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Succession

Succession Planning Series: A Blueprint for Hedge Fund Founders Seeking to Pass Along the Firm to the Next Generation of Leaders (Part One of Two)

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A generation of hedge fund founders is arriving at a crossroads. By one estimate, around $600 billion of the industry's assets are managed by firms whose founding principals will reach at least their sixties in the next decade.[1] As they begin to contemplate retirement or devoting time to other projects, founders are considering a fundamental question: Do I want the firm to continue after I leave the stage?

Some founders will choose to wind up the firm. Others, however, will want to leave behind an institutionalized business. One way to do that is to sell a significant stake in the firm to an outside investor. Alternatively, the founder may decide to groom a successor generation of leadership and make operational adjustments designed to let the firm thrive as an independent organization after the founder's departure. This article is about the latter approach to institutionalization – preparing to bequeath a free-standing franchise to the manager's remaining principals and employees. More specifically, the article addresses the imperative of advance planning for leadership transitions; choosing new leaders; the treatment of the founder's economic interest in the firm; retaining and motivating key talent; and a variety of issues concerning succession execution, including investor communications, consent issues and key-man provisions in partnership agreements. In a subsequent companion article, we will explore the possibility of selling an interest in the manager to a third party, where, in a different context, the institutionalization process is also important. For more on succession planning, see "Key Considerations for Hedge Fund Managers in Developing a Succession Plan (Part Two of Two)," The Hedge Fund Law Report, Vol. 5, No. 8 (Feb. 23, 2012).

Why Plan the Leadership Transition in Advance?

Where the goal is for the institution to outlast its founder, a mixture of interrelated issues must be addressed. These include identifying the individuals who will take the reins when the founder departs, maintaining the confidence of investors, determining how to compensate the founder for the franchise value he or she has created and retaining and motivating key manager personnel. Each of these topics requires careful thinking. A hastily conceived leadership transition is less likely to work than one that has been clearly planned, properly communicated and smoothly executed over time. It is therefore ideal to begin planning for the transition well before the founder intends to retire – perhaps three or more years prior to the anticipated time of exit.

Issues to Address in the Transition Planning

An effective hedge fund leadership transition involves many actors: the founder, the individuals chosen to assume leadership, current and prospective investors and the manager's remaining principals and employees. While there is no standard template for a leadership transition, a successful process will account for the interests of all those constituencies.

Identifying the Successors

Identifying and readying one or more successors to the founder is the cornerstone of transition planning. From an internal firm perspective, questions include whether there will be a single successor whose role basically replicates the founder's, or multiple new leaders who will have responsibility over different aspects of the business but share overall authority. This decision often is influenced by how complex the manager has become in terms of size, geography, assets under management, investment strategies and other operational factors. It may be that a firm that initially could be run more or less single-handedly now lends itself to a joint leadership structure.

Whether a single leader or multiple co-leaders will be selected, the founder must decide whether to promote from within the firm or seek talent in the market. This decision will be highly firm-specific and typically hinges on whether there are one or more internal candidates who have both the requisite skills to manage the enterprise and the respect and support of colleagues.

Making Good Use of the Pre-Departure Period

The sign of a successful leadership transition is a feeling of anticlimax when the founder actually walks out the door. Once the next generation of leadership has been identified, the transition process ideally entails a relatively long acclimatization period during which the chosen successors have an opportunity to prepare for the handover. During this time, the designated successors should work on developing necessary additional skills, begin to exercise increased leadership responsibility within the firm (possibly coupled with a new title indicating shared authority with the founder), build support from the manager's principals and employees and gain increased visibility and an opportunity to interact regularly with existing and potential investors. An interim developmental period of this sort helps ensure that the founder's departure, when it happens, occasions the least possible surprise and anxiety among investors and employees alike.

Treatment of the Founder's Economic Interest

A major economic issue in a leadership transition is the treatment of the founder's interest in the manager and the general partner. Two elements are often in tension: the need to reward the founder monetarily for the franchise value he or she has created versus the practical ability of the firm to finance that monetization while preserving the economic capacity to retain and attract talent going forward. Underlying the monetization issue, of course, is the actual value to be assigned to the founder's interest. Firm operating documents may provide (or may be amended to provide) for a valuation formula or procedure, possibly involving input by one or more independent valuation firms.

One approach to founder economics is a buy-out by the remaining principals, with a single payment, of most or all of the founder's interest in the manager and the general partner. While this is a clean approach and delivers immediate liquidity to the founder, it may prove financially unrealistic if the manager controls a majority of the equity and the firm has a large enterprise value. A possible alternative, therefore, is for the remaining principals to buy out the founder over time in phased increments, possibly with the use of outside debt financing.

As an alternative (or partial alternative) to a buy-out, the founder might get his or her economics by retaining a post-departure interest in management fees and incentive allocations. In this case, the parties must determine whether and to what extent the founder's participation in these income streams will decline over time (a so-called "sunset" approach). A related question is whether and to what extent the founder will be entitled to a portion of the proceeds if the manager is sold in whole or in part within a certain post-exit timeframe.

It is often desirable from an investor relations standpoint for the founder to maintain a post-departure investment in the firm, as a signal of confidence in the successor leadership. Thus, another aspect of the founder liquidity issue is whether the founder plans (or will be required) to maintain a significant investment, in the form of a capital account at the general partner or a limited partnership interest in one or more funds advised by the manager. If the founder does stay invested, converting an interest in the general partner to a fund limited partnership interest will help the founder avoid potential liabilities incurred by the general partner. The firm may wish for the founder to have exposure to some degree of general partner liability, however, with respect to pre-departure matters. This can be achieved either through the founder's retention of an interest in the general partner or by a contractual claw-back mechanism.

To the extent at least some of the founder's ongoing investment takes the form of a fund limited partnership interest, the manager may consider waiving or reducing the associated management fee and/or incentive allocation with respect to that interest, as a means of incentiving the founder to remain invested. Such a waiver/reduction also can be used to offset cash payments that otherwise would be owed to the founder as part of his or her equity buy-out.

Retention Incentives for Key Talent

Another element of the transition planning process is creating a compensation environment to motivate the investment professionals and other employees who are central to the firm's continued success. See "How Can Hedge Fund Managers Use Profits Interests, Capital Interests, Options and Phantom Income to Incentivize Top Portfolio Management and Other Talent?," The Hedge Fund Law Report, Vol. 6, No. 33 (Aug. 22, 2013). Talent retention features incentives and disincentives. A major incentive might be the delivery of equity in the general partner or the management company to those individuals the firm wants to remain in place and committed post-departure. Fundamental questions here are whether the equity is granted or must be purchased and whether it is voting or non-voting.

On the "stick" side of the retention equation, the manager might consider assigning a vesting schedule to the equity (real or phantom) designed to encourage continued service. A variety of straight-line or cliff alternatives is imaginable. The forfeiture of equity or similar contract rights upon voluntary termination or the commission of defined "bad leaver" actions is another form of retention incentive.

An additional compensation question is how the manager's profits will be allocated among employees at the end of the year. In some cases, the founder will have been doing this in his or her sole discretion for a long time. Will the successor leadership, especially if it is a single person, have the stature and "moral authority" to assume that role? Or will it be preferable to establish a compensation committee or other more democratic means of dividing annual earnings?

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Executing the Transition

Keeping Investors Informed

As noted above, investors ideally will have been made aware that new leadership has been chosen, and will have had the opportunity to meet with and evaluate the performance of the identified successors during a meaningful period prior to the founder's departure. Investors must be given a clear sense not only of the successor's competence and personality, but also as to whether the firm's historical investment strategy will stay in place after the founder leaves. A more specific communication task is telling investors the actual date of the founder's exit, once it has been determined. This communication might take the form of a letter or other notice to current fund investors and managed account clients.

Is Investor Consent Required?

Beyond keeping investors informed of succession timing, the manager should consider whether investor consent to the succession is required as a legal matter. The firm's investment management agreements presumably will contain a provision, as required by Section 205(a)(2) of the Investment Advisers Act of 1940 (Advisers Act), to the effect that the agreement may not be "assigned" by the manager unless the client consents. Section 202(a)(1) of the Advisers Act provides that an assignment includes "any direct or indirect transfer . . . of an investment advisory contract . . . or of a controlling block of the assignor's outstanding voting securities . . . ." Whether a controlling block of manager equity is being transferred, or any other form of assignment is occurring, is a factual question hinging on whether or not a person or group is gaining or ceding a controlling position over the manager.

The question thus is whether the succession – especially if it features a complete or partial transfer of the founder's equity interest in the manager – gives rise to a deemed assignment of the investment management agreements between the manager and the funds or other accounts it advises. If the succession does constitute an assignment, investor consent will be required. The specific procedure for obtaining the consent will be driven in part by what, if anything, the fund documents say about consents to assignments or consents more generally.

Key-Man Clauses and Special Redemption Rights

Another investor-related aspect of the leadership transition involves analyzing the impact of any "key-man" clauses contained in the fund partnership agreements. While key-man clauses have many flavors, the basic idea is that if the founder and/or other named individuals cease to be actively involved in the manager's business – due to resignation or otherwise –investors may elect to redeem their fund interests on an accelerated basis, i.e., without having to wait for the next regularly-scheduled quarterly or annual redemption period. Assuming a fund does have a key-man clause, an important question is whether the clause is activated by the departure of the founder alone, as opposed to the departure of the founder and one or more additional key persons.[2]

If the founder's resignation will trigger a key-man clause with accelerated redemption rights, the manager should consider how the special redemption process lines up with the next regularly-scheduled redemption period. If the two cash-out opportunities fall near each other on the calendar, investors effectively may have two bites at the redemption apple around the time of the founder's departure. On the other hand, a key-man clause might provide that the special redemption right supplants the next regular redemption opportunity, in which case, depending on timing, investors might have to wait an abnormally long time to redeem following the founder's departure. Managers in these situations may either time the founder's departure so that any special redemption right coincides with a regular redemption right or seek investor consent to synchronize the special and regularly-scheduled redemption rights, to provide a single liquidity opportunity on a relatively normal timeframe.

Updating Marketing and Regulatory Materials

Once the decision has been made to proceed with a leadership transition, the relevant information must be reflected, when appropriate, in the manager's fund marketing and similar materials, such as offering memoranda, pitch books, due diligence questionnaires, website and the like. Once the founder has chosen his or her exit date, the manager should consider whether it is prudent to suspend marketing activities or at least the acceptance of new subscriptions, until the departure plans have been made public. The manager also will need to update relevant regulatory materials, such as its Form ADV, to reflect the founder's departure and any associated changes to titles and responsibilities of manager personnel.

Adjustments to Manager and Fund Documentation

The exit of the founder and the resultant new authority for successor leadership also will have to be reflected in the manager and fund documentation. For example, where the manager's operating agreement provides for certain decisions (e.g., regarding compensation and approval of investments) to be made by the founder, those clauses will need revision to correspond to the new power structure. Similarly, key-man clauses in fund partnership agreements or articles of incorporation may require amendment. On a more ministerial level, signature authority, standing board authorizations and comparable administrative documentation also should be reviewed and changed as necessary. The manager's written compliance policies will require amendment to the extent they refer to or vest authority in the founder; investment committee guidelines and other internal operating documents are also likely to need attention.

Agreements with Third Parties

Finally, the manager should determine whether the founder's departure implicates any of the manager's agreements with third parties, including loan agreements, leases, brokerage agreements, insurance policies, etc. Such agreements may require notice to the counterparty. In less usual cases, the counterparty's consent may be necessary.

Conclusion

A hedge fund leadership transition is an inherently personal and challenging process, and there is no objectively "right" approach. That said, advance planning that takes account of the issues described above – in an appropriately firm-specific way – will improve the chances for a transition that feels natural, timely and undramatic, and that portends continued success for the firm.

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[1] Stephen Taub, "The Great Hedge Fund Succession," *Institutional Investor,* June 2012.

[2] If a manager's fund documentation includes a key-man clause triggered solely by the founder's departure, the manager may wish to seek investors' consent to an amendment at the time new leadership is identified (well before the actual succession). The amendment would revise the key-man clause to provide that it is triggered only if both the founder and the successors cease active involvement with the manager.