HEDGE FUND legal & compliance digest

www.hedgefundlcd.com

Preserving A Hedge Fund's Business and Legacy: The Keys to A Robust Succession Plan

Developing a thriving hedge fund business, as distinguished from a traditional corporation, involves fostering a network of interpersonal connections because investors often decide to allocate to one manager over another at least in part due to the strength of a personal connection. In some cases, a manager's reputation attracts investors as much as the potential returns its funds can produce. Despite this relationship-centered model, investors are increasingly requiring managers, especially smaller firms, to show that they have a sustainable business model, or succession plan, in place that will outlast the founder, key man or portfolio manager they have a personal connection with to ensure that those who remain at the firm will maintain and grow its business and performance uninterrupted. In addition to mollifying investors, succession plans can help hedge fund managers strategize about the future of the firm, in order to preserve the manager's legacy and the value of the business.

This article explains the succession plan's purpose and applicable regulatory expectations, provides guidelines on how hedge fund managers should craft a succession plan and reviews key elements of the plan, such as the primary employee positions the plan should cover, preparing employees to take over key roles, documenting the plan's contingencies and what investors look for when they evaluate hedge fund managers' succession plans.

Purpose of a Succession Plan

General partners' main goal for their succession plans generally is to preserve the business in the event of some contingency. Succession plans can also be an important tool for fund managers to achieve loftier aims such as raising and retaining institutional investor capital, or institutionalizing the business so that it succeeds after the founders are gone.

According to Myron Kaplan, a founding member of Kleinberg, Kaplan, Wolff & Cohen, "Succession planning allows the continuation of the franchise that a hedge fund founder has built. Without a succession plan in place, this franchise likely would not last beyond the founder's departure."

"Construction and implementation of the various elements of a viable, fully fleshed-out succession plan is the best way for a manager to align the manager's and investors' interests and to minimize business risk," Kaplan continued. "With such a succession plan, a manager is building a franchise, and the franchise can continue after the manager's departure. Although given the nature of the business, the manager will always be subject to performance risk, by implementing a succession plan which involves the institutionalization of the business, the manager is creating franchise value that can be very significant."

Meryl Wiener, a partner at Warshaw Burstein, agreed that succession plans allow managers to maintain the franchise they've built. "A succession plan allows you to build a legacy. Once you've left the business, you've increased the likelihood that the business will carry on if you want it to. If you have a great product and a great team behind you, then having a succession plan will allow you to move on to other things or will ensure the smooth transition of the business to new management if something unexpected happens."

Hedge fund managers should also have a succession plan in place in the event a key decision maker unexpectedly leaves the firm so that ongoing business operations can proceed smoothly, said Schulte, Roth & Zabel partner Stephanie Breslow. “Regardless of why or how someone is no longer in a key position, the responsibilities of that person are still going to be there, so it’s just good business sense to make sure you have something in place so your employees and counterparties know who will now take care of those things.”

John Hunt, a partner at Sullivan & Worcester added, “Some managers plan for the future and the day they will no longer be involved. They will choose a successor because they want to be able to sell the business or ensure it is able to continue successfully when they retire to try to capitalize on all of the equity and hard work they’ve put into the business. They’re going to want to make sure the transition is smooth to keep as much value in the firm as possible when they leave.”

Regulatory Requirements

In June 2016, the Securities and Exchange Commission proposed a rule that would require registered investment advisers to adopt and implement written business continuity and transition plans outlining how a firm should carry out and/or recover vital functions in the face of an unplanned event, such as a disaster, or the loss of key personnel. “The SEC hasn’t adopted that rule, and there has been no conversation that it will be adopted anytime soon,” said Hunt. “However, it did shine a light on the issue.”

Although managers do not have a strict regulatory obligation to implement succession plans, all managers should have them, said Wiener. “A succession plan can be more critical for a smaller fund. If you’re an investor who has invested with a larger fund, there is a larger organization behind a manager, and if a fund manager were to leave, there is a degree of comfort that this departure will not significantly disrupt the fund’s operations and that an investor’s money will evaporate before their eyes. Conversely, if you have a smaller fund, the knee-jerk reaction of an investor is to remove their money if the manager leaves and there is no clear succession plan.”

Developing a Succession Plan

Succession planning involves more than simply determining which employee or employees will take over when key executives leave the firm. Managers must also consider which key positions to include in the plan, and prepare and train employees designated to assume their roles.

In addition, different elements of a succession plan involve different personnel, Breslow pointed out. “The areas dealing with keeping the lights on, continuing payroll and other business issues should be done with the people who have those day-to-day responsibilities, such as the CFO, chief operating officer and general counsel, just as the people who are heading up trading or portfolio analysis should be involved in developing the portions of the plan dealing with investment decisions. You need to think about how those various responsibilities will be divided during a succession event. The issues dealing with economic succession are ironed out by the founders and the true equity holders.”

If there is an advisory board or a board of directors, George Schultze, managing member and founder at Schultze Asset Management, said these boards should be involved in developing the succession plan. “An advisory board or a board of directors can help oversee the succession when and if it happens. To be able to do this, they need to have a reasonable level of transparency as to how to implement the plan.”

Hunt also pointed out that who develops the succession plan depends on where the fund is in its lifecycle. “If the firm is just getting started, one of the last things the managers will be thinking of is a succession plan. As firms get larger and the managers get older, if they have been very successful then they are thinking of how to keep the business going and who will take over when they’re gone. I wouldn’t say they have a succession plan in place, but they start thinking about how they can sell the business to the existing employees and to what extent they want to maintain an ownership interest. They usually talk to attorneys about their options.”

Wiener agreed and noted, “The size of the fund has a lot to do with who develops the succession plan. In a larger fund, it’s likely the top echelon of money managers or management. In a small to medium-sized fund, the founder or group of founders often develops the plan.”

Key Elements of a Succession Plan

Some of the most important elements of a succession plan include: identifying key positions which should be covered in the succession plan, identifying successor(s), creating a management committee, developing a written plan and assessing the plan's progress.

Very simply, Schultze said, "Some key elements of succession planning are [that] there is a plan in place, it is documented, the business is not entirely dependent on one or two people and if something happens to one or two executives, then the next group of executives can reasonably take over the business for the interest of its stakeholders."

The key positions that every succession plan should cover are those that are critical to the ongoing operations of the firm, such as the CEO or chief investment officer. Kaplan said that the other roles included in a succession plan will vary based on the amount of assets under management.

Schultze agreed that who is included in a succession plan will vary from fund to fund and noted, "Each business has a number of key executives, such as the CEO, the CFO and sometimes other chief executives. The succession plan will include leadership but may also include positions in finance, business development, operations, and legal and/or compliance. If a manager prefers to grow internally, they will prepare someone in-house to take over in the event one of these key people leaves the firm rather than hiring an outsider.

However, Hunt said he has never seen a succession plan that included executives like the CFO, because these positions can be filled by hiring someone externally or simply promoting someone junior within the firm to replace the departed executive.

When choosing a successor, Breslow said managers need to consider how they can institutionalize the business, so that it can continue to have value even after a founder has retired or is suddenly no longer with the firm. "You need to identify someone within the firm who can take over for the departed executive and who can be introduced to investors and seen in a more prominent role." Identifying executive positions to include in a succession plan and individual successors ultimately is about identifying the right person who is incentivized to stay with the firm, will not create conflicts with other employees and will not leave to start a rival firm once named a successor, Breslow added.

The person chosen to replace a departing founder or other executive also needs to have the necessary skillset to fulfill the departing person's responsibilities and ideally should be someone who has shown an interest in taking on a greater role at the firm. According to Wiener, "You need to have someone whose interpersonal skills are such that the person could grow to become the firm leader. You need someone who has the combination of the motivational, intellectual and interpersonal skills needed to run the firm. It's a very delicate process."

Where the departing person is a founder who has been the face of the firm, the succession plan has to include a transition period during which the successor is presented to employees, service providers and investors as the new face of the firm. "In making people the face of the firm, the successor will often attend investor meetings and other events to give everyone a chance to get to know and get comfortable with this new person," explained Kaplan. "This lets investors have exposure to the firm's next leader and try to assess whether this is someone with whom they are comfortable investing."

Another key element of a succession plan is the valuation of the hedge fund company, Hunt said. "When you're developing a succession plan, valuing the company becomes a very big issue. There will be some mechanism for determining the value of an owner's interest. It's usually turning to an investment bank or other valuation entity to help determine the value. The compensation schedule can be a simple percentage of profits, or it can be a gradual winding down on interests over a certain period."

Training Employees to Take Over

The best option for ensuring a successor can effectively take over a top position is to prepare the successor to slowly take on additional and new responsibilities and gain more prominence within the firm and with investors over a period of time. Wiener said this type of preparation typically takes at least three years.

Hunt agreed there should be a transition period before the successor takes over for an executive that is, or no longer will be, with the firm. “A succession plan is usually thought out over a longer period of time, perhaps over five to seven years, so it is a gradual process. There needs to be time for the transition of leadership and the firm’s identity to ensure the transition is successful.” The founder or other departing executive often mentors their successor as well.

“I would announce who the successor is,” Wiener said. “You want to introduce the investors and service providers to this person and have that person more and more involved with the business and your responsibilities over an approximately three year period. You want to develop a comfort level, not just internally but externally with your investors. A lot of the things that the principal had done independently should now be done jointly with the successor. Progressively, it moves along the continuum, so that at the end of the three years when the principal is ready to leave, you have the successor in place with whom the rest of the team and your investors are comfortable.”

In some instances, though, outside of the successor and a few key executives, there may not be a need to notify other employees of the details of a succession plan, Schultze said. “If it’s a very small business and only a couple of people are operating it, then most likely they all will have access to the succession plan. If it’s a larger business, then there are certain levels of transparency that don’t make sense, such as for junior-level or mid-level staffers at the firm. Sometimes it doesn’t make sense for all of the senior-level executives to have full knowledge of the succession plan. It may be a ‘need to know’ basis only document because of confidential information such as insurance policies and private employee information.”

Reviewing a Succession Plan

Schultze said a succession plan needs to be a “living, breathing document” that should be reviewed regularly and updated as needed.

Hunt agreed and added, “It should be actively monitored when and if there are changes in the industry or within the firm that require an updated look. At the very least, the plan should be looked at once a year and updated as needed. As the business plan changes, the succession plan should change with it. The succession plan should be a living breathing document that changes over time.”

Compensation Structures in Succession Plans

Another component of a succession plan is the compensation of the executive who is leaving and of that individual’s successor. Often equity stakes are given to allow key employees to share in the profits and/or growth of the business. With departing executives, equity in the firm is often reduced over a period of time.

As to how employees are compensated and how a successor’s compensation is determined going forward, Kaplan explained, “The equity in a hedge fund management business is the discounted future value of its performance fees and net management fees after management company expenses. These fees form a compensation pool and are paid out every year. The owners are entitled to whatever is left after salaries and bonuses. A mature hedge fund management company can typically dedicate up to 40 to 50% of the profits from the management/performance fee pools to the owners of the business. Thus, there’s room for a founder to give or sell equity to key employees. That is an integral step in succession planning.”

Kaplan continued, “The general partner owns a form of permanent equity which can be sold or left to heirs, trusts or a foundation. What the equity employees typically receive is a guaranty of a portion of the firm’s profits each year and participation in an event like a sale of the firm. However their equity is not permanent equity and, at least initially, not voting equity. If an employer who owns vested equity departs, he receives reducing tail payments for his equity for a set number of years.”

In order to provide fair value to departing owners or executives, the firm should retain a valuation firm or investment bank to determine the value of the business and how much a certain percentage of ownership is worth and, as a result, how much the departing owner will be paid and the successor could earn, and what is left for the remaining employees.

In discussing the compensation provisions of succession plans, Breslow noted that firms should consider what the economic sunset of the departing principal should be. “If there are multiple founders or multiple people who are true equity owners in the business, often those people have come to an economic understanding that if one leaves, that person sunsets down with a declining interest in the general partner and management company.”

Schultze advised, on the other hand, that the details of compensation should not be included in a succession plan. “The market changes rapidly, and the specifics about what you compensate individuals can change very rapidly depending on what’s happening in the market. That’s something that has to be monitored real time and should be checked at the time the plan is put into action. A good compensation plan will pay employees fairly and will incentivize them to stay with the firm following a transition. You want their interests aligned long-term with the customers.”

Documenting the Succession Plan

Often, a succession plan is not just one document, but a patchwork of policies and procedures outlined in various fund documents, such as the offering memorandum, PPM, and compliance policies and procedures. Succession plans may be outlined in the fund’s operating agreement—a standard agreement between owners of a limited liability company—and lay out what happens if one of the members leaves or dies.

According to Hunt, “Transitions of ownership are usually reflected in a transition agreement. If the adviser is formed as an LLC then there will be provisions in the LLC agreement outlining the transition plan, the economics of how the departing owner will be compensated and for how long.”

Breslow added, “There is not normally a document called ‘succession plan.’ It’s normally a set of practical standing instructions to counterparties on who is responsible within the firm for various functions in the event of the departure of a founder or principal, plus provisions in the management company and general partner operating agreements that govern economic arrangements among the principals.”

What Investors Look for in Succession Plans

Managers have no obligation to provide specific details of a succession plan to investors; rather, how much is shared is within their discretion and may be impacted by whether or not investors specifically request information. Managers may choose to only share the general principles of the plan, or they could make a formal announcement to investors when a succession plan is being implemented.

Although investors may not ask for specific details, they do want to know that a manager has a succession plan in place, Schultze said. “The larger and more institutional an investor is, the more involved the investor tends to be when conducting due diligence on an asset manager, and they tend to give more focus to succession issues. They may not need every detail about the plan, but they may want to spend some time interviewing senior management about the succession plan to get some details or at least some comfort about what’s in place.”

Hunt said questions about the manager’s transition plans tend to come up during the due diligence process and may depend on whether the reputation of the hedge fund has been built on particular personalities at the firm. “Where a manager’s identity is closely tied to the hedge fund, investors may be more interested in the firm’s succession plan,” Hunt added. “If an investor has allocated to a manager because they believe this manager has a winning strategy and is set up for success, then they want to see a manager with a succession plan in place to ensure the ongoing success and viability of the business.”

Added Breslow, “I think investors are interested in understanding how succession would work. They do care about who will be controlling the portfolio in the event someone leaves or dies or falls ill. They want to know about vulnerabilities that could threaten the portfolio.”

Intersection Between Succession Plans and Key Man Provisions

Many investors have negotiated key man provisions that give them certain rights should one or several of a hedge fund's key partners or employees involved in the day-to-day management of the firm leave. The provisions often go hand-in-hand with succession planning.

According to Kaplan, "The management company's succession plan and its key man provisions in its fund documents are related. Both deal with what happens when certain people, usually the founder or another top investment professional, leave the firm. To minimize investor redemptions, agreements should be in place to retain top talent and the key man provisions should be nuanced and evolve with the institutionalization of the firm."

Determining if a Succession Plan is Successful

Managers cannot develop a succession plan and then forget about it until it is needed. Instead, they should evaluate the plan periodically to ensure that all of the people identified in the plan are still with the firm and that the plan can still attain its goal of ensuring the continuing viability and success of the firm. Managers should review the succession plan at least annually or as key people leave the firm.

According to Breslow, some indicators that a succession plan could be successful before the succession event has occurred are that the manager is able to attract the right personnel to the firm and investors think the manager has things under control and are willing to invest with the manager.

"If the plan contemplated that certain people would still be there after the transition, and they are, and they are happy, then you can say it was a successful transition," Hunt added. "That's the whole point of the transition plan."

According to Schultze, "A succession plan is unpredictable and can't be tested, so it's impossible to determine before an event whether your plan would be successful. The best you can do is surround yourself with smart advisors and professionals that have good knowledge of these things, and do your best to formulate a plan that is consistent with your firm's budget and with industry best practices."

Schultze said managers can benchmark their succession plans against "some of the best firms in the industry to see how they have succeeded over time or where they have failed, and try to learn from that."

In trying to assure the future success of a succession plan, Wiener advised, "One of the things I would do to increase the odds that the succession plan works is to keep a portion of my investment in the fund to show my confidence in the successor. Investors want to see that management has skin in the game, and they get a sense of comfort from a departing principal remaining invested alongside them. This will certainly increase the chances that investors remain, and that is one of the determining factors of whether a succession plan is successful."

Kaplan agreed that the founder's continued investment is critical. "It is important to the success of a continuity plan for the founder to leave a significant portion of his money invested in the firm's funds. This sends a message that the founder is comfortable enough with his successors and the firm going forward to keep his money invested with them."