



message from partner in charge

It is my pleasure to introduce Pepper's *New York Update*. Our clients and friends often ask Pepper attorneys for advice and education on subjects of interest. The Update 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 Group. The article focuses on the obligation that may arise when hedge funds and private equity funds partner.

I'm also pleased to announce that we have expanded the New York office with the addition of several new partners.

I hope that you enjoy the *New York Update* and welcome your suggestions for topics to include in future editions. If you have questions about information in this newsletter, give us a call 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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Peppercast: What To Do If An Employee Gets Arrested

Listen to a short podcast with Sean McDevitt, a partner with Pepper Hamilton's Labor and Employment Group, as he discusses what employers should and should not do if an employee is arrested.

If you are interested in the latest updates in the world of labor and employment, e-mail podcasts@pepperlaw.com to subscribe to *Pepper@Work*. This is an electronic news alert that provides employers with advice on how recent labor judgments and opinions will affect their organization.

Listen today by visiting the Labor and Employment section of www.pepperpodcasts.com.

Upcoming Events

Pepper Hamilton is proud to sponsor three upcoming Capital Roundtable events:

- **Private Equity Investing in Energy Services**
September 19, 2007
- **Private Equity Investing in Healthcare Services**
October 17, 2007
- **Private Equity Investing in Medical Products and Devices**
October 18, 2007

For more information about The Capital Roundtable and these events, please visit www.capitalroundtable.com.

Pepper partners Jim Rosener and Julie Corelli will be co-chairing the upcoming Private Equity – Doing the Deal conference hosted by CLE International.

- June 21-22, 2007
Loews Hotel – Philadelphia

Visit www.cle.com for more information about this event.

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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.

New York Office Expands with Three New Partners

Pepper is pleased to announce the expansion of our New York Office with three new partners. Kenneth J. King and Samuel J. Abate, Jr. have joined the firm's Health Effects Litigation Practice Group and Stephen G. Gorell has joined the Employee Benefits Practice Group.

Ken has experience defending clients in complex litigation in the areas of product liability, commercial and intellectual property litigation. He has handled cases on a variety of issues, including fraud, RICO, breach of fiduciary duty, trademark and copyright infringement, and law firm liability claims, and has been trial counsel for a major pharmaceutical manufacturer and a major computer manufacturer.

Sam has served as lead counsel for major pharmaceutical and medical device manufacturers. He has handled a variety of commercial and corporate litigation matters in the areas of breach of contract, breach of fiduciary duty and common law fraud, and numerous insurance-related matters.

Steve focuses his practice in the area of employee benefit plans, including qualified plans, nonqualified plans, and

health and welfare plans from an ERISA and tax perspective. He is an expert in the design and implementation of sophisticated pension and retirement programs, pension plan termination issues, ERISA compliance, dispute resolution with the IRS, settlement negotiations, and spin-offs and mergers.

Please join us in welcoming Ken, Sam and Steve to Pepper.

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