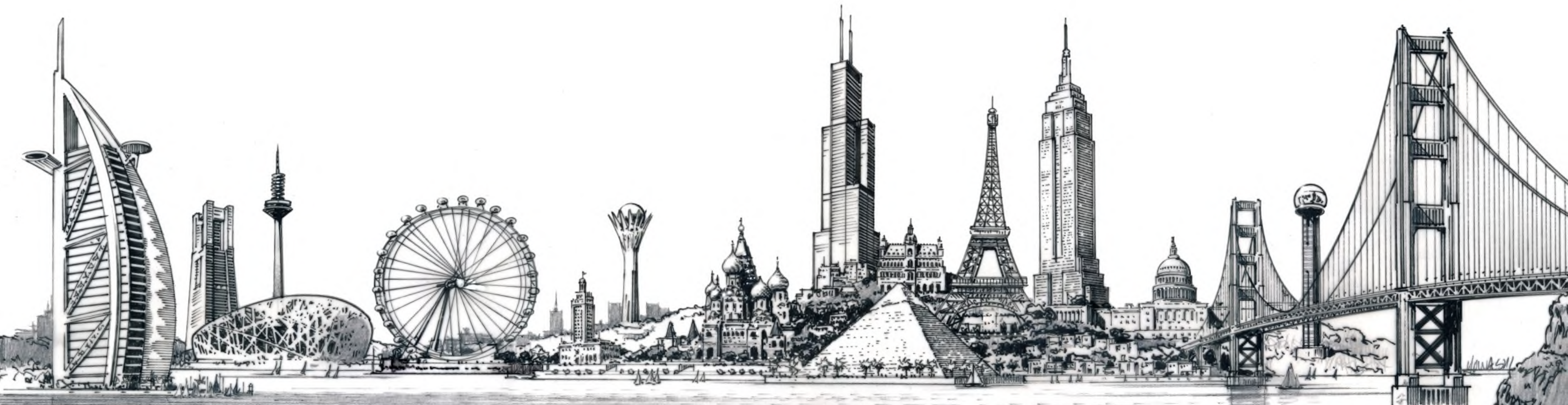
Morgan Lewis

FUNDAMENTALS OF FUND FORMATION: STRUCTURING THE UPPER TIER

Private Investment Funds Practice



Overview

- Basic Structure
  - Planning objectives and factors
  - Sample structures
- The Agreement Among Principals
  - Management philosophy
  - Economic arrangement
- Employee Participation
  - Pros and cons
  - Alternatives

Basic Structure of the Upper Tier

- Primary Planning Objectives
  - Maximize after-tax return
  - Limit liability
  - Maintain flexibility

Basic Structure

- Primary Planning Objectives (continued)
  - Maximize after-tax return
    - Capital gains vs. ordinary income
    - Avoid double taxation
    - Tax deferral on distribution of appreciated assets
    - Minimize state tax exposure
    - Facilitate individual tax planning
    - Reduce self-employment tax
    - Foreign tax issues
    - Qualified small business stock considerations

Basic Structure

- Primary Planning Objectives (continued)
  - Limit Liability
    - Avoid personal liability
      - GP liability
        - Clawback
        - Third-party claims
        - Any unfunded obligations of the partnership
      - Investor liability
        - Control person liability
      - Employer liability

Basic Structure

- Primary Planning Objectives (continued)
  - Maintain Flexibility
    - Allocation of separate streams of income
    - Deal-by-deal allocations
    - Flexible management structures

Basic Structure

- Primary Planning Factors
  - Three Streams of Income
    - Carried interest
    - Management fee
    - Investment income
  - Management Structure
    - Benevolent dictator
    - Politburo
    - Equal partners
    - Corporate sponsor
  - Domicile of the Partners
  - Succession Planning

Basic Structure

- Primary Planning Factors (continued)
  - Fund Management Factors
    - Type of Fund
      - Hedge Fund
      - Fund of Fund
      - Venture Capital or Private Equity Fund
    - GP Contribution Obligation
      - Promissory notes
      - Management fee waivers
    - Clawback Liability
      - Holdbacks
      - Guarantees

Basic Structure

- Choice of Entity
  - C Corp.
    - Limited liability
    - Double taxation
    - Tax insulation
    - Inflexible allocations
    - Succession a problem
  - S Corp.
    - Limited liability
    - Tax pass-through
    - Shareholder restrictions (only U.S. individuals)
    - Inflexible allocations (must be pro rata)
    - Tax incurred upon distribution of assets

Basic Structure

- Choice of Entity (continued)
  - LLC
    - Limited liability
    - Tax pass-through
    - No shareholder restrictions
    - Flexible allocations
    - No tax on distribution of assets
  - Limited Partnership
    - Requires additional limited liability GP entity
    - Otherwise same attributes as LLC
    - Better tax treatment in certain jurisdictions
      - Pennsylvania phasing out
      - Certain foreign jurisdictions (Ireland)

Basic Structure

The General Partner

- Typically a Limited Liability Company
- Limits liability for members and managers
- Tax advantages
  - Pass-through
  - Capital gains treatment for carried interest
  - Tack holding period for capital gains
  - No tax incurred on distribution of assets

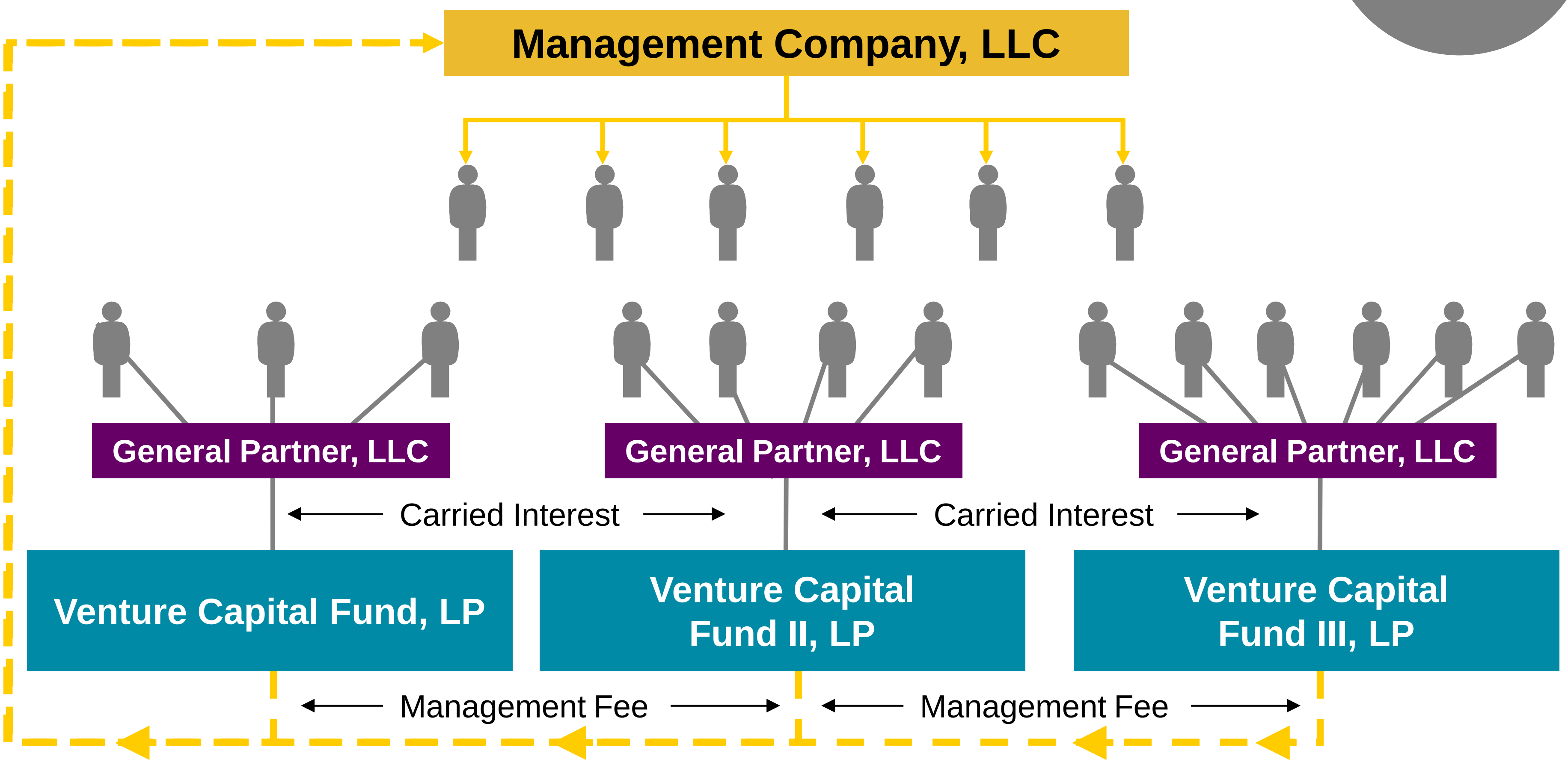
Basic Structure

The Management Company

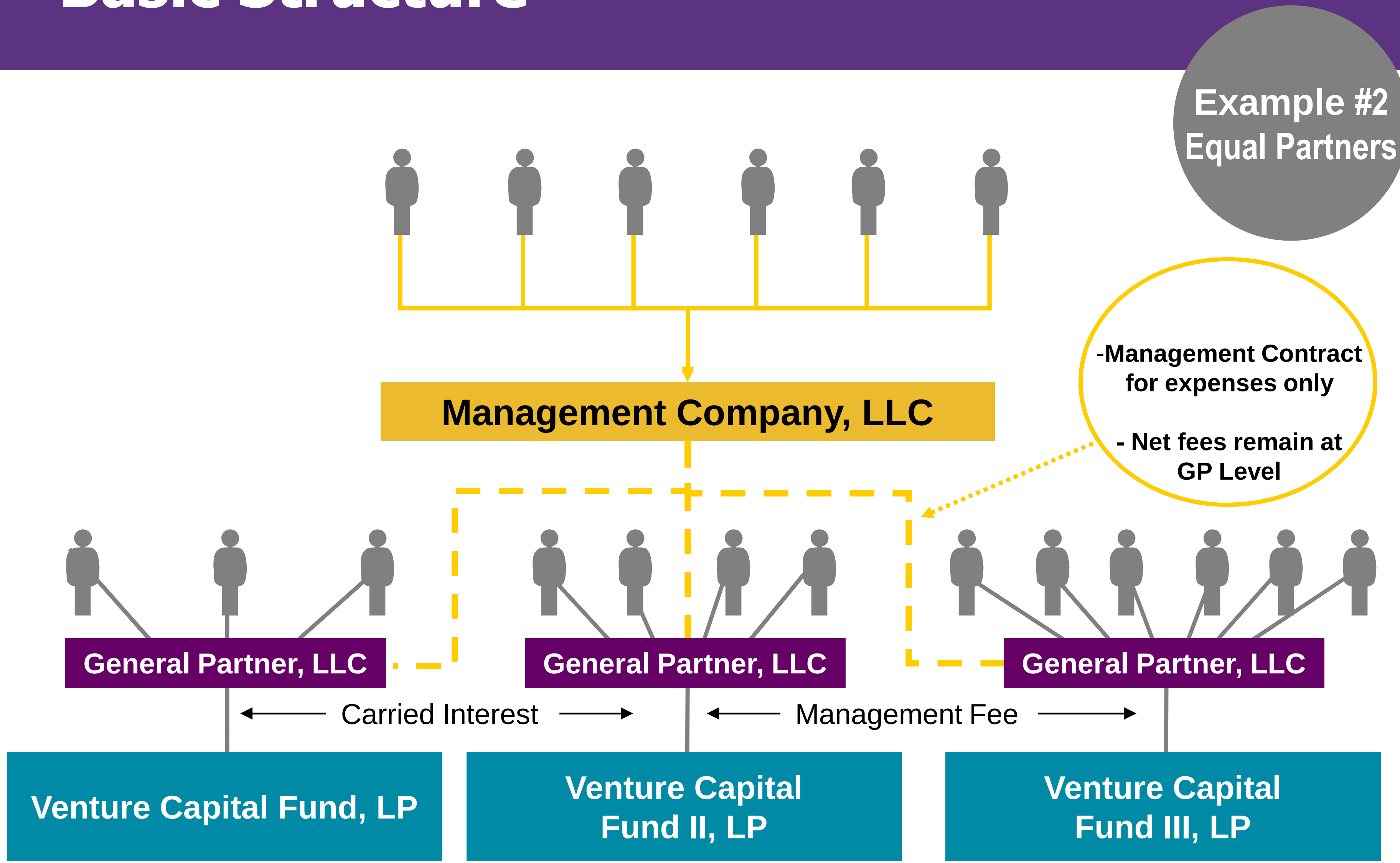
- Permanent entity
  - Office lease
  - Employees and benefits
  - Trademarks (i.e., fund names)
  - Insulates liability from any one fund
- Consolidation
  - Can pool all excess management fees
  - May have fewer managers with more power
  - Controls formation of successor fund

Basic Structure

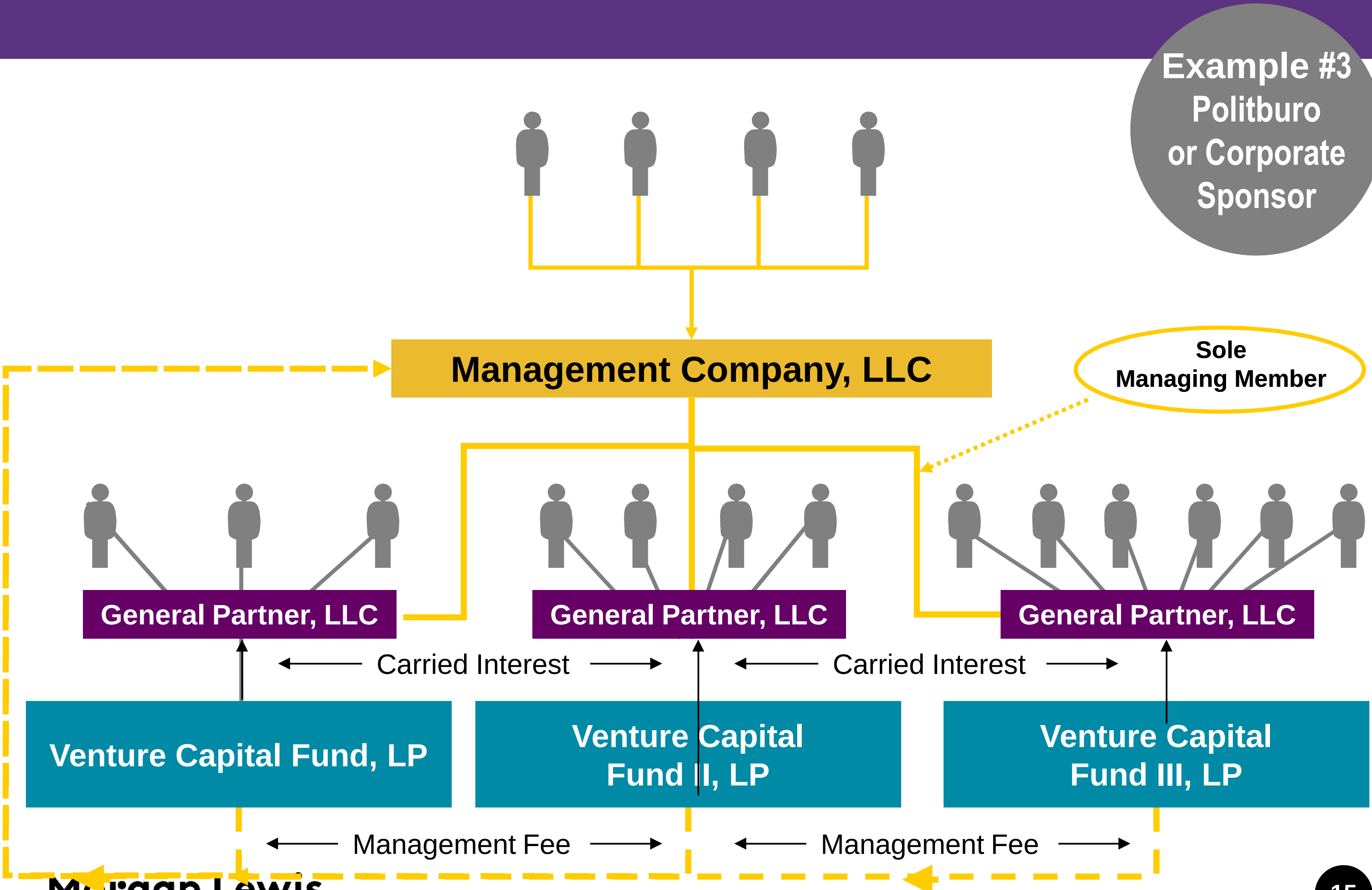
Example #1
Equal Partners



Basic Structure



Basic Structure



The Agreement Among Principals

Primary Drafting Objectives

- Reflect management structure
- Allocate the economics
- Align interests
- Plan for growth and succession

The Agreement Among Principals

- Reflect Management Structure
  - Basic philosophy
    - Equal partners
    - Politburo
    - Benevolent despot
    - Corporate sponsor
    - Special rights for founders
      - Veto rights, nonexpulsion, accelerated vesting schedule

The Agreement Among Principals

- Admission of New Managers
  - Vote threshold required
  - Determining the economics
    - Share of prior deals and appreciation
    - Make-up allocation
    - Who gets diluted?

The Agreement Among Principals

- Termination of a Manager
  - Vote threshold required
    - Unanimous (by others) vs. Something slightly less than unanimous
    - Founders sometimes protected
  - Should cause be required?
    - Generally, no
    - Some agreements provide monetary payout if no cause (i.e., severance)
  - Conform mechanics at GP and management company
  - Ownership of management company should terminate
    - Use shareholder agreement for share repurchase at cost if a corporation
    - Provide automatic termination if no longer a GP in latest fund
    - Use of “at will” employment agreements

The Agreement Among Principals

- Termination of a Manager (continued)
  - Consequences of termination
    - Vesting in carry
    - Continuing capital contribution obligation
    - Generally no further interest in net management fee
    - Clawbacks
  - Separation agreements
    - Economic arrangement
    - Mutual release
    - Nondisparagement
    - Public disclosure
    - Transitional matters (e.g., Board seats)

The Agreement Among Principals

- Investment Decisions
  - Generally unanimous in practice
  - Generally avoid documenting as unanimous
    - Unanimity can be cumbersome and even detrimental
    - Effects transaction opinion mechanics (need all signatures)
    - Transactions occurring during termination negotiations

The Agreement Among Principals

- Allocation of the Economics
  - Investment income
    - Income attributable to the GP's investment in the fund
    - Allocated in proportion to capital contributions by each member
  - Carried interest
    - Allocated as determined by the managing members
    - Subject to vesting
  - Management fee
    - Net fee allocated equally among the managing members only
    - No vesting (i.e., no ongoing interest in fees after termination)

The Agreement Among Principals

- Allocation of the Economics (continued)
  - Capital contributions
    - Allocation of GP contribution requirement
    - Cash, Promissory Note, or fee waiver mechanism
    - Default and departure issues
  - Distributions
    - Holdback accounts to fund clawbacks (vesting and fund level)
  - Clawback guarantees
    - Who is required?
  - Other income received by managers from portfolio companies

The Agreement Among Principals

- Vesting in Carried Interest
  - Vesting "in the fund" or "deal-by-deal"
    - In the fund
      - All deals in a particular fund regardless of when consummated
      - Generally preferred by Venture Funds
      - Simpler
      - Promotes team approach
    - Deal-by-deal
      - Only share in particular deals
      - Complicated by timing and overall carried interest
      - Generally preferred by Private Equity Funds
      - Rewards specific efforts
    - Hybrid models can combine both aspects
      - A guaranteed share in each deal with remainder subject to vesting

The Agreement Among Principals

- Vesting in Carried Interest (continued)
  - Vesting Schedule
    - Determines vested percentage
    - Varies widely among funds
    - Often loosely tied to investment period
    - If "deal-by-deal," then tied to each deal

	Incremental Amount of Carried Interest Vesting at:										
	Closing	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10 Liquidation
Example 1	-	20%	20%	20%	20%	20%	-	-	-	-	-
Example 2	20%	-	20%	20%	20%	20%	-	-	-	-	-
Example 3	20%	-	15%	15%	15%	15%	-	-	-	-	20%
Example 4	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	

The Agreement Among Principals

- Vesting in Carried Interest (continued)
  - Adjustments Based on Circumstances of Departure
    - Cause
      - Usually defined as just bad acts
      - May result in forfeiture of up to all carry
    - Death or disability
      - Often granted some acceleration
    - Breach of noncompetition and nonsolicitation
      - May result in post-departure reduction of carry
      - May be unenforceable in CA and some other states

The Agreement Among Principals

- Vesting in Carried Interest (continued)
  - Adjustments to Allocations and Distributions
    - Future Allocations Reduced to Vested Percentage
    - Vested in Prior Allocations?
      - All prior allocations of income made at 100%
      - Generally recalculate capital account balance based on reduction of prior allocations
    - Vested in Prior Distributions?
      - If unvested in prior allocations
      - Capital account balance may be negative
        - » Potential clawback of "unvested" or overdistributions
        - » Clawback obligation varies among funds

The Agreement Among Principals

- Other Terms
  - Noncompetition
    - State law restrictions (California)
  - Nonsolicitation
  - Control of trademark
    - Controls who forms new fund
  - Use of track record
    - Requires consent to use of fund's or personal track record
  - Indemnification
    - Think twice before including separate indemnity at GP level
    - Indemnity would come out of other GP pockets
  - Dispute resolution
    - Generally prefer confidentiality of arbitration

Employee Participation

- Reasons for Considering It
  - Promotes employee stake in firm performance
  - Investment opportunity seen as a "benefit"
    - Often on better terms (i.e., no fee and/or no carry)
  - Employees often request it
- Different Methods Used
  - Investment in GP
  - Investment in the fund
  - Investment in friends and family/employee fund

Employee Participation

- Pitfalls
  - Employees are often unaccredited and unsophisticated
    - Triggers information and sophistication requirements for 506 offering exemption
    - Increases risk for GP
      - High-risk investments are inappropriate for nonaccredited investors
      - Employment relationship a negative factor in downside scenarios
      - Some state labor laws (e.g., California) prohibit employment conditioned on investment
  - Employees are transient but investment is long term
    - Default issues
  - Administrative burden for limited benefit
  - Confidentiality
    - If investing in GP entity, employee may have access to books and records, etc.

Employee Participation

- Alternatives to Direct Employee Investment
  - Grant Carried Interest
    - Benefits
      - No capital investment made
      - No accredited investor requirement
      - No knowledgeable employee requirement
      - Subject to vesting
      - Capital gain treatment
    - Concerns
      - Clawbacks
      - Ongoing interest after termination
      - Potential access to GP information

Employee Participation

- Alternatives to Direct Employee Investment (continued)
  - Adopt Phantom Equity or Bonus Plan
    Based on Performance of Fund
    - Benefits
      - No capital investment made
      - No accredited investor or sophistication requirement
      - No knowledgeable employee requirement
      - No ongoing interest (although can be if desired)
      - Simple administration
    - Concerns
      - Payments treated as ordinary income

	Incremental Amount of Carried Interest Vesting at:										
	Closing	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10 Liquidation
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Example 2	20%	-	20%	20%	20%	20%	-	-	-	-	-
Example 3	20%	-	15%	15%	15%	15%	-	-	-	-	20%
Example 4	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	

Additional Information

For more information on the issues discussed here, please contact your Morgan Lewis Private Investment Funds Practice attorney.

About Morgan Lewis's Private Investment Funds Practice

Morgan Lewis has one of the nation's largest private investment fund practices and is consistently ranked as the "#1Most Active Law Firm" globally based on the number of funds worked on for limited partners by *Dow Jones Private Equity Analyst*.

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Morgan Lewis provides comprehensive transactional, litigation, labor and employment, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our regulatory and industry-focused practices help clients craft and execute strategies to successfully address legal, government, and policy challenges in today's rapidly changing economic and regulatory environment.

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