Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

Employee Participation

Participation by employees in the fortunes of the funds that they manage is an excellent way to align employee interests, provide incentives, and promote retention and teamwork. Such participation, however, comes fraught with peril for an employer if not handled appropriately. First and foremost, employee investment in employer-managed funds cannot be, or be perceived as, a prerequisite for employment. That is a violation of employment laws. Second, there is a tendency to relax investor eligibility and suitability standards when making offers to employees. A common perception is that the fund manager is offering the employee a great benefit by allowing him or her to invest, often at more favorable terms. Contrary to this perception, however, these are still very risky long-term investments, and investor suitability standards are even more important in this regard in order to protect both an unsophisticated employee and an overconfident employer. And last, employment relationships come and go, but a fund commitment lasts for more than 10 years and will require continual capital contributions, potentially long after employment has been terminated voluntarily or involuntarily.

Untangling these relationships, particularly where the employment was terminated involuntarily or even acrimoniously, can be troublesome. In general, we recommend focusing on allocation of carried interest and participation in incentive bonus plans to achieve the benefits described above without the complications and risks associated with capital investment by employees. However, we recognize that employees often request or expect to be able to invest, and fund managers are eager to accommodate them.

Investor Suitability

Before addressing the methods employed for facilitating investment by employees of a fund manager, we must first confront the question of whether such employees make suitable investors, and why fund managers should view the protections afforded investors under the securities laws as actually protecting them as well. Fund managers often want to be able to allow employees who do not meet the investor eligibility requirements for nonaffiliated investors to participate in their funds. They want to waive the applicable eligibility requirements for the benefit of their employees without regard to the true risk of their venture.

This impulse, however well intentioned, should be resisted even though it may be allowed under the securities laws. Although not advisable due to the risks described further below, there is no absolute prohibition in the securities laws against selling to investors who are not "accredited investors."[1] In fact, a fund manager could sell to up to 35 nonaccredited investors and still remain within the safe harbors for private placement exemptions, so long as the fund manager meets additional information disclosure

1. Rule 501 of the Securities Act of 1933, as amended, defines an accredited investor as, among other things, any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his or her purchase exceeds $1,000,000; and any natural person who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year.

requirements equivalent to the information required in an S-1 registration statement and all such nonaccredited investors (or their purchaser representatives) have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment.

Notwithstanding the foregoing, we generally advise that all sales be limited to accredited investors so that no question exists with respect to the adequacy of the disclosure or the true level of sophistication of an investor. While adequate disclosure of risks and other information and a limited circle of investors will generally mitigate the possibility that a fund manager would be viewed as engaged in an unregistered public offering, there can be no absolute assurance on this point unless all investors are accredited investors. When considering the risks of waiving recommended investor eligibility requirements, fund managers should always keep in mind the potential causes of action that could appear in a complaint from a disgruntled ex-employee and how such complaint might have more merit if the employee is an unsophisticated, nonaccredited investor who makes claims that the fund manager pressured him or her to invest and subsequently lost his or her money.

Investment Options

There are several ways for fund managers to provide employees with investment opportunities or participation in the profits of a fund, some of which are briefly described below.

Direct Co-Investment in Portfolio Companies

Theoretically, offering direct co-investment opportunities to employees would be a good way to offer such employees discrete investment opportunities on favorable terms, unburdened by carried interest, management fees, or a long-term commitment. If employees were to make direct co-investments, the investor suitability standards would be the responsibility of the issuing portfolio company and not the responsibility of the fund or the fund manager. This form of investment does not require that the participating employees be either "qualified purchasers" or "knowledgeable employees" (as each term is defined under the Investment Company Act of 1940) but generally would require them to be "accredited investors" as discussed below. In practice, however, the ability to provide such opportunities will be rare because (i) such practices will generally be prohibited by the terms of the fund's limited partnership agreement because limited partners do not want a fund manager or its affiliates or employees to be able to "cherry-pick" the best investments for themselves, and (ii) most portfolio companies, particularly those beyond the seed stage of investment, will be unwilling to accommodate such investors.

Participation in Special Purpose Vehicles

Some employers seek to provide employees with discrete investment opportunities by forming special purpose vehicles (each, an SPV) with the aim of pooling investments by current employees in a vehicle formed for the single purpose of investing in one portfolio company. This approach is taken generally for two reasons. First, it addresses the portfolio company's desire to avoid the administrative burden and other issues raised by having a multitude of unknown individual investors. The use of an SPV shifts such burden to the employer that formed the SPV. Second, in some cases, SPVs are formed in an effort to satisfy a portfolio company's rightful insistence that each investor be an "accredited investor," sometimes achieved by qualifying the SPV at the closing and subsequently transferring interests in the SPV or granting "participating interests" in the income of the SPV to nonaccredited investors. The approach proposed for this second purpose is highly discouraged and would expose employers to multiple claims, including (i) claims from the portfolio company for breach of standard securities law representations made by the SPV at the time of investment, (ii) claims from employees for violations of the securities laws as they pertain to the SPV and the sale of its interests to employees, and (iii) claims based upon the implicit provision of investment advice to such employees regarding the underlying investment in the portfolio company. Regardless of purpose, SPVs are disfavored for their expense in formation and operation.

Participation in an Employee Side Fund

As an alternative to direct co-investment by employees or use of single-investment SPVs, fund managers can form an employee co-investment fund. Co-investment vehicles are typically formed as parallel investment vehicles that invest alongside the fund in each of the fund's portfolio companies. Such a vehicle would generally be created to enable investment by nonmanager personnel of the fund manager or any affiliate on terms that may be more favorable than those of the fund. The vehicle will generally invest proportionately (based upon available capital) in all portfolio investments and dispose of investments at the same time and on effectively the same terms and conditions as the fund managed by the fund manager. Limited partners of the main fund generally are amenable to allowing the applicable co-investment percentage for the co-investment fund to vary year by year, particularly if the maximum co-investment percentage is 5% or less of the main fund's aggregate commitments. These terms would generally need to be set forth in the fund's limited partnership agreement (or similar governing document). The structure does not require that the participating employees be either "qualified purchasers" or "knowledgeable employees" (as each term is defined under the Investment Company Act of 1940) but generally would require them to be "accredited investors" subject to the discussion above.

Participation in the Fund Through the General Partner

Rather than forming a new side fund, employees can participate in fund investments through capital contributions to the general partner. In private equity funds, where contributions tend to be more investment-by-investment related, contributions could be limited to specific portfolio investments. Without exception, all employees participating would have to be "qualified purchasers" or "knowledgeable employees" if the main fund is structured as a qualified purchaser fund as discussed above. While the interest of a general partner is generally not considered a security because it is not relying on the skill of others, investment through the general partner by persons who are not the investment professionals managing the fund but merely support staff would still be considered a security subject to the restrictions placed on other investors.

Direct Participation in a Fund as a Limited Partner

Employees can be offered the opportunity to invest directly into a fund on the same terms and conditions as all other investors in such fund. This would require them to meet any and all investor suitability requirements of the particular fund vehicle. This does not address issues that may arise once the employment relationship is terminated. Employees must be treated like any other investor for whom the obligation will continue regardless of any employment relationship.

Profit Participation in Carried Interest

As an alternative to finding avenues for employees to contribute their capital to a fund, fund managers should consider the allocation of grants of carried interest, either directly through grants of profits interests in general partner entities or indirectly through grants of phantom equity interests in bonus pools that track the receipt of carried interest from managed funds. Such interests have the benefit of eliminating the securities law issues pertaining to investments in the fund or related vehicles. In addition, using vesting schedules in connection with such grants will mitigate some of the employment-related issues discussed above. Structuring such participation in the general partner has the advantage of capital gains treatment versus ordinary income treatment that would result from participation in a bonus pool. Interests in a bonus pool, however, have the advantage of reducing the administrative burdens of financial reporting and issuing K-1s, and may avoid equity owner rights to confidential information.

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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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