Mutiny at PIRATE CAPITAL

Tom Hudson has made a fortune as the hedge fund Captain Kidd. Now, trading losses and rebellion inside his firm threaten his Jolly Roger Fund.

By Anthony Effinger and Katherine Burton

MICHAEL EDWARDS (PIRATE); GETTY IMAGES (BACKGROUND)

Tom Hudson and his pirates had a blunt message for resort owner Intrawest Corp.: “Surrender the Booty.”

It was March 2006, and Hudson, who runs a hedge fund firm called Pirate Capital LLC, spied treasure at Vancouver-based Intrawest. Its shares were trading at $32, and Hudson owned 5.8 million of them. That made him the company’s biggest shareholder and, in his eyes, the boss. So Norwalk, Connecticut–based Pirate, which flaunts its “booty” motto on hats, demanded Intrawest put itself on the block.

“We urge you to fulfill your fiduciary duties to all shareholders by immediately initiating a sale of the entire company,” Pirate analyst Stephanie Tran wrote to the board. Five months later, Intrawest, with 24,800 employees, sold itself to New York–based Fortress Investment Group LLC for $1.8 billion, or $35 a share. Pirate had begun buying the stock at $15.80.

Hudson, 41, has made a fortune as the hedge fund Blackbeard, dragooning companies that don’t make him enough money. A Wall Street outcast who was fired from Goldman Sachs Group Inc., Hudson buys stocks and then battles managements to drive prices in his favor. Since Hudson founded Pirate in May 2002, he and his crew have fought their way onto the boards of eight companies. To enrich himself and his investors, Hudson has helped scuttle a proposed $7.9 billion takeover of Princeton, New Jersey–based NRG Energy Inc. by Atlanta-based Mirant Corp.; prompted

Tampa, Florida–based coal and homebuilding company Walter Industries Inc. to spin off a unit for $400 million; and driven Houston-based Cornell Cos., which runs prisons, into the arms of a suitor.

Only now, the winds have changed. Since May 2006, Hudson has battled trading losses and a rebellion within his firm. More than half of his two dozen employees have left, including his most-active analyst, Zachary George. Pirate is leaking money. Its assets fell to $1.56 billion as of Oct. 31 from a peak of $1.8 billion in August, according to figures Pirate has sent to investors. Hudson's Jolly Roger Fund returned 9.5 percent in 2006, trailing a 15.8 percent return for the Standard & Poor's 500 Index. It was Pirate's worst year ever.

As if that weren't enough, a former client and partner, Nassau, Bahamas–based Magnum Global Investments Ltd., has sued Pirate in New York State Supreme Court, saying Hudson reneged on a promise to pay the investment firm in return for steering investor dollars Pirate's way. Hudson has asked the judge to dismiss the case.

> At Pirate, Hudson buys stocks and then battles managements to drive prices in his favor.

It's a remarkable turnabout for Hudson, whose fund posted an average annual return of 31.3 percent from July 2002 to December '05, according to Pirate marketing documents. Hudson is trying to contain the damage. As the $6.6 billion blowup of Amaranth Advisors LLC convulsed the hedge fund industry this past September, Hudson told his clients he had no plans to shut his firm. "I fully intend to refocus, streamline and navigate the portfolio back to the positive performance I began the firm with," he wrote in a Sept. 28 letter to clients.

This isn't the first time Hudson has run aground. Goldman Sachs dismissed him in 1999, after discovering he was having an adulterous affair with Gabrielle Katz, a 24-year-old trading assistant. Hudson, who admitted to the affair, sued Goldman for at least $120 million, claiming, among other things, that senior executives were having dalliances of their own. The judge threw out his suit. His next employer, New York–based Amroc Investments LLC, fired him, too. Hudson eventually married Katz, his third wife, in 2001. Four years later, he filed for divorce. Katz declined to comment for this story.

Hudson runs Pirate out of an anonymous concrete building tucked between strip malls in Norwalk, about 40 miles (64 kilometers) northeast of New York. It's not far from the Connecticut shore where, legend has it, Captain Kidd buried some of his gold. A life-size wooden pirate, complete with peg leg, hook hand, eye patch and cutlass, guards the door to Hudson's fourth-floor offices.

Interviews with former Pirate employees paint Hudson as a man who relishes his freebooter image. His personal trainer chauffeurs him in a black Cadillac Escalade. Hudson sends "Surrender the Booty" hats and foam-rubber galleons to his investors and, in Pirate Capital newsletters, brands money-losing stocks as "shipwrecks."

On the Pirate trading floor, he keeps a tank of carnivorous South American fish called cichlids. In the past, he's dispatched interns to a PetSmart store a half mile down the road to buy minnows for his fish to devour, to the leering delight of his staff. He's also ordered interns to work seven days a week, swabbing the deck of the *Jolly Roger,* his 27-foot (8.2-meter) powerboat, and watering flowers at his home in bucolic Wilton, Connecticut, 10 miles from his office. In 2004, Hudson demanded a Monday–Saturday workweek from his full-time employees, former workers say. He brooked no complaints. "If you want a friend, get a dog," Hudson told them, according to two employees who have since left the company. These and other former employees spoke on the condition they aren't named, saying they fear Hudson would sue them.

"I make no apologies for the reputation I have garnered as a demanding boss," Hudson said in a written response to questions from Bloomberg News. "I work very hard and expect the same from every member on my team. Above all else, I'm interested in making money for our investors. We believe that at the end of the day, what matters to investors is the return that we are able to generate, not the departure of analysts who were dissatisfied with the level of responsibility and/or autonomy that they were afforded on my team."

Hudson is an extreme example of the shareholder activism that's ripped through corporate America since the 1980s. Public pension funds led the way. Then, mutual fund managers charged in. Now, so-called activist hedge fund managers have joined the fray. Hedge funds, which are private pools of capital that enable their managers to participate substantially in investment gains, have what it takes to rattle companies. Their combined assets soared to $1.34 trillion as of Sept. 30 from $490 billion at the end of 2000, according to Chicago-based Hedge Fund Research Inc.

Thomas Hudson Jr. grew up in suburban Braintree, Massachusetts, 10 miles south of Boston, according to Pirate documents. Hudson told Pirate colleagues that his parents ran an office cleaning company. Braintree, established in 1640, has a rich history. It's the birthplace of U.S. presidents John Adams and John Quincy Adams. The town seal features an arm brandishing a saber.

Hudson graduated from nearby Babson College in 1988 with a bachelor's degree in entrepreneurial studies. After collecting an MBA from the Tuck School of Business at Dartmouth College in Hanover, New Hampshire, in 1993, he went to work for New York–based Merrill Lynch & Co. trading distressed bank loans.

Initially, Hudson thrived on Wall Street. In April 1997, Goldman Sachs offered him a job for $1 million a year, according to Goldman Sachs's offer letter, a copy of which was later included in Hudson's complaint against the firm. Hudson would later say in court filings that he made $10 million for Goldman Sachs in 1997 and as much as $15 million for it in 1999, the year the then private partnership went public on the New York Stock Exchange. Before Goldman Sachs held its initial public offering, it awarded Hudson stock and options worth about $5 million as of February 2000, according to his complaint. Today, his reward would be worth far more: Goldman Sachs stock has since almost quadrupled, to $208.11 on Jan. 10 from its IPO price of $53.

Happier times: Pirate Capital founder **Tom Hudson** and **Gabrielle Katz,** his third wife, met at Goldman Sachs. For a time, she served as Pirate's chief operating officer. The couple later divorced.

LOURDES DELGADO

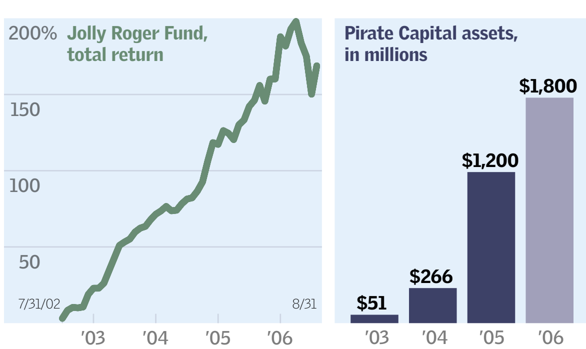
Hudson never collected a dime of his treasure, because Goldman Sachs fired him first. Documents filed by Hudson and Goldman Sachs in New York State Supreme Court tell conflicting stories about what happened.

One thing isn't in dispute: Hudson, then 32 and married to his second wife, had embarked on an affair with Katz, who closed trades in his department. Hudson's boss, John Urban, learned about the affair after intercepting an e-mail and confronted Hudson, according to the complaint.

Hudson, in his complaint, said he admitted to the affair. Goldman Sachs, in its filings, said he initially tried to deny it.

Ahoy

Pirate's rising returns attracted new cash each year.



Returns are for the onshore fund net of fees. Asset figures are as of Dec. 31, except for 2006, which is as of Aug. 31. Source: Pirate Capital documents

Whatever the case, the jig was up: Goldman Sachs fired Hudson. Katz lost her job, too.

Hudson sued, claiming he was fired because Urban disapproved of adultery. "John Urban has publicly made pronouncements condemning extramarital sexual relations and justified this condemnation by reference to religious beliefs," his complaint said.

Hudson accused the firm of breach of contract and violations of labor and electronic privacy laws. He said the firm owed him salary and bonuses—and his promised stock and options in the newly public Goldman Sachs.

Hudson claimed he never thought his affair would trouble Goldman Sachs. His bosses had encouraged him to entertain clients at strip clubs, his complaint said. And Hudson said it was common knowledge that many Goldman partners had illicit liaisons. "Hudson believed that numerous high-ranking Goldman Sachs partners and employees had engaged in extramarital sexual relations with other Goldman Sachs employees and that such relationships, widely known at the firm, had not hindered the careers of such partners and employees," his complaint said.

Goldman Sachs denied Hudson's claims. The firm said it fired Hudson because his romance had created a conflict of interest. Hudson "was in a position to directly influence Ms. Katz's career," Goldman Sachs said in its response to Hudson's suit.

New York Supreme Court Judge Beatrice Shainswit threw out Hudson's complaint in December 2000. She wrote that she did so "with great reluctance" and questioned Goldman Sachs's motives for firing him. "When all of this is viewed in context, plaintiff's discharge appears more likely to have been motivated by the prospect of paying him a multimillion-dollar bonus if he stayed than by any mid–20th-century devotion to the ideals of home, hearth or truthfulness," Shainswit wrote. Hudson appealed, to no avail. Urban, who retired from Goldman Sachs in 2001 at 38, couldn't be reached for comment.

And so Hudson suddenly found himself out of work. After Katz found a new job at Amroc Investments, which specializes in distressed debt, she introduced Hudson to Amroc founder Marc Lasry, according to a person involved in the discussions. In September 1999, Hudson went to work for Lasry, running Amroc's bank-loan trading desk.

Disgruntled partner: Magnum President **David Friedland** has sued Hudson's firm for breach of contract.

Hudson lasted 16 months. Amroc fired him, effective immediately, in February 2001. In his statement to Bloomberg, Hudson said he'd been let go in a round of cost cuts. He sued Amroc for breach of contract, saying Lasry should have given him 15 days' notice, during which he could have closed trades and collected commissions. He also said Amroc owed him vacation time and sick days, which he could have used to close trades.

New York State Supreme Court Judge Walter Tolub dismissed all of Hudson's causes of action except one: He ruled that Amroc should have given Hudson 15 days' notice and let him work vacation days. Hudson, in his statement, says he settled the matter. Lasry declines to comment.

After being fired twice, Hudson became his own boss. He married Katz and then, in May 2002, formed Pirate with $2 million of savings. Katz, then a 50 percent owner, became chief operating officer. Amroc veteran Andrew Stotland joined them and began cold-calling investors.

At Pirate, Hudson turned his attention to stocks and began hunting for beaten-down companies with hard assets, such as real estate. His fund scooped up real estate investment trusts, or REITs, and posted a return of 19 percent during the second half of 2002, according to a Pirate marketing document.

Hudson and Katz seemed to be going places. That October, they bought an $890,000 house in Wilton. Two months later, Katz gave birth to a son, according to court documents. Then, in 2003, the fund jumped 41 percent, and money poured in. By December of that year, Pirate was managing $51 million.

While Hudson was raking in money, life for Katz took a turn for the worse. In 2003, she was diagnosed with Lyme disease, a tick-borne infection that attacks the nervous system, according to a person familiar with the situation. She began missing work to make medical appointments.

As Katz coped with her illness, Hudson piloted his fund ever higher. He posted a return of 30 percent in 2004 as Intrawest, his biggest investment, gained 44 percent. Cornell, the prison company, gained 11 percent that year.

Hudson was living the hedge fund dream. Like most hedge fund managers, he charges his investors a management fee of 2 percent a year. Such fees amounted to $1.5 million in 2004—just for turning on the lights. On top of that, he took a 20 percent cut of all profits. That brought in about $9.5 million more, according to calculations based on Pirate's assets and returns.

The task of wringing more money out of Cornell and several other Pirate investments soon fell to George, who'd joined Hudson in March 2004 after a two-year stint as a credit analyst at Mizuho Corporate Bank Ltd.

George, now 29, lashed Cornell and Harry Phillips, its chief executive officer, for not doing enough to prod the company's stagnant stock. "How many failures in the areas of financial control, operations and business development will it take for you to actually start protecting the interests of shareholders?" George wrote to the board in August 2004. He demanded Cornell fire Phillips, then 54. Phillips quit that January. "The decision to leave was his," Cornell spokeswoman Christine Parker says.

Cornell has fattened Pirate's purse. Hudson began buying the stock in May 2004 for $11.71 a share. By the end of that year, Cornell was trading at $15.18 a share—a 30 percent gain. Last October, New York–based buyout firm Veritas Capital agreed to buy Cornell for $245 million, or $18.25 a share. That's a 56 percent gain since Hudson began buying the stock.

A life-size wooden buccaneer guards Pirate's office door. Hudson dubs money-losing stocks 'shipwrecks.'

By 2004, Hudson was reaching for more. He struck a deal with Magnum in which the Bahamas firm invested $2 million in Pirate and steered $28 million from other investors to Hudson's fund in exchange for a 20 percent cut of all fees on those assets, according to Magnum. The next year, Pirate hired another employee, Miguel Triay, to woo more investors.

A grab-it-while-you-can ethos pervaded the firm. Hudson met with his sales team at 10 a.m. each day to check on their progress raising money. In July 2005, Hudson threw a barbecue for employees at his home. Along with hot dogs and beer by the pool, he offered them a money-making opportunity, people who were there say. One by one, Hudson's

BRIAN SMITH

guests stepped into a clear plastic chamber. Inside was play money—cash emblazoned with skulls and crossbones. An electric fan then sent the bills swirling into the air. The object: Grab as much money as fast as possible. Hudson then redeemed the phony bills for real ones.

Hudson also asked Pirate personnel to sign employment contracts that required the investment of 30 percent of their 2005 bonuses in the Jolly Roger Fund for as long as three years. If employees left before then, they'd forfeit it all.

For hedge funds, size is money: The more assets they control, the more money they collect in fees. In 2003, when Pirate managed $51 million, it pocketed about $1.3 million. In 2005, when it had $1.2 billion in assets, the firm collected $56 million. Former Pirate employees say Hudson paid analysts $600,000–$700,000 a year in salary and bonuses, leaving the bulk of these fees for himself.

As the money rolled in, Hudson swapped some of his old Oxford shirts for silk ones, former employees say. Sometimes, he'd sit at his desk leafing through Sotheby's catalogs and yachting magazines. In October 2005, Hudson promoted Pirate marketer Isa Bolotin, 31, the daughter of singer Michael Bolton, to head investor relations. She arranged a cruise on New York Harbor for clients. "Meet the pirates," the firm's newsletter beckoned. That month, Hudson sued Katz for divorce in Connecticut Superior Court in Bridgeport. Katz countersued. The divorce was granted in 2006.

The Jolly Roger Fund posted a gain of 19 percent in 2005, trouncing the S&P 500, which rose 4.9 percent that year. As thanks, Hudson paid for everyone at Pirate to go to the $650-a-night Four Seasons resort on the Caribbean island of Nevis. The Jolly Roger soared 11 percent in January 2006, its strongest monthly return ever. Hudson, who then had $1.58 billion under management, booked about $39 million for a month's work.

Hudson made big promises for 2006. He told his marketing team that he'd pay them bonuses if they raised a combined $1 billion from investors, according to former employees. If they raised $2 billion, he promised, they'd get

Buccaneer: **Zachary George** lashed prison operator Cornell for its stagnant stock. He left Pirate in September.

bonuses and $100,000 cars—a BMW, Infiniti or Range Rover or whatever else they chose. Hudson found photos of the cars and put them in a frame on the department wall. By April, he had seven employees raising money and dealing with clients compared with five researching stocks.

Then, the Jolly Roger Fund suddenly began to founder. The fund sank 4.75 percent in May and 3.07 percent in June, according to marketing documents. In July, it slumped 9.05 percent as falling coal prices sent Walter Industries, Pirate's third-largest holding, tumbling 22.4 percent. Richmond, Virginia–based James River Coal Co., another Pirate pick, sank 17.9 percent that month. In its August newsletter to investors, Pirate named the company its "shipwreck of the month."

Former Pirate employees say analysts began arguing with Hudson over trades and urged him to sell positions. In August, Stotland, now 29, and three others who helped Pirate Capital tap investors—Kerry Baldwin, 34; Greg Teitel, 33; and Triay, 35—all quit. Hudson has since sued Triay, who was one of Pirate's directors of sales, alleging Triay stole a list of Pirate clients and violated a noncompetition clause by going to work for another hedge fund firm, New York–based Argonaut Capital Management LP. Triay

Storming the ship

Pirate Capital pushes companies to make changes that will lift their stocks.

RANK IN PORTFOLIO	5 MIRANT UTILITY	2 BRINKS SECURITY	11 CORNELL PRISONS	1 INTRAWEST SKI RESORTS	3 Walter Industries COAL, HOMEBUILDING
DEMANDS	Scrap bid for NRG Energy, sell plants outside U.S.	Sell all or part of company, add Tom Hudson to the board.	Fire CEO Harry Phillips, sell company.	Sell company.	Spin off homebuilding unit and Mueller Water Products.
RESULTS	Meets all demands.	Company says it will consider Hudson for the board.	Phillips resigns; Veritas Capital buys Cornell for $245 million.	Fortress Investment Group buys company for $1.8 billion.	Spins off Mueller Water Products.
'06 RETURN	40%	34%	33%	23%*	8%

Portfolio rankings are as of Sept. 30; returns are in U.S. dollars. Pirate sold its stake in Mirant in November. *Through Oct. 27 buyout. Sources: Companies, regulatory filings

MICHAEL EDWARDS

declined to comment. As of Jan. 10, he'd yet to reply to the suit in court.

More Pirate employees quit. George and another analyst, David Lorber, resigned on Sept. 26. A day later, Carl Klein, a Citigroup Inc. veteran who'd been billed as Pirate's second portfolio manager, also bolted.

Hudson told his side of the story in his letter to clients on Sept. 28. In that note, he said he'd fired two analysts, Matthew Goldfarb and David Muccia. Goldfarb, 35, joined Pirate in 2005 after working for four years for billionaire investor Carl Icahn.

Goldfarb and Muccia, 34, said otherwise. "What Hudson wrote in the letter to investors is a blatant mischaracterization of the circumstances of our departure," the pair said in a statement at the time.

Hudson recanted. Goldfarb and Muccia hadn't been fired; they'd quit, he said. "I have now become aware that both had voluntarily and independently decided to resign from Pirate Capital and that their decision to resign was without impetus from me," Hudson said.

In his Jan. 16 statement to Bloomberg News, Hudson said, "The Pirate Capital team is highly skilled and cohesively motivated to excel despite any obstacles that were presented to the firm as a result of what, we believe, were a series of coordinated departures timed to be particularly disruptive to current investment activities and damaging to the firm's reputation."

To top it off, Magnum sued Pirate for breach of contract in November. Rather than giving Magnum its cut of fees, Hudson expelled the investors that the Bahamas firm had brought to Pirate, Magnum President David Friedland says. "It got pretty ugly," Friedland says. "If we'd known this was the kind of character he had, we wouldn't have invested."

According to Hudson, Pirate had the right to terminate the agreement.

The storm at Pirate has left Hudson with an investment team of two traders and three analysts. Some of the people who've abandoned Pirate say they're sorry the old team disintegrated. "We had such a good thing going," a former employee says.

Hudson shows no sign of surrendering. As Pirate was listing in November, he was preparing to storm Richmond-based Brink's Co. As of Jan. 4, he'd amassed 4.1 million shares of the armored-car service provider, which made him the largest shareholder, according to U.S. Securities and Exchange Commission filings. Hudson has told Brink's he intends to seek a seat on its board and push for a sale of the company. Edward Cunningham, director of investor relations at Brink's, says company executives are evaluating Hudson's credentials.

Hudson still has the old Pirate swagger. Now, he just needs to deliver the booty.

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BLOOMBERG TOOLS

Finding Pirate Capital's Filings

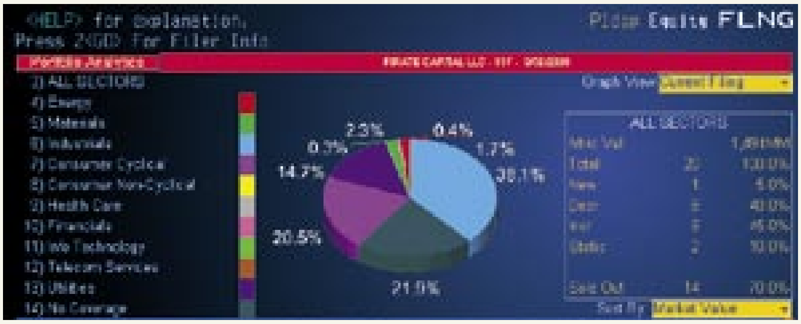
Pirate Capital worked to snag a couple of grappling hooks onto Brink's in January. The hedge fund firm, which had urged the Richmond, Virginia–based armored-car service and home security system company to hire an investment bank to explore a sale of the company, notified Brink's on Jan. 4 of its intent to nominate Pirate founder Tom Hudson and General Counsel Christopher Kelly for election to the company's board of directors.

Type 697713Z US <Equity> CF <Go> to use the Company Filings (CF) function to find documents Pirate has filed with the SEC. In the list of results, click on the DFAN14A received on Jan. 4 to see Pirate's proxy submission. DFAN14A is a form for filing information related to a proposal for a shareholder vote submitted by someone other than company management.

Pirate, like other institutional money managers with more than $100 million in assets, is required to file Form 13F reports on its holdings. You can use the 13F Filing Summaries (FLNG) function to analyze the firm's investments. Type FLNG <Go>, tab in to the COMPANY NAME field, enter *PIRATE* and press <Go>. Click on Pirate Capital LLC in the results for a breakdown of its holdings by sector, as shown below.

Type HFND for the main menu of hedge fund data, news and functions.

JON ASMUNDSSON



For the Fund Search function, type FSRC <Go>.