

# Succession Planning

With SRZ's leading fund formation group

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**H**edge fund managers are thinking about succession planning earlier on than they used to, “but usually not on day one – and rarely in their offering documents,” says Stephanie R. Breslow, Schulte Roth & Zabel (SRZ) partner and co-head of the Investment Management Group. They want to have clear plans in place as part of the drive to become more institutionally palatable – and sometimes to help facilitate strategic deals.

A leading law firm serving the alternative investment management industry, SRZ has been advising hedge funds since the infancy of the industry in the 1960s. Steven J. Fredman, SRZ partner and co-head of the Investment Management Group, recalls how “back in the day, a business died after the founder left. Now it is good to work out how to divvy up the pie before anything happens.”

“Today, succession planning is an increasingly popular topic among a greater number of firms. This is due to the maturation of the industry and the institutionalization of many firms,” says SRZ partner David Nissenbaum.

Delicate communication needs to be crafted and drafted. “Many funds are built around people or teams so certain names can be key and it is unusual to see succession plans on day one,” reflects Fredman. Considerations for a succession plan include “how to structure the business internally, maintain relationships, and introduce the next generation of managers to investors without scaring anyone off,” in Fredman’s experience of advising on such matters. Careful choreography is preferable to a ‘palace coup’.

This kind of longer-term succession planning should be back-stopped by provisioning for emergencies, such as the sudden incapacity, death or departure of a key manager. Explains Breslow: “In these situations somebody internal or a friend may be asked to be godfather to the fund, in which case the identity of this person is not normally disclosed.”

## Secrecy and signalling

Nissenbaum adds: “It is very much an art in terms of how to structure and implement a succession plan. There is very little public information about how to design and manage a succession plan, especially prior to the date it is triggered.”

Secrecy may be appropriate for key person event succession planning, according to SRZ partner Jason S. Kaplan, who explains that cognisance of who successors are can give them an internal political advantage at a firm and create internal strife. Consequently, “the name(s) of the successor(s) may be kept secret from firm personnel,” Kaplan has witnessed, and neither colleagues nor investors nor fund directors will know who the person is until the key person event occurs.

Yet the eventual identity of successor(s) should not come as a complete surprise to the sharp-eyed investor. Over the years, Fredman has noticed various ways in which hedge funds can subtly hint who successor(s) are. He cites two examples: “Letters to investors that were once signed by a sole founder may start to have more signatories, or the stage at annual general meetings may be shared with other managers.” And internally, “funds may set up various committees to get others involved,” he notes.

## Key person clauses

Though prospectuses will not normally name successors, “an ever-larger percentage of offering documents have ‘key person clauses’ yet they are only triggered in extraordinary circumstances,” says SRZ partner Jennifer Dunn. This is partly because as the industry has institutionalised, key man clauses have become plural – so key men and women clauses would be a more apt description. Explains Breslow, “Larger hedge funds tend to have multi-tiered key person clauses, which may only be triggered if a certain proportion of managers, such as two out of three, are no longer in situ.”

Sometimes, these clauses percolate down the corporate pyramid and might, for instance, be triggered if four out of seven second-tier managers depart, elaborates Breslow. Key person clauses can arguably be rendered redundant in the largest multi-strategy shops that may have hundreds of risk-takers. In any case, key person clauses are very rarely as pivotal for hedge funds as they can be for some of the private equity funds that SRZ advises – for the simple reason that most hedge funds offer an exit route, in the form of normal fund liquidity terms. “Multi-year lock-ups are becoming less saleable for all but the most illiquid strategies,” observes Breslow.

It is important to recognise that key person scenarios fully address the succession issue. “There is a common misconception that a key person clause is the succession plan,” says Nissenbaum. “The key person clause protects investors with respect to their relationship to the fund. A succession plan addresses a host of other issues related to the investment manager’s overall business continuity and the relationship between the surviving partners and the departed key person or his or her heirs.”

## Structuring transfers of ownership

Kaplan finds it is often normal market practice for retirees to retain some ‘tail’ ownership in a stable business. But a large lingering interest can turn into a drag on everyone else’s profits, so Breslow does not expect to see a tail of more than 5-10%.

Valuation is rarely an explicit requirement for typical transfers of ownership around succession. “These transactions are not structured in the same way as selling minority or controlling interests to seed or strategic investors,” Breslow reveals. Rather, “a sunset provision lets the key person continue to share in profits on a declining basis, and in this way they get ‘sunsetting’ out of the business,” explains Breslow. This may imply some probabilistic value on what is a kind of declining variable annuity, but there is no need to carry out a valuation exercise.

One reason for this deal structure is optimising tax efficiency for the continuing employees. Explains Nissenbaum, “Though a one-off sale of retirees’ ownership could be advantageous for their estate, because profits would incur capital gains tax at lower rates than income tax, if the new owners made an outright purchase of interests in the business, the consideration would not be tax deductible as it would be viewed as like an investment in public equity.” SRZ also has specialist teams of industry-leading tax lawyers who will advise on these matters parallel to the fund formation team.

### **Centenarian managers?**

Though both emergency and longer-term succession plans should be in place, in some cases they may not be actioned for many years or even decades. The absence of a mandatory retirement age in the United States – combined with the energy, stamina and good health of some people working in finance – means that a number of septuagenarian and even octogenarian hedge fund managers are still going strong. The number of nonagenarian and centenarian money managers seems sure to grow. Studies including some from the

Brookings Institute show higher income groups in the US are extending their lifespans every year. At the other end of the age spectrum, many successful hedge fund managers could afford to retire almost any time and some choose to do so in their 40s, making it a more urgent matter. [THFJ](#)

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