Institutional Investor Insight

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Reverse Thinking on Founder’s Rights

In light of the lowest annual hedge fund returns since 2011 and an increase in shut-downs among large funds, institutional investors seeking to maximize gains from liquid strategies may consider targeting new managers. An emerging manager may be able to buck industry trends and achieve higher returns using novel strategies. However, a less-established manager can also present greater risks to investors, because the manager may have a limited track record (or one with attribution questions), less robust operational and compliance infrastructure and a smaller or less seasoned investment team.

To incentivize early investors to accept the risk inherent in an emerging manager, the manager may be willing to offer certain “founder’s class” rights to early investors, such as hurdle rates on performance allocations, reduced management fees or, in certain cases, an equity interest in the general partner of the fund.

However, with certain emerging managers, institutional investors may wish to consider what might be referred to as “reverse” founder’s rights. Reverse founder’s rights are typically appropriate with a newly launching manager who may find it difficult to cover its current operating budget if it has to reduce management fees to early investors. The idea here of course is to avoid what some investors refer to as the “red zone”—when a manager is dependent on earning a performance allocation in order to pay its normal personnel compensation, rent and other overhead costs.

In exchange for supporting the emerging manager economically during its start-up or adolescent phase, the early investor typically seeks two commitments from the manager. First, the investor likely will want a commitment from the manager that the investor will be allowed to invest additional amounts with the manager over time, up to an agreed cap. Second, the investor will want to receive a fee break as the manager’s capital under management increases and the manager becomes more stable overall.

Investors negotiating reverse founder’s rights in a side letter or similar agreement should consider a variety of factors, including:

- What fee break will be provided—reduced management fee, reduced performance allocation or a combination? Often this decision involves an assessment of what level of returns the fund is likely to generate. At mid-range returns, a hurdle rate before the performance allocation is earned can sometimes be better for the investor than a lower performance allocation charged on all gains.

- Should the investor agree to a lockup in exchange for reverse founder’s rights? Conventional wisdom would suggest that a lockup is inappropriate, because the investor is not receiving a fee break on its initial capital. Accordingly, with an emerging manager,
any lockup negotiated should generally be soft or subject to a “down and out” clause permitting the investor to withdrawal if there are losses that reach certain agreed levels. Perhaps the best approach is for the right to a future fee break to be eliminated if the investor withdraws a certain portion of its capital within the first several years.

- The appropriate threshold AUM at which the fee break begins. For instance, as AUM of the fund increases, it may become more difficult to execute the fund’s strategy and generate returns through trade selection. The investor should try to ensure that the fee break occurs well within the phase during which the manager can still effectively employ the fund’s strategy.

- How AUM is measured. For instance, do withdrawals of the general partner’s performance allocation reduce AUM for purposes of determining when the investor is entitled to fee breaks? How are the manager’s other pools and accounts considered for this purpose? What happens if the fund hits the agreed threshold but subsequently slips below the threshold again, due to losses, withdrawals or otherwise?

- Will the fee break apply merely to the investor’s initial capital invested in the fund, or will it apply to subsequent investments as well? What about profits left invested in the fund? What about investments after the threshold is reached? Does the investor have to maintain a minimum investment in the fund once the fee break starts?

The relevant factors will depend on each investor’s circumstances and goals, and reverse founder’s rights may not always be appropriate. Nonetheless, when allocating to an emerging manager, an institutional investor should consider ways to incentivize the manager to maximize the potential of the fund’s strategy. Creating effective incentives may require the investor to trade favorable economics in the short term for the prospect of better returns in the long run. Further, reverse founder’s rights could allow the investor to take advantage of a new strategy while acknowledging that the strategy may require some development. The investor benefits from favorable terms in later periods—terms the investor might have been unable to obtain had it declined to make an early investment in the fund. Careful negotiation of these types of provisions can help the investor minimize risk and maximize returns.

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