THE GATE AND THE HEDGE

Heavy redemptions are making hedge fund managers hope they have the right lawyer.

The financial crash has reminded many hedge funds of the importance of good legal counsel. It’s a lesson some funds learned too late.

Camulos Capital LP, a Stamford, Connecticut–based hedge fund with approximately $2 billion in assets, was one of the lucky ones. In late July, Camulos saw trouble looming on the calendar. Like many of Camulos’s peers, the performance of its funds had dropped, and the deadline for year-end redemptions was fast approaching. If too many investors fled—and there was $43 billion withdrawn from U.S. funds in September—the run on capital could have brought operations to a halt. “We saw what was happening in the markets, and we thought it was a prudent time to lock up the capital,” says Michael Iuliano, the fund’s general counsel.

This was new territory in the secretive, $2 trillion hedge fund world. The boilerplate language in every fund’s offering documents spells out just what is allowed in worst-case scenarios. Some hedge fund managers hadn’t paid close attention when those documents were written; the Camulos team had, and they knew they had options.

Camulos’s COO, Richard Holahan, Jr., and Iuliano reached out to their old firm, Akin Gump Strauss Hauer & Feld, and partner Stephen Vine. They asked Vine to quickly draw up an exchange offer to shareholders. By early September, Camulos made a proposal to investors: stay put, and Camulos will shave management fees from 2 percent to 1.25 percent and cut its share of future profits from 20 percent to 10 percent through 2010. Close to 90 percent stuck with Camulos.

In September, hedge fund Ore Hill International Ltd., a $1.5 billion fund, was in more dire straits. A rush of investor withdrawals had triggered a legal mechanism known as a “gate”—a limit on the amount of money that can be withdrawn each quarter. Common wisdom used to hold that lowering a gate spelled doom for a fund. But the situation was eased when the fund and its longtime outside counsel, Sidley Austin’s William Kerr, worked out a sliding-scale fee arrangement to stave off collapse. Investors got a discount on fees if they stayed put; the longer they stayed, the deeper the discount.

Ore Hill survived, but these days, gates are dropping like deflated helium balloons after a party, and it’s expected to get worse. Multiple deadlines for year-end redemptions are fast approaching, and more funds are looking to slash fees to buy themselves another year or two of operation. Even relatively profitable shops are pondering their options if too many investors head for the exits.

Eliot Raffkind, a partner in Akin Gump’s Dallas office, says that he had conversations with about two dozen fund managers in the span of a week, “just to talk about the worst-case scenario.”

Bad legal counsel can compound bad performance. When the funds (and their lawyers) first negotiated with brokers and lenders, some funds didn’t give enough thought to worst-case scenarios. In a credit squeeze, lenders can force hedge fund investments to dump positions. The trigger point, however, is open to negotiation. Funds that set the bar too low at the outset are now at the mercy of their lenders, forced to sell holdings at fire-sale prices.

One fund that avoided those pitfalls is Octavian Advisors, LP. President Gregory Racz, a veteran of Wachtell, Rosen, Lipton & Katz, made sure that the fund wouldn’t be forced to sell in a bear market when he signed agreements with prime brokers in 2006. Today, the $1.3 billion New York fund is defying the industry trends by attracting fresh capital, adding staff, and welcoming new investors. Says Racz: “Twelve months from now, people will look back and ask, ‘Did the hedge fund manager have the right counsel?’”

—Seth Hettena