Hedge Fund Alert
THE WEEKLY UPDATE ON FUND MANAGEMENT INTELLIGENCE

In Arms Race for Top Talent, Contract Provisions Increasingly Carry Penalties, Spinout Guarantees

As competition for the highest-achieving investment professionals continues to escalate, negotiations between star portfolio managers and the big hedge fund operators willing to pay dearly for them are increasingly hinging on protections against broken promises and guarantees tied to spinouts.

One growing development: Breakup fees, a phrase often shortened to break fees, are showing up more frequently in employment contracts, according to hedge fund lawyers and executives at large multi-strategy shops. The penalties – amounting to as much as $1.5 million, a lawyer said – are paid by one party that changes its mind after committing to the other.

From the perspective of hedge fund operators, the clauses offer a form of insurance when in-demand portfolio managers who've committed to a job are lured away by an even more lucrative offer. And for PMs, who often engage in months of negotiations while also sitting out lengthy gardening leaves, the provisions provide a payout when a would-be employer reneges on a deal without good cause.

Similarly, portfolio managers who are proven profit generators are increasingly insisting on contract clauses that compel firms to back them should the PMs choose to spin out on their own after a set period, typically three years. Such clauses are mainly contingent on whether the portfolio manager has reached performance and risk-management thresholds.

Neither development is wholly new. Industry professionals said the spinout provision has existed for many years, though it was very rarely invoked. And **Bloomberg** reported in late 2022 that **Millennium Management** and **Brevan Howard Asset Management** had begun demanding that potential hires agree to pay a penalty should they choose to back away from offers.

What's changed is the frequency of the clauses.

Daniel Hunter, who co-heads the investment-management group at law firm **Schulte Roth,** said he's witnessed a half-dozen recent examples of fund operators including penalties of between $200,000 and $1.5 million in contracts.

"My understanding is once the firm starts asking for the break fee, they ask it across the board for any position, not just a trading role," Hunter said.

An executive at a large multi-strategy shop said such contracts "are evolving every week."

"They are playing legal chess," he said.

Another multi-strategy executive said recruiting successful PMs and minting deals with them amounts to a "significant cost."

"They don't want to waste time with those who are shopping around," the executive said.

Some hedge fund operators employ language in their standard contracts spelling out conditions for spinning out, including a promise to back a manager's startup on a non-exclusive basis. In the recent past, many fund operators have been loath to consider such language, believing it encourages disloyalty among portfolio managers. But fund operators have warmed up to such agreements to lure top PMs, industry participants say. How common such guarantees really are is not entirely clear.

"Any large multi-strat will tell you they do it rarely, and 30 guys there will say they have that deal. It's somewhere in the middle," one multi-strategy executive said.

Once the domain of big multi-strategy shops, these types of spinout arrangements are being agreed to by some single-manager sector funds, including startups, that are trying to attract top investment talent from multi-strategy rivals, Hunter says.

Max Karpel, a partner at law firm **Akin,** said the recent developments demonstrate "a lot of creativity in the space."

Karpel doesn't limit that creativity to penalties and spinouts. He often represents emerging hedge fund managers who receive external allocations from multi-strategy shops, a booming trend led by the **likes of Millennium and Schonfeld Strategic Advisors**.

"There is room for negotiations," Karpel said, "and not all the platforms require the same terms." ■