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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

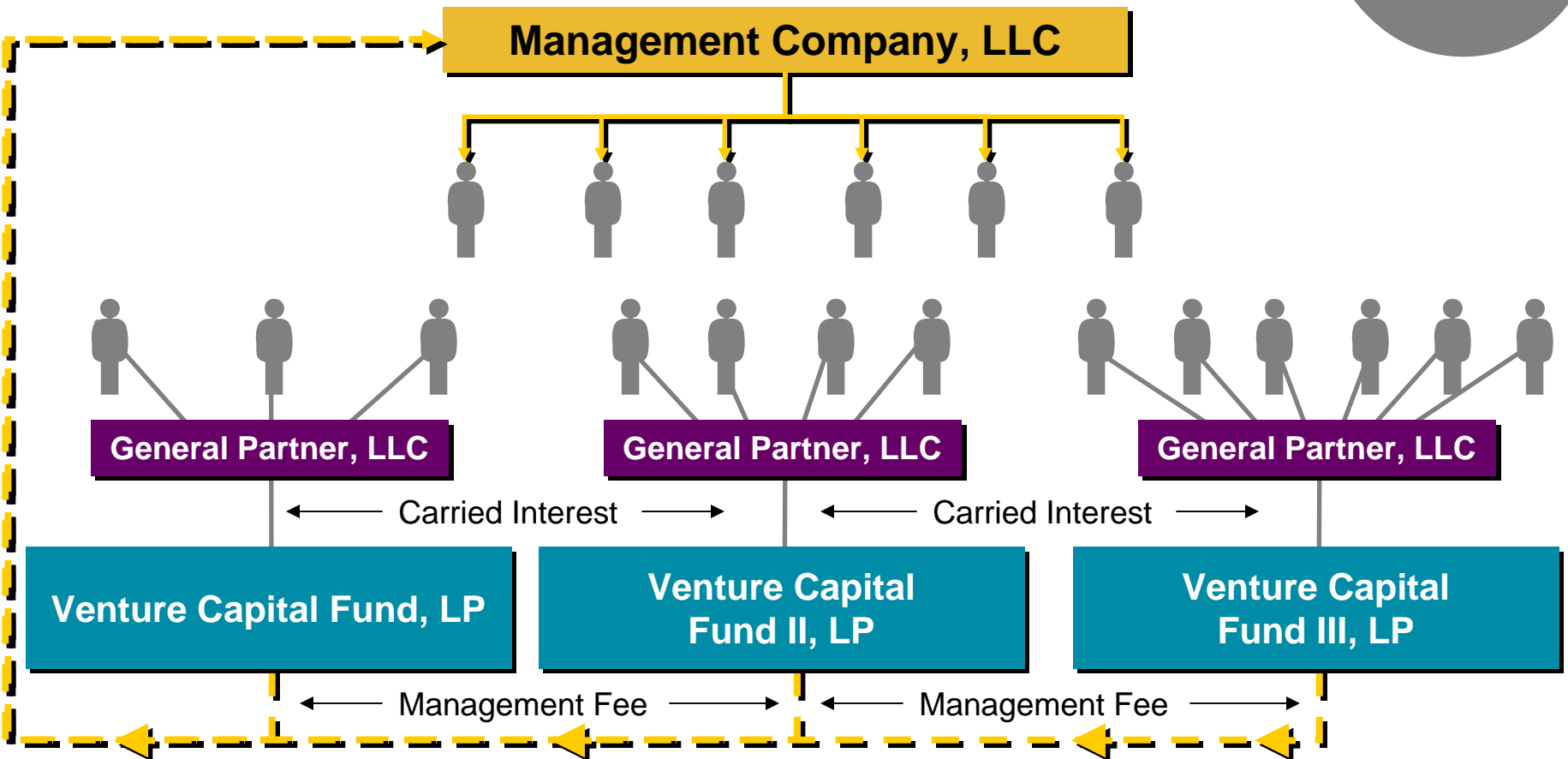
Basic Structure

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

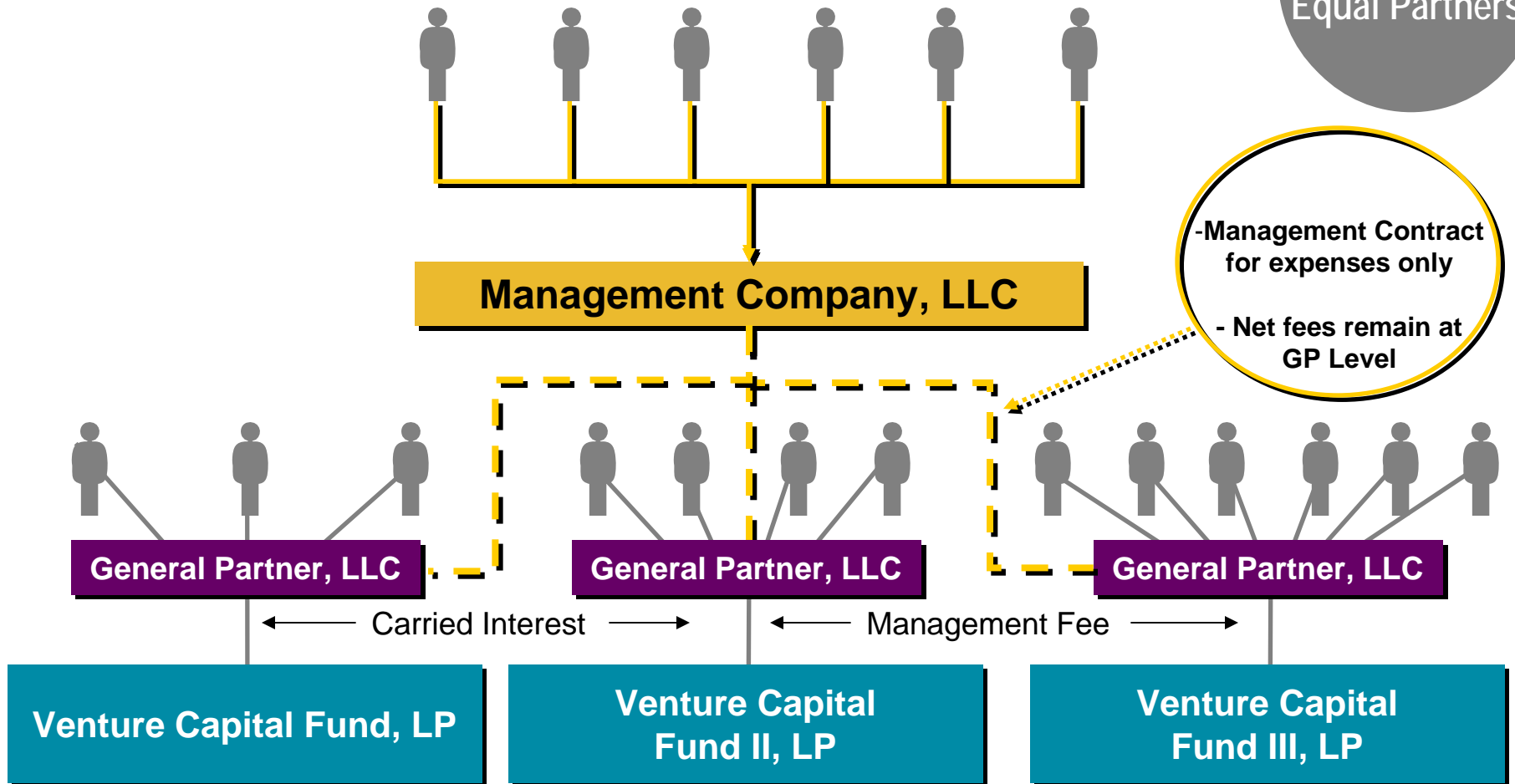
Basic Structure

Example #1
Equal Partners



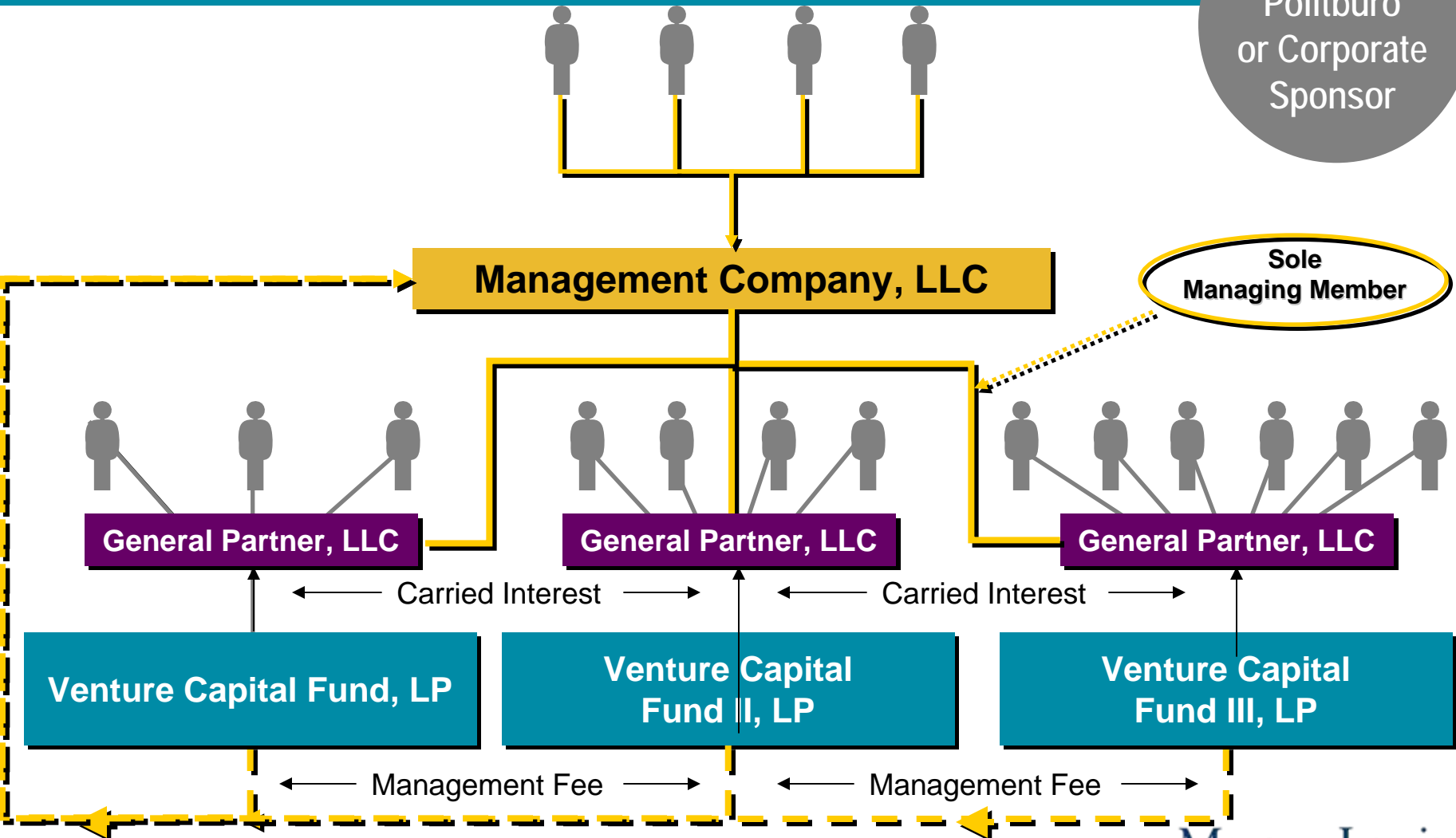
Basic Structure

Example #2
Equal Partners



Basic Structure

Example #3
Politburo
or Corporate
Sponsor



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

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