance fees paid to the hedge fund's managers.

It is important for a PE fund to perform due diligence on co-investors, though it's less necessary when investing with

other private equity funds that are frequent co-investors. A close scrutiny of the hedge fund's governing documents is warranted, and the PE fund needs to understand what obligations the hedge fund managers have to its investors. What kind of investor does the hedge fund have? What is the hedge fund's investor turnover? What disclosure obligations does the fund have to its investors?

Understanding the hedge fund's construct, including investor risks and the hedge fund's obligations, is critical to the private equity fund's relationship with its co-investor. PE firms will be less reticent to co-invest with hedge funds if hedge fund managers provide detailed disclosures of risks and obligations.

These are just a few of the areas that warrant scrutiny when these funds co-invest. Because of the administrative complexities of side-pocket investing, many hedge fund managers are forming separate partnerships designed to work just like a stand-alone PE fund. Where that is the case, the co-investing PE fund can view the relationship as if it were co-investing with a PE fund that is moving into a new industry segment or company stage – one that has limited operational experience but with skill in driving to a successful exit. The key is to understand and align their respective interests up front.

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## Pepper Sponsoring City Year Boston

Pepper Hamilton was a platinum sponsor of City Year Boston's annual "Starry Starry Night" gala, on May 24 on City Hall Plaza.

City Year is a full-time youth service corps, whose mission is "to build democracy through citizen service, civic leadership, and social entrepreneurship."

The gala, now in its twelfth year, raises funds to support City Year and its Boston corps members. The featured speaker for this year's event is Theo Epstein, Executive Vice President and General Manager for the Boston Red Sox.



## Peppercast

### Private Equity Mezzanine Funds: Lenders or Investors?

The greatly increased activities of offshore hedge funds in the U.S. debt markets and the increased propensity of hedge funds to make loans have dramatically elevated the visibility of the “trade or business” status issue.

Listen to a short podcast with **Len Schneidman**, of counsel with Pepper Hamilton’s Tax Practice Group and resident of our Boston office, as he discusses this issue which has drawn the attention of the IRS and the popular press.

Len’s recently published book, *U.S. Taxation of Foreign Portfolio Investors*, is the only professional book dedicated to the complex analysis of the critical U.S. and cross-border rules and regulations needed by foreign portfolio investors to minimize U.S. taxes on dividends, interest and trading gains. Please email [podcasts@pepperlaw.com](mailto:podcasts@pepperlaw.com) if you are interested in receiving a complimentary copy of the first chapter of his book.

Listen today by visiting the Tax section of [www.pepperpodcasts.com](http://www.pepperpodcasts.com).

### Private Equity Insight: Key Issues and Trends Facing Dividend Recapitalizations

Pepper Hamilton and PricewaterhouseCoopers are releasing a new study that presents findings from a survey of private equity firms. The study is entitled “Private Equity Insight: Dividend Recapitalizations” and was conducted in association with mergermarket, a research and publishing company.

The report is centered on a survey conducted in late 2006. mergermarket interviewed 75 senior private equity practitioners with a working knowledge of dividend recapitalization processes. Some key findings include:

- 97 percent of respondents expect to recapitalize portfolio companies in 2007
- the majority of dividend recaps will involve middle market companies
- most firms are comfortable with post-dividend recap leverage ratios of 3.5 or 4 to 1.

We hope you find **Private Equity Insight: Dividend Recapitalizations** both interesting and informative. You can request a complimentary copy of the entire report, including forewords and commentary by Pepper Hamilton and PricewaterhouseCoopers, by contacting Brian Dolan at [dolanb@pepperlaw.com](mailto:dolanb@pepperlaw.com).

## **Boston Office Expands with IP Group and Corporate Partner**

Pepper has expanded its Boston office and its intellectual property practice with the addition of partners William D. Belanger and Michael T. Renaud and associates Ibrahim Hallaj, Aaron J. Levangie and Alison L. McCarthy. All joined Pepper from Mintz, Levin, Cohn, Ferris, Glovsky and Popeo P.C. in Boston.

Bill concentrates his practice in patent litigation, licensing and client counseling on intellectual property matters. He has litigated cases involving a wide range of technologies, including digital imaging, subsea equipment, telecommunications and networking, computer software, automotive components, laser and ink jet printers, memory devices and fiber optics. Mike focuses his practice on intellectual property litigation, primarily patent, copyright, trademark and trade secret disputes. He has successfully litigated patent cases in a variety of industries, including electronics, telecommunications and networking, digital imaging, computer software, medical devices, explosive detection systems and interactive voice response systems.

Ibrahim's practice includes representing plaintiffs and defendants in patent litigation, as well as prosecuting U.S. and foreign patent applications, and developing patent portfolios for small and medium-sized clients. Aaron focuses his practice on intellectual property litigation, primarily patent disputes. Alison prosecutes patent applications in the high-tech arena and handles various aspects of IP due diligence, licensing and litigation.

Steven R. London joins the firm as a partner in the Corporate and Securities Practice Group. Prior to joining Pepper, Steve practiced with Brown Rudnick Berlack Israels LLP in Boston, where he was a partner in that firm's corporate group. He concentrates his practice on corporate finance, securities and general corporate matters, and focuses on emerging growth companies and middle market businesses. Steve will help lead the firm's efforts to build the practice of

the Boston office, particularly in the private equity and life sciences sectors.

Please join us in welcoming the group to Pepper. Below is their contact information:

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