

VENTURE CAPITAL & PRIVATE EQUITY FUNDS DESKBOOK SERIES

Preparing for and Handling a GP Separation

One of the most important roles of the agreements between the individual managers of a private investment fund is to set forth the terms of their divorce: who can be removed, by whom, and what are the departing manager's basic economic rights and ongoing obligations. The extent to which these matters are clearly documented in the organizational documents of the management company and general partner entities will determine how smoothly a settlement can be reached and a transition can be made with a departing manager. Whether the departure is voluntary or involuntary, be prepared for a negotiation upon a departure regardless of the circumstances of the separation or how well documented everyone's rights may be. Almost all separations involving a managing member involve a negotiated separation agreement, typically because both sides have something the other wants. Firms want releases, cooperative transitions, and coordinated messages to limited partners, while departing managers may want severance, relief from ongoing capital and clawback obligations, and accelerated vesting. The likelihood of such a negotiation is a good reason to provide rather one-sided company-favorable terms in the organizational documents at a time when the parties are on good terms so that when any individual leaves, the firm has negotiating leverage on these points and the option at its choosing to relax any of the terms imposed in the documents.

The following is a list of legal issues to consider with respect to a departure. Many, if not all, of these can and should be initially addressed at the outset in the fund manager's organizational documents.

- **Removal Mechanics**—Who can be removed? What vote is required? Does it differ for bad acts, not poor performance, and, if so, how is that defined?
- **Nonemployee Status**—Is it clear that managing members are not employees? This is important in order to forestall any claims for employment law protections (e.g., age or race discrimination) upon a removal.
- **Vesting in Carried Interest**—Are the entitlements to carried interest clearly articulated, including any adjustments upon termination and dilution thereafter?
- **Capital Commitment**—Is there an ongoing capital contribution obligation and is it subject to repurchase? An ongoing obligation to contribute capital is important to protect the company and its ability to meet its obligations to the fund but it is often a useful bargaining chip if a company is in a position to replace the funding and otherwise would like to recapture some vested carry.
- **Severance Payment**—Is one already specified in the organizational documents? Is it tied to receipt of a release of claims?
- **Nondisparagement**—Is there a covenant to refrain from making damaging statements (even if true) about the other party?

- **Confidentiality**—Are there clear restrictions on the use of confidential information? A manager’s “personal” track record is the property of the company and not the professional, and this should be made clear in the documents.
- **Interest in Fund Name and Mark**—Does the departing manager have any remaining interest in the name and mark of the fund manager? This should be set forth very clearly at the outset of the relationship.
- **General Release**—Is there a release of all known and unknown claims? Sometimes this is a condition to receive severance payments. Note that California requires specific waiver of statutory language in order to grant a waiver of unknown claims.
- **Nonsolicitation/No-Hire**—Is a departing employee subject to nonsolicitation or no-hire restrictions? Note that California law would invalidate a no-hire restriction.
- **Noncompetition**—Is a departing manager subject to a noncompetition covenant? Note noncompetition restrictions are unenforceable in California unless coupled with the sale of a business.
- **Offsets**—Does the company have the power to withhold payments or distributions from one fund to satisfy obligations with respect to other affiliated entities?

Regardless of whether the foregoing matters have been well documented before any departure occurs, it is often advisable to enter into a separation agreement at the time of a departure. In such an agreement the parties can affirm, modify, or otherwise address the legal entitlements and obligations referenced above; agree on the factual matters regarding such items (e.g., the actual vested percentage, remaining capital commitment); and address any practical transitional matters. Set forth below is a list of such additional items that should be considered and potentially memorialized in a separation agreement.

- **Resignation, Withdrawal or Removal**—Document the actual removal, withdrawal, or resignation from every position held as this may encompass multiple entities.
- **Severance Payment**—Set forth any specific agreement regarding ongoing severance payments.
- **Ongoing Benefits**—Set forth any entitlements to ongoing health benefits, including COBRA elections.
- **Loans or Advances**—If there are any outstanding loans or advances to the departing manager, payments should be addressed.
- **Holdbacks**—Have distributions been held back and will distributions be held back further?
- **Vesting**—Calculate and agree on the actual vested percentages and any negotiated changes such as acceleration or forfeiture.
- **Clawback Related to Vesting**—Determine whether, pursuant to the terms of the agreements, the departing manager has been overdistributed carry and the consequences thereof.
- **Clawback Related to Funds**—Address any issues regarding liability for clawback to the funds, including any withholding of distributions as credit support.
- **Capital Contributions**—Determine if the company will exercise any buy-out rights with respect to existing investments in the funds.

- **Unpaid Capital Commitment**—Determine the amount of any outstanding capital commitments and address the departing manager’s obligations with respect to them.
- **Legal Expenses**—Will the departing manager’s legal expenses with respect to a separation agreement be covered by the company, and, if so, for how much?
- **Public Announcement/Talking Points**—Is there an agreed-upon communication to the limited partners or to the press regarding the departure and the reasons therefor?
- **Personal Track Record**—If desired, agree upon which investments can be attributed to the departing manager as part of a personal track record and agree on the facts and figures regarding such investments (including current valuation and IRR).
- **Portfolio Company Board Commitments**—If the departing manager serves on portfolio company boards, set forth an agreement on a transition of such board positions to remaining managers and address any board compensation that may arise in the interim.
- **Specific Portfolio Company Matters**—If any portfolio companies in which the departing manager is involved is planning any upcoming financings, determine how that opportunity will be handled.
- **Office Space, Secretarial Support**—Address any potential use of office space and secretarial support during any severance period.
- **Office Equipment**—Address the return of any company property such as computers and Blackberrys.

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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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Morgan Lewis has one of the nation’s largest private investment fund practices and is ranked as “#1 Most Active Law Firm” in the U.S. based on the number of funds worked on for general and limited partners by *Dow Jones Private Equity Analyst* (2011).

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