

# Alternative Asset Manager Governance & Succession: Founder Overview

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As founders of hedge funds and private equity funds approach retirement, it is critical for them to ensure institutional stability through well-considered succession plans and governance arrangements. Failure to properly prepare for the transition to the next generation can result in severe business instability or even a firm's demise. This is a brief overview of key issues to consider in thinking about these topics.

1. Economics. Very often a founder holds a substantial portion of firm economics. When the founder transitions to a more inactive role or full retirement, the transition can result in correspondingly less equity being available to compensate the remaining active partners and employees or to achieve other corporate development goals (e.g., stock-based acquisitions).
  - a. Recapture by the firm. Rather than retaining some or all of the founder's equity indefinitely (including through transfer to heirs), the founder might consider selling or transferring the founder's interests back to the firm or its next generation of leaders.
  - i. Financial planning. Given the potentially high value of these interests, this process may need to occur over a period of years and the buyer may require financing, including directly from the transitioning founder, remaining founders, the firm or external lenders.

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- b. Retaining a stake. In some cases, the founder may wish to retain an equity stake for the founder or the founder's heirs. It is essential to consider liquidity rights associated with the stake.
  - ii. Applicability to future growth. The firm will want to consider whether the transitioning founder's stake will be limited to residual economic stakes in current businesses, platforms and funds or whether the founder will remain entitled to receive economics generated by expansion into new areas of firm growth. A hybrid approach would ratchet down over time the transitioning founder's economic entitlements in businesses, platforms and funds formed following the succession.
  - iii. Calls / puts. The firm may want the ability to call the founder's stake, and the founder correspondingly may want the ability to put the stake to the firm or to mandatorily require it to be repurchased out of firm earnings over time. The firm will need to consider carefully its ability to pay for that stake at the agreed valuation at the time any redemption option is exercised. The valuation methodology for the stake also likely will be a complex point of negotiation.
  - iv. Drag- / tag-along. Similarly, the founder may want the ability to drag along other holders if the founder chooses to sell, or to tag along with others if they choose to sell. Other holders also might want the right to tag along on any sales the founder carries out.
  - v. Splintered interests. A founder typically holds entitlements to carry/incentive and management fees, the firm's goodwill and coinvestment/limited partnership interests in the firm's funds. The founder may want the ability to sell these individual interests to separate buyers, while the firm may prefer that they be sold only as a whole to ensure complete alignment of interest with the buyer.
  - vi. Founder protections. The founder typically will require an array of protections to ensure the value of the stake is not inappropriately compromised – *e.g.*, consent rights over entering a new line of business; engaging in a business combination; selling material assets; issuing significant minority stakes; incurring substantial debt; changing how the firm is valued; excessively diluting the founder's interest; paying excessive compensation; key person hirings and firings; excessive spending or distributions; or carrying out an IPO or direct listing.
  - vii. Firm protections. In turn, the firm may seek to limit the founder's ability to transfer the stake to any external third party (in particular, a competitor or other holder unattractive to the firm), and may prohibit this type of transfer or seek a right of first offer or refusal on any such proposed transfer.
2. Governance. If a founder's family members are not involved in the business, it generally makes little sense to pass control to them, rather than the next generation of business leaders. In some cases, the next leader or leaders will be apparent for years and the transition will not be controversial. In other cases, there may be a number of potential internal contenders, as well as outside candidates.
  - a. Total power vs. constitutional approach. In all cases, it will be necessary to determine whether simply to transfer power fully or instead to implement an enduring "constitution" to govern the firm.
    - i. Governing body. For example, the firm may desire to institutionalize a formal governing body that transitions the firm

away from being a founder-driven enterprise. A board of directors, executive committee or similar framework could be implemented, with authority to select firm management and make key operational decisions.

- ii. Voting and representation. The body could be elected in proportion to the economics held by a set of senior employees, and, if useful, have seats designated to represent other constituencies (*e.g.*, all employees and external investors, if any, and perhaps the transitioning founder).
  - iii. Lasting architecture. The constitutional approach provides a more enduring foundation for governance and checks-and-balances against a poor succession decision by the founder, as well as on future leadership. The system typically would be amendable only with a supermajority vote, making it hard to replace without overwhelming support and economic alignment.
  - b. Clearly defining the transitioning founder's role. To ensure clear lines of control, the firm will want to ensure a transitioning founder's role is clearly delineated.
  - iv. Founder duties and obligations. Consideration should be given to agreeing on which of the firm's policies and procedures will apply to the transitioning founder to ensure there is no ambiguity. The particular economic and governance terms of the founder's arrangement will be important in determining the scope of compliance required.
  - v. Founder rights. A founder, particularly one that will retain substantial economics at least for some time, likely will want retain specified consent rights to ensure oversight over major decisions, as noted above, as well as consent rights related to governance, such as material changes to organizational documents or structure; entry into related party transactions; and bringing or settling material litigation.
  - vi. Founder title / function. The founder similarly may wish to serve in a chairman or similar role to help guide the firm through the transition, and to received continued office space and support staff (*e.g.*, to support the founder's family office activities).
  - vii. Sunset. These rights can sunset over time or in proportion to decreases in the founder's economic stake.
3. Third-party rights. It is important to be mindful of rights that external constituencies may have in connection with a founder transition.
    - a. Firm investors. A third-party investor in the firm may be entitled to have its interest redeemed in the event of a founder departure or change in control, or liquidity rights that could be implicated when a founder's stake is redeemed or sold (*e.g.*, tag-along rights).
    - b. Fund investors. Similarly, investors in the firm's funds may have consent rights under the Advisers Act and "key person" contractual rights under fund documentation upon a change in control.
    - c. Lenders. Bank loan covenants also may restrict liquidity transactions involving the founder and the structural changes sometimes undertaken contemporaneously with founder transitions. For example, a firm instituting a "constitution" might wish to change its form of organization from a corporation to a limited liability company for greater flexibility in crafting rights and obligations (including the scope of any fiduciary duties), or to change its corporate structure to more readily position itself for a business combination or IPO.
    - d. Regulators. Regulatory notifications or consents may be required in connection with a

change of control of the firm or underlying portfolio companies in regulated industries.

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- e. Amendments. In addition to the type of rights described above, to address or effectuate resolution of the issues arising in connection with the succession, amendments to firm governance and economic vehicles, fund documents, credit agreements and other agreements likely will be necessary. A careful survey of these documents to determine whether any external parties have consent rights over these amendments will need to be conducted.

4. Remedies / dispute resolution. A transitioning founder must consider which remedies are most appropriate if the founder's rights are violated post-transition, along with how disputes will be adjudicated. For privacy and expediency, binding arbitration typically is preferred, with the arbitrators having the power to issue financial and injunctive relief. Financial or other special penalties also can be established depending on the circumstances.
5. Competition / outside activities. A transitioning founder often wishes to manage family assets and may want to work in other capacities following the transition. It is important to agree on any obligations of the transitioning founder to share corporate opportunities and the scope of permissible activities, particularly if they might compete with the firm's business. It also is critical to ensure clarity around the founder's use of the firm's track record and intellectual property (e.g., investing strategies). Similar considerations apply regarding the founder's solicitation of firm employees and investors.

Founder transitions generally are complex transactions requiring expertise across many areas (e.g., corporate, finance, funds, tax, compensation, securities and regulatory law). When carefully planned and executed, the results can be outstanding, both cementing the founder's legacy and securing the firm's future success for the next generations.