Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

Contribution by Principals

A perennial question from fund managers is, "How much do we have to put in?" In a simpler time, the easy answer was 1% of the total committed capital of the fund. That was borne from tax advice given to ensure that a general partner would be treated as a partner for tax purposes and therefore be entitled to capital gains treatment on its carried interest. The rule of thumb took root and held sway for many years. These days, however, with the advent of the "check the box" regulations obviating the need for significant contributions of capital for tax purposes, the question is answered purely from a market-driven perspective. Limited partners want their fund managers to have significant "skin in the game" in order to align their interests. Determining what constitutes "significant" will be driven, in part, by what the principals can afford, i.e., what is meaningful enough to them personally to actually align their interests. The traditional 1% commitment is still a good starting point, particularly in the venture capital context; however, commitment percentages have been trending upward as limited partners seek greater alignment with their fund managers. As fund sizes have increased dramatically, fund managers have also begun to specify their commitment as a minimum fixed-dollar commitment rather than a fixed percentage.

Once an appropriate commitment level is determined, further questions need to be answered. Who will be responsible for such payments? Will the contributions be made to the general partner, to the fund directly, or into some other vehicle? When will the payments be due, and in what form of consideration will they be made?

Responsibility for Funding Commitment

The obligation to invest is usually stated as the general partner's obligation, leaving the principals to determine how to fund the obligation among themselves. Some diligent limited partners may inquire how such obligation is funded, wanting to make sure the burden is appropriately borne by the principals and not financed in some other fashion, for instance by selling interests in the general partner to other investors. More recently, fund managers have sought to broaden the scope and method of meeting their obligation and limited partners have been generally accommodating, so long as it is transparent and in a manner that preserves the intent of aligning the interests of the principals with those of the limited partners.

Structure of Commitment

There are three basic ways of structuring a general partner's commitment. First, it may be handled in the traditional manner by principals funding the general partner's direct commitment to the fund. Second, principals may choose to invest directly as limited partners in the fund. Or third, principals may coinvest alongside the fund, either in a parallel fund vehicle or directly into each portfolio company. Limited

partners should be indifferent to the structure chosen, so long as sufficient parameters are built in to ensure proper alignment of interests from the beginning to the end of the fund's life.

Timing of Contribution

Generally, a fund manager's contribution will be made pro rata with contributions made by limited partners, regardless of how the commitment is structured. However, if the contribution is made through the general partner, it is possible, although very rare, to vary the timing of the payment of such contribution, usually by scheduling it out. In essence, it is a way to finance a contribution directly through the fund and without interest. This is clearly an accommodation by limited partners not wanting to burden a fund manager with having to seek outside financing for its contribution but still requiring the overall level of commitment.

Form of Consideration

Lastly, the form of consideration for a principal's commitment can be varied. The most typical and preferred form is cash. Promissory notes are not uncommon. These are typically nonrecourse promissory notes, secured by the general partner's interest and offset by any future distributions until paid. Another funding option is the management fee waiver, whereby payment of the management fee is waived in exchange for a potential future allocation of income equal to a like amount of the waived fees. By putting the waived fees at risk, capital gains treatment can be achieved. Limited partners are split on how they feel about this structure, some seeing it as a sign that the fund manager does not need the fees, while others see it as a further alignment of interests as the fund manager will not receive its fees unless the fund generates a profit.

Each of the structures and other terms described above requires careful consideration of the tax consequences as well as the terms set forth in the partnership agreement and in disclosure to limited partners.

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

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