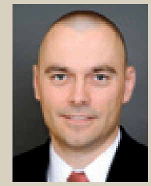
Hedge Funds and Private Equity Funds:

What They Are, How They Operate, How to Value, and What Every Matrimonial Attorney Should Know About Them

Part One

By Vladimir V. Korobov, Adian R. Welsh and Peter Bryniczka



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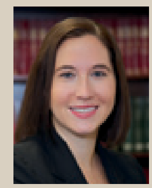

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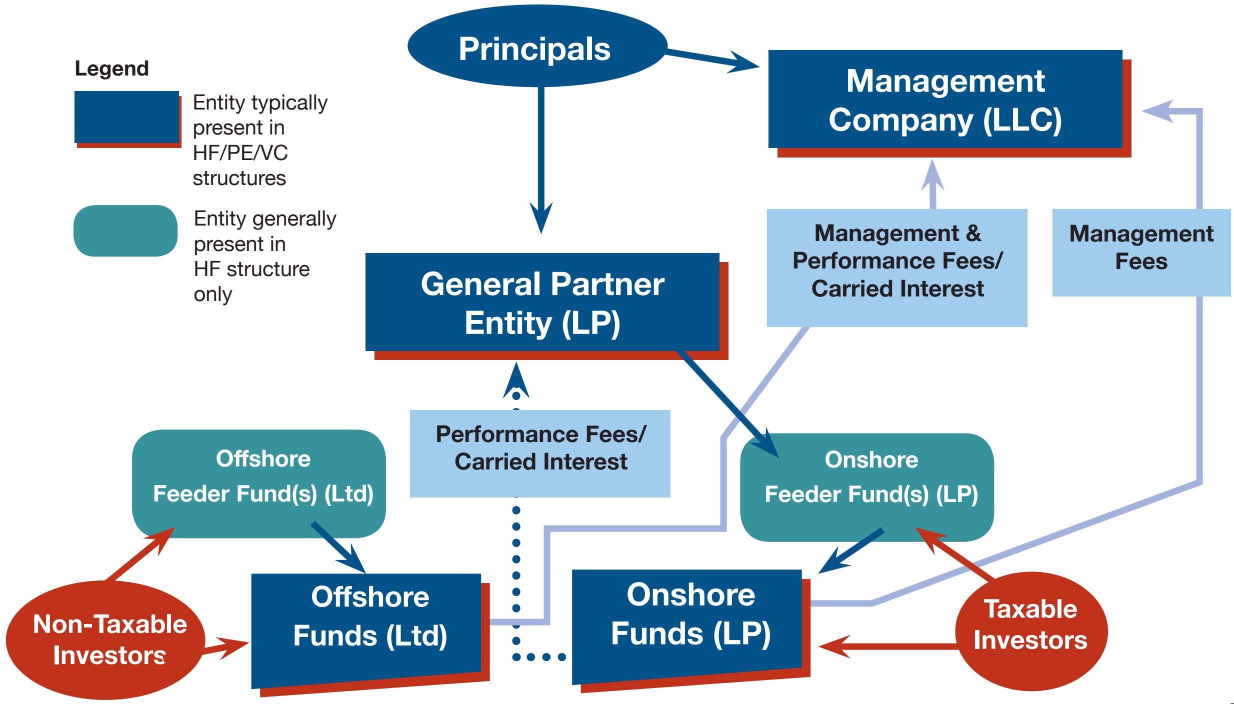

Chart 1

Introduction

The alternative asset management industry, which includes hedge funds, private equity ("PE") and venture capital ("VC") firms, commodity pool operators, etc., has been a prominent feature in, and an important element of the economy of, the lower Fairfield County in Connecticut.

From the perspective of lawyers practicing matrimonial law in the State of Connecticut, the principals of the alternative asset management firms (for the sake of ease of reference, we'll be referring to these firms collectively as "hedge funds," even though there are many subtle and important differences among the firms in the industry) present a unique business opportunity, in no small part because of the great need for sophisticated legal advice and potentially large sizes of marital estates involved. This opportunity, however, almost always comes with significant challenges related to the complexities of the firms' operating structures and unique valuation issues that the hedge funds pose. To successfully tackle these challenges and effectively advise their clients, the legal counsel and, most importantly, valuation experts engaged by the counsel, must have the necessary expertise. In this two-part article, we will offer readers insights into some of the valuation and legal challenges that often arise in matrimonial cases involving hedge funds.

What Is a Hedge Fund?

Hedge funds and similar alternative asset management firms, in general, are investment companies that sponsor and manage pooled investment vehicles (i.e. investment funds). They generate income by charging management and performance-based fees (referred to as "performance or incentive fees, "carried interest," or simply "carry") to the funds under their management. Unlike traditional asset management companies, the hedge funds are less regulated; they can invest in a wide range of asset classes (for example, commodities, derivatives, etc.) and pursue a variety of investment strategies (for example, equity long-short, event-driven, macro, etc.). However, these firms are prohibited from marketing their investment funds to the general public, and can only accept capital from qualified investors.[1] The investment process is generally carried out through a network of affiliated entities. For example, investment decisions are made by a management company that charges a management fee to the funds based on the assets under management ("AUM"). Typically, management fees range between 1 percent and 2 percent of AUM. A general partner entity is tasked with managing the affairs of the investment funds.[2] The general partner earns the incentive fees, which are typically 10 percent to 20 percent of the net investment profit of the funds.[3] The funds are the entities that hold the investments—the funds' shares are offered for purchase to qualified investors.[4]

Organization of a Hedge Fund

For a typical organization of a hedge fund complex, see Chart 1.

Key Differences between Hedge Funds and Private Equity/Venture Capital Firms

Although, as Chart 1 illustrates, hedge funds and PE/VC fund complexes have similar organizational structures, these types of firms differ significantly from the operational perspective. Chart 2 compares some of the key operating metrics of the hedge funds and PE/VC firms.

Hedge Funds	Private Equity/ Venture Capital
Fee Structure: Management fees – 1% to 2% of AUM; Performance Fees/Carried Interest – 10% to 20% of profits.	**Fee Structure:** Management fees – 1% to 2% of committed capital or actively managed assets; Carried Interest – 10% to 20% of profits.
Term: Generally, no limitation on funds' life. However, funds' longevity depends significantly on ability to achieve consistent performance.	**Term:** Generally, the funds' life is finite, defined contractually.
Performance Measurement: Generally, absolute return. Sometimes, for purposes of incentive fees, performance can be measured relative to a benchmark.	**Performance Measurement:** The funds' performance is measured as an internal rate of return ("IRR") and is often subject to a minimum hurdle (or preferred) rate.
Performance Realization: Generally, continuous while the assets are invested (subject to high-water mark and clawback provisions).	**Performance Realization:** Generally, after the hurdle rate has been achieved. PE/ VC funds typically report negative performance in their early years.

Chart 2

Two of the referenced metrics are worth highlighting, because they have a profound impact on the value of the interests in the management company and a general partner entity.

First, an assumption of perpetual operation—a typical premise in valuation of non-distressed traditional businesses—is often not valid, or at least needs to be evaluated in every case, in the context of valuing hedge funds. These firms' ability to raise new funds—and thus to perpetuate their existence—depends largely on their investment performance. In addition, PE and VC funds have finite lives—usually, no more than 10-12 years. Furthermore, the firms' longevity depends, among other factors, on the size of AUM, the type and diversity of investor base, the age and intentions of the firms' principals, as well as the principals' ability and willingness to transition their duties to others within the firm.

Second, a pattern of cash flows of hedge funds and PE/VC firms in the early stages of the funds' lives can be dramatically different. During this time, PE/VC funds make capital calls and use cash, as they deploy the capital committed by the investors and make investments. As a result, although the PE/VC firms collect management fees, at this stage of the funds' lifecycles (which can last several years) they report negative investment returns and, thus, do not earn performance fees. The hedge fund firms, on the other hand, do not usually go through such a pro-longed capital drawdown phase, and, therefore, can earn performance fees immediately following a launch of a new fund, provided, of course, that the new fund generates investment profits.

Overview of Approaches to Valuation of Hedge Funds

In discussing approaches to valuation of hedge funds, it is important that our readers understand what we mean by "valuation of a hedge fund." We use this term to mean a valuation of an ownership interest in a hedge fund management company and/or carried interest, and not the valuation of the hedge fund's investments or the valuation of the limited partnership interests in the hedge fund.

Accepted Methodologies of Valuation

Traditionally, in the valuation of a business, the three generally accepted methodologies are (1) an income approach, (2) a market approach, and an (3) asset approach. The income approach focuses on the income-producing capability of the business. The premise of this approach is that the value of an enterprise equals the present value of cash flows that the business is expected to generate in the future.[5] The market approach focuses on the prices of similar assets. The premise of this approach is that the prices of shares of similar businesses that are listed on public exchanges, and the prices which similar businesses have been acquired for, can provide an indication of value of the enterprise. The asset approach focuses on the net asset value of the enterprise. In a typical application of this approach, the assets-both tangible, and intangible, and liabilities are restated to their values, and the value of equity is calculated by subtracting the value of liabilities from the value of the assets. While each of these approaches is initially considered in the valuation analysis, the selection of a particular approach or approaches is dependent on the nature of the business and the characteristics of a subject interest, among other factors.

As we pointed out earlier, the focus of our discussion is on valuation of ownership interests in hedge fund management companies and carried interests. Thus, we will review the application of the valuation methodologies for these types of interests separately.

Income Approach—Discounted Cash Flow Method of Valuation Preferred

The market approach is poorly suited for valuing interests in hedge fund management companies. This is because the existing publicly traded hedge fund and private equity firms typically manage multiple funds that invest across many asset classes and investment strategies. A typical privately held hedge fund manage-

Income Approach	Market Approach	Asset Approach	Option-Pricing Models
Preferred (and ofte the only) method	Difficult to apply due to lack of information	Generally, used to value GP or holding entities in the investment company structure that are not allocated fee income (such as carried interest), and LP interests in the investment funds managed	Option-pricing models are sometimes utilized to value carried interests
Discounted Cash Flows is typically utilized	Even if comparables are found, "key person" and other issues make application of multiples problematic		This methodology may be less familiar to courts when it is applied in this context
Allows to explicitly model return and operating assumptions	Due to its shortcomings, Market Approach is generally used only as a reasonableness check for the Income Approach results		
Can accommodate simulation techniques, such as Monte Carlo			

Chart 3

ment firm, on the other hand, lacks such diversification and a large asset base. Furthermore, unlike their publicly traded counterparts, private hedge fund management companies typically have "key person" issues (i.e. their success depends significantly on their "star" founders/portfolio managers). Finally, the sufficient information about the acquired hedge fund firms rarely, if ever, exists to determine meaningful valuation multiples. The asset approach is generally not appropriate for valuing profitable, operating companies.[6] Thus, the income approach- specifically, the DCF method, is the preferred and, often, the only viable valuation technique. However, the expert needs to be certain that the cash flow projections used in the DCF method will be credible, appropriate and admissible.

Application of the Discounted Cash Flow Method

The application of the DCF method typically involves the following steps:

1. Forecasting the funds' AUM, which considers the future expected investment returns; investors' contributions; and redemptions from the fund, fund closures, or new fund launches, as well as other factors that are known or knowable as of the date of valuation
2. Forecasting management fees (and carried interest distributions) based on the forecast of AUM
3. Forecasting the company's operating expenses, based on the analysis of historical costs, expected expense levels, and giving proper consideration of reasonable compensation issues
4. A development of the appropriate discount rate
5. A determination of value of the business as the present value of the expected cash flows
6. A determination of value of the subject ownership interest in the hedge fund management company given consideration to the appropriate discounts (such as a discount for lack of control and/or a discount for lack of marketability)

Income Approach—Discounted Cash Flow Method of Valuation Preferred

The market and asset approaches are generally not appropriate for valuing carried interests for the same reasons that we have outlined in the discussion of valuation of ownership interests in management companies. The carried interests can be valued using the DCF method (based on the same AUM forecast that we described earlier).[7]

Information Category	Relevance to Valuation Process	Relevance to Employee's Income/ Property Interests	Specific Reporting/ Maintenance Requirements
Investment complex's organizational structure chart	• Identifies entities in the hedge fund structure and their purpose • Outlines cross-entity ownership	• Facilitates understanding of employee's income/property interests in the context of other entities in the structure	• No specific regulatory requirements for hedge funds to maintain this data, but the charts are typically maintained for internal purposes
Partnership/ limited liability company agreements and similar organizational documents	• Stipulate equity ownership, management and profit allocation rights, restrictions on transferability, etc.	• Stipulate specific rights attributable to employee's property interests that must be considered in valuation analysis	• These documents are maintained in the ordinary course of business
Employment agreements/ Incentive Compensation Plan Documents	• Stipulate employment terms, as well as compensation that an employee is entitled to (e.g. salary, bonus, profits participation, carried interest allocations, etc.)	• Stipulate employment terms, as well as compensation that an employee is entitled to (e.g. salary, bonus, profits participation, carried interest allocations, etc.)	• These documents are maintained in the ordinary course of business
Corporate and employee's personal tax returns and supporting schedules and forms	• Evidence of compliance with tax reporting requirements • Results of operations, when these are not generated for financial reporting purposes • Evidence of sources of income (for employee)	• Provide evidence of income allocated to employee for tax purposes, as well as distributions received • Report employee's capital account balances arising from employee's income/ property interests	• Tax returns are required to be filed and maintained
Funds' historical investment performance data, AUM, investor communications	• Evidence of historical investment successes and failures with managers' explanations • Trends in investors' capital contributions and redemptions	• Data helps explain, and provide the necessary context for, employee's historical compensation levels to enable future forecasting	• Periodic investor communications that include historical investment returns and other disclosures is a standard industry practice
Audited financial statements	• Independent attestation of the funds' results of operations, AUM, and other relevant disclosures	• Attested data provides additional level of comfort for the financial inputs used in valuation analysis of employee's income/ property interests	• The funds are typically required to issue audited financial statements annually

Chart 4

Summary of Valuation Methodologies

Chart 3 provides a summary of the valuation methodologies that that have been discussed.

Role of the Experts

A valuation of a hedge fund is a complex exercise. It requires not only highly technical valuation acumen and finance skills, but also a thorough knowledge of the industry practices. This is why many, even otherwise highly qualified, business appraisers do not have the necessary skills to perform hedge fund valuations. Unfortunately, all too often legal counsel fails to recognize (or fully appreciate) a specialized nature of the skills and knowledge that an expert must possess to perform a credible hedge fund valuation. Nowhere else a valuation specialist's lack of expertise turns into a headache for attorneys like in a dispute or litigation. While two qualified experts may—and often do—reach different opinions of value for the same interest, a direct result of failure to engage a qualified expert is often wild and irreconcilable differences between the experts. Such differences almost always become significant hurdles to a successful resolution of the cases.

Once a qualified hedge fund expert is engaged, however, the attorney can use their expertise in a wide range of issues in the case. Below some examples are outlined.

Expert assistance with the discovery process:

There has yet to be a hedge fund employee, a litigant in a divorce case, who is eager or perhaps even able to provide extensive details and information about the hedge fund, its processes, strategies, performance, and/or methods of compensation in discovery. Moreover, the hedge fund itself is even less interested and less inclined to provide any details of what it considers to be strictly confidential information just because one of its top employees is going through a divorce. As a result, the discovery process when a divorce case involves a hedge fund employee is rarely quick, easy, or straightforward. Confidentiality agreements certainly can help move the process along but often even with the confidentiality agreement, there is great reluctance on the part of the fund and/or the employee to provide any information that a financial expert want and require in order to value the litigant's interest in the fund. The employee-litigant also may not have permission to obtain nor access to the information sought from the company by the opposing side to produce in their divorce case.

The goal of the matrimonial attorney, from a broad strokes perspective, is to identify all of the hedge fund employee's sources of income derived from the fund and further identify any property and/or equity interests in the fund(s) and/or the G.P. and/or Management Company held by the employee. This sounds straightforward but can be complex. The attorney should utilize and rely on his or her expert's insight and understanding of hedge funds in general and the subject fund in particular in order to identify the areas of inquiry for discovery, and the records and documents to be provided. The expert knows what he will need to see and review in order to do his work. The attorney must ensure such information is ultimately provided for the expert's use.

Discovery in Cases Involved in Hedge Funds

For some examples of the information that the valuation experts typically request in these cases, view Chart 4.

Expert involvement with settlement discussions and/or mediations:

The experts should be of immense help to the matrimonial attorney by ensuring they have a continuing ongoing dialogue with the matrimonial attorney: (a) to ensure the attorney is well-versed at all stages of the proceeding in the progress the expert is making; and (b) so that the attorney is able to succinctly and accurately articulate their position as to the hedge fund to his client, to the opposing side, and/or to the court. An attorney cannot settle the case if he does not understand the assets and income involved with the case. The expert must ensure the attorney has this understanding as early as possible in the case and that the attorney is updated in real time with important developments in the analysis.

Mediation provides an opportunity for the expert to be directly involved in the matrimonial in a manner other than testifying at a deposition and/or at a trial. The matrimonial attorney should absolutely plan any mediation with an eye to having his experts present and ready to directly assist with any discussions related to hedge funds issues. CL

Notes

1. Qualified investors are typically institutions (e.g. sovereign wealth funds, pension funds, endowments, family offices, etc.) and high net-worth individuals.
2. A general partner is usually a sponsor of the investment funds offered by the hedge fund firm. It is not uncommon for a hedge fund structure to have a single entity that performs the functions of both a management company and a general partner of the investment funds. In this case, this entity earns both management and incentive fees.
3. In this context, a carried interest can be thought of as an unpaid portion of the general partner's share of the investment profits.
4. Investors, who are subject to the US taxation, are typically offered shares of "onshore" funds, i.e. the funds that are domiciled in the US. On the other hand, foreign or institutional investors, who are not subject to the US taxation, are typically offered shares of "offshore funds, i.e. the funds that are domiciled in offshore zones, such as Cayman Islands.
5. An example of the application of the income approach is a discounted cash flow ("DCF") method.
6. While the asset approach is generally not appropriate for valuing carried interests and the interests in management companies, this approach may be used for valuing holding entities in the hedge fund complexes and limited partnership interests in the investment funds.
7. In a non-litigation setting, option-pricing methods and simulation techniques are sometimes utilized in addition to the DCF. We caution, however, that the application of these methods in the context of the carried interest valuation has not been accepted by the courts in Connecticut in matrimonial cases.

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Part Two

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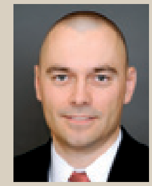

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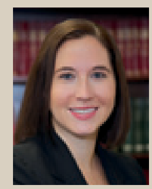

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This article is the 2nd part of a Two-Part Series on Hedge Funds and What Family Law Practioners Should Know

Hedge Funds in the Family Law Context

In the typical matrimonial case involving a hedge fund employee, each party will be armed with his or her respective expert ready to opine as to the hedge fund employee's compensation from and/or interests in the fund. While the opposing experts will (or should) be working from the same information, their ultimate conclusions, opinions, and recommendations will likely be different—sometimes strikingly so. At the end of the day, the mediator, arbitrator, or superior court judge charged with resolving the matrimonial case will have to make a determination regarding valuation, income, assets, and/or other financial issues based in no small part on the experts' input and issue settlement recommendations or binding orders (as the case may be). Thus, it is a key task of the matrimonial attorney involved in a hedge fund case to ensure that an expert and the expert's opinion are the most persuasive and intelligible.

The first and most important point to remember for the matrimonial attorney in this context is she will never be as expert as the expert. Therefore, she should use and rely on her own expert to assist him in assessing and attacking the opposing expert's report and conclusions at deposition and/or trial.

How to Bolster Your Expert and Attack the Opposing Expert

While the subject of how to bolster your own expert and attack the opposing expert could fill a trial-practice textbook, the following are some highlights to be aware of:

- Attack credentials. (BUT only if your expert is better credentialed)
- Attack valuation assumptions and/or lack of investigation. If they're working from the wrong facts or inaccurate assumptions, then that undercuts their conclusions.
- Attack inconsistencies between a prior report and the current report and/or between testimony (deposition or trial) and the report(s).
- Attack the choice of methodology and/or approaches to value. Are the valuation methods and/or approaches to value inconsistent or incompatible with each other? With the facts? With underlying assumptions? What alternatives were available and could have been used?
- Where does the opposing expert agree with your expert? (This helps bolster your expert to show the opposing side agrees with aspects of their work)
- Are there any key omissions from the opposing expert's report that could undercut their conclusions?
- If the opposing expert represents the employee, did he conduct any independent investigation or make an independent request for information from/about the hedge fund or did they base his work solely upon the information that the employee and/or fund provided to them?
- What is the definition of value[1] that the expert is using and what is the valuation date?
- How clearly has the expert identified the asset[2] being valued and how and what is his understanding of all aspects thereof?
- What is the key information an expert would need to do an adequate job proceeding on the particular valuation approach and methodology selected? Did the expert in fact obtain such information? How many years' worth of such information did he obtain and how much should he have obtained?
- What is the level of subjective judgment interjected by the expert? Anywhere the expert has made such judgments is a potential area of attack.

A Closer Look at Ways to Attack the Opposing Expert in a Case Involving Hedge Funds

Specifically for hedge funds, some examples of the foregoing items would be:

- Failure of an expert to link his valuation analysis and conclusions to the assets under management and/or investment returns
- Assuming an unreasonable investment return
- Misplaced reliance on capitalization of earnings method of the income approach
- Failure to distinguish between the economic and ownership interests

Let's look at the hedge fund-specific examples closer.

- *Failure to link valuation analysis and conclusions to the AUM and investment returns*

  The expected levels of AUM and future investment returns are the fundamental value drivers for hedge funds. Unfortunately, all too often experts mistakenly forget or ignore this fact. The result of their forgetfulness—or ignorance—is that their analysis is often internally inconsistent. Consider the following example. An expert develops a forecast of the hedge fund's cash flows based on the entity's historical earnings (both management and performance fees). The historical earnings, however, exhibited significant growth due to the fact that the fund was able to attract several large investors. An outlook as of the date of valuation, however, is that such capital raising success is highly unlikely in the future and, in fact, the fund is no longer actively marketed to potential investors. The expert ignores this fact and assumes that the earnings will continue to grow at the historical rate. Setting an investment return aside, the expert's earnings forecast implies that the fund will continue adding new investors; thus, the forecast contradicts the outlook and expectations as of the date of valuation.
- *Unreasonable investment return assumption*

  The investment return assumption is, arguably, one of the most frequent sources of disagreements between the experts in the context of the hedge fund valuations. The most common intellectual fallacy that the experts succumb to is when they assume that, when a hedge fund earned high investment returns historically, it will continue earning exceptional returns in the future. Such a simplistic view of the world by some experts is even more puzzling, considering the fact that (a) a phrase "past performance is no guarantee of future results—an investment may lose value" or its variations accompanies a prospectus of virtually every mutual fund available for purchase by the general public in this country, and (b) the last fund that promised consistent high investment performance turned out to be the Bernie Madoff's ponzi scheme. So why then some experts simply assume unsustainable investment returns based solely on the history of high performance? In our experience, this occurs when the expert does not possess the necessary industry knowledge and valuation skills to formulate and support a reasonable and defensible investment return assumption.

- *Reliance on a capitalization of earnings method of the income approach to value a hedge fund*
  When valuation experts rely on a capitalization of earnings method to value hedge funds, they often justify their selection of this method by arguing that its simplicity makes it more easily understandable for the judges. In general, a capitalization of earnings method[3] is a valid valuation technique that has merits in certain limited circumstances. An example of such circumstances is when a business generates stable, predictable earnings year after year. The critical assumptions that form the basis of this method are that (a) the business has a perpetual life; and (b) the earnings grow at a long-term, *sustainable* rate, which is generally considered to approximate a rate of inflation. Based on the method's assumptions, the value of the business in this example can be reasonably estimated by dividing the business's earnings by an appropriate capitalization rate. A seeming simplicity of the assumptions, however, is what makes this method completely inappropriate for valuing hedge funds. The reason for this is twofold. First, as we pointed out earlier, the assumption of perpetual life of the business implicit in the method is often invalid, especially for private equity funds. Second, while an inflation rate may be a reasonable expectation of a long-term growth in earnings of a traditional business, it is not an appropriate gauge of the long-term earnings of a hedge fund firm. After all, why would anyone invest in a hedge fund that promises to earn a rate of inflation?

- *Failure to distinguish between economic and ownership interests*
  A common error made by the experts (and attorneys) who are not experienced with hedge funds is that they automatically assume that a tax form K-1 issued to an employee is evidence and proof of the employee's equity ownership in the hedge fund entity that issued the form. While, in general, the tax form K-1 is consistent with the equity ownership in a partnership or a limited liability company, this is not always the case for hedge funds. Often, a hedge fund employee who is granted carried interest—i.e. an economic interest in a portion of the investment profits, receives a treatment as a partner of the hedge fund's GP entity for tax purposes. As such, the employee receives a K-1 form from the GP entity, even though the employee does not actually have the equity ownership interest in the entity. Thus, the employee has an economic interest in the hedge fund's GP entity in the form of a capital account balance and a right to a portion of the carried interest. An ancillary issue to the difference between the economic and ownership interests is when the employee's right to income (for example, the right to a portion of the profits) stems from the employment agreement.

Other Issues

What to do when the hedge fund and/or employee refuses or is resistant to providing the discovery information requested

If the paramount concern for the fund and/or the employee is the confidentiality of its information, then the first and easiest step is to suggest a reasonable confidentiality agreement to protect their interests stating, at the least, that the information provided in discovery will only be used for the purposes of the matrimonial litigation and will not be further disclosed. The attorney requesting discovery from the employee and/or the fund should offer such a confidentiality agreement at the time they first request production related to the fund.

It is possible that the hedge fund resists production by either directly, or through their employee, asserting that certain requested information is not relevant, is unavailable currently, or does not exist. In such an instance, the expert can be of great assistance to the attorney by explaining why these documents likely do or must exist—either because the fund is mandated to keep such records and/or because such funds typically track such information internally for their own internal reporting, performance tracking, or other purposes (For more information, see chart 4 from part one of this article). Such insight from the expert greatly assists the attorney seeking these records—whether in discussions with opposing counsel or in argument before the court on discovery disputes.

Still a bigger issue arises when/if the hedge fund takes the (extreme?) position that certain proprietary information of the fund is not disclosed under any circumstances to anyone and that they will resist to the fullest extent the disclosure of any such information. It could be that the information sought in discovery from the fund itself is not even available to the employee/litigant in the divorce case. The attorney seeking the disclosure of information from the fund that is "arguably calculated to lead to the discovery of admissible evidence" (per Connecticut Practice Book § 13-2) is on solid legal footing to assert disclosure of the information. Theoretically, any and all information useful to the attorney or expert in identifying, understanding, quantifying, and/or valuing the employee's compensation, economic benefits, interests, cash flows, and/or property or equity interests should be deemed discoverable by the courts and ordered produced. However, the hedge fund may assemble a very large and very expensive team of corporate lawyers to resist, delay, and/or frustrate the production of any material the fund has decided it doesn't want to produce. This is a losing scenario for both parties to the divorce action given the marital estate to ultimately be divided will be depleted by the attorneys' fees generated in relation to such a discovery battle. If the information which the fund resists providing is absolutely critical to preparing the case and for the expert to do their work, then there is little choice but to press on. However, to the extent the expert can suggest creative "workarounds" and/or alternate ways of getting to the information they need, they can be of great help in avoiding discovery battles. It can also be useful to compartmentalize the process. For instance, does the expert need the same information to assist in settlement of the case or a mediation as they would to issue a full valuation report for purposes of a trial?

Compensation of employees—Income versus asset

A typical compensation arrangement for a hedge fund employee consists of a base salary, cash bonus (discretionary and/or performance-based) and, often, grants of carried interest and restricted investment funds' units.[4] The compensation of hedge funds' principals, however, is often less structured. For example, it is not uncommon for the principals to receive only distributions of carried interest and profits from the management company instead of a traditional salary and bonus.

The nature and details of the equity interests and/or compensation the hedge fund employee receives due to employment are a key issue for both the attorney's and the expert's attention. It is unrealistic to assume that the hedge fund employee will be compensated along the simple lines of a salary and cash bonus only. The hedge fund employee will also likely receive additional forms of compensation linked in some fashion to the performance and/or growth of the fund and which encourages them to stay at the fund. Understanding how the employee is compensated and on what that compensation is based is an important step the attorneys and experts must deal with and any matrimonial case involving hedge funds in order to properly identify value and/or evaluate what is at stake in the case. Going a step further, it should be determined which aspects of the employee's compensation represent regular income and which aspects perhaps represent a return on investment or a return on income deferred in the past. What aspects of the employee's compensation structure represent income for alimony and support purposes and what aspects perhaps could be considered property rights to be divided between the parties as equitable distribution on divorce (and without the tax consequences associated with alimony)?[5]

How to structure a settlement when the fund or the parties' interest there in is illiquid

An issue of illiquidity frequently comes up in settlement discussions. In a typical scenario, a property spouse has an interest in the hedge fund's management fees and carried interest. A division of property essentially means that the interest is sold at the fair market value, and the net proceeds are distributed equitably between the spouses. In practice, however, such a sale of the interest in the hedge fund rarely, if ever, happens; and, in fact, the property spouse typically retains the interest. This presents a challenge if the marital estate does not have sufficient other, liquid assets to achieve an equitable division of the marital assets. To address this challenge, the parties can establish a constructive trust, with the non-property spouse as a beneficiary, that would hold the property spouse's interest (or a portion thereof) in the hedge fund. As the beneficiary, the non-property spouse would then be entitled to the future cash flows from the interest. Any retained rights to the future cash flows must be carefully considered for purposes of structuring alimony. **CL**

Notes

1. For example, fair market value, fair value, other?
2. Does the asset represent (a) an interest in the management company, (b) carried interest, (c) limited partnership interests in the investment funds, (d) all of the above?
3. According to the International Glossary of Business Valuation Terms adopted by the majority of the professional organizations representing business valuation appraisers in the United States, a capitalization of earnings method is a method within the income approach whereby economic benefits for a representative single period are converted to value through division by a capitalization rate.
4. A portion of the annual bonus is often deferred, while the grants of the carried interest and the restricted units are typically subject to vesting and continued employment.
5. Broadly speaking, under Connecticut Law, something is considered property for purposes of distribution in a divorce case where there is a presently existing and enforceable right to something and the likelihood of receiving the asset is not overly speculative.