

Life Cycle of a Fund Manager

Schulte Roth&Zabel

PRIVATE EQUITY FUND
CONFERENCE

MAY 19, 2016



Omoz Osayimwese

Partner

Schulte Roth & Zabel

+1 212.756.2075

omoz.osayimwese@srz.com

Omoz focuses his practice on the representation of sponsors and investors in the formation and structuring of private equity funds, hedge funds and hybrid funds. He has extensive experience representing sponsors and investors on funds employing real estate, buyout, credit, distressed investment, structured products, activist, multi-strategy and long-short equity strategies. He also represents hedge fund managers and investors in the negotiation of seed-capital transactions, and he advises sponsors of private equity firms in the structuring of complex carry-sharing arrangements among principals and employees. Omoz's recent representations include institutional sponsors and boutique firms in the formation of private equity funds, hedge funds and hybrid funds; lead investors on their investments in private equity funds; hedge fund managers and investors in seed-capital arrangements; investment managers in joint venture arrangements; and investment managers and investors in the formation of special purpose acquisition and co-investment vehicles.

Omoz is recognized as a leading lawyer by *The Legal 500 United States*. He regularly addresses investment managers about current developments relating to private investment funds, and his recent speaking engagements have addressed trends in fund governance and economics; structures, terms and fiduciary duties regarding co-investments; market terms and regulatory issues surrounding co-investments; market updates for private equity funds; and trading compliance. He is a contributor to the *Fund Formation and Incentives Report* (SRZ in association with Private Equity International).

Omoz received his J.D. from University of Michigan Law School and his B.A., with highest honors, from Michigan State University.



Phyllis A. Schwartz

Partner

Schulte Roth & Zabel

+1 212.756.2417

phyllis.schwartz@srz.com

Phyllis focuses her practice on the structuring, formation and operation of private equity funds, including buyout funds, venture capital funds, mezzanine funds, distressed funds and real estate funds. She represents both fund sponsors and investors in her practice. In addition to assisting fund sponsors with their internal management arrangements, succession planning and the creation of internal investment and co-investment vehicles, she has extensive experience with institutional investors and regularly advises clients on market terms of investment funds. Phyllis also advises private equity funds in connection with their investments in, and disposition of, portfolio companies.

Phyllis is recognized as a leading practitioner in her field by numerous independent publications, including *The Legal 500 United States*, *The Best Lawyers in America*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Investment Funds, Private Equity) and *Expert Guide to the World's Leading Women in Business Law* (Investment Funds). A member of New York's Private Investment Fund Forum, Phyllis frequently shares her insights on effective fund formation strategies at industry conferences and seminars. She recently discussed regulatory and compliance concerns for co-investments; conflicts of interest; and other ethics issues for private equity fund managers. Phyllis is also the co-author of *Private Equity Funds: Formation and Operation* (Practising Law Institute), which is considered the leading treatise on the subject, and she contributed to *Fund Formation and Incentives Report* (SRZ in association with Private Equity International) as well as a chapter on "Advisers to Private Equity Funds – Practical Compliance Considerations" to *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute).

Phyllis received her J.D. from Columbia University School of Law and her A.B. from Smith College.

Life Cycle of a Fund Manager

I. Introduction

- A. Private equity managers consist of two principal entities: (1) the general partner of the private equity fund (the “GP”); and (2) the investment adviser or management company (the “management company”). Usually, a new GP is formed for each fund (or group of parallel or related funds), whereas it is customary for a private equity firm to form a single management company that provides investment advice across multiple funds.
- B. The life cycle of managers encompasses three stages: (1) formation; (2) ongoing operations and relationships; and (3) winding up. Planning for these stages requires coordination and balancing between the requirements and concerns of fund investors and the GP’s internal objectives.
- C. Investors conduct extensive due diligence on both the fund and the GP/management company and require “key person” provisions as part of their decisions to invest.
- D. Changes to the GP team have become commonplace. Best practice is to anticipate changes to the team in both fund documents and governing documents for the GP and management company.

II. Formation of General Partners and Investment Managers

- A. The GP and the management company are, like the fund, flow-through entities (such as LLCs or limited partnerships), whose owners have economic and governance rights.
 - 1. Owners of the GP typically consist of a broader group than the owners of the management company. Recent trends show that all or some of the general counsel, chief compliance officer, chief operating officer and chief financial officer may be admitted to the general partner. In addition, senior and mid-level investment professionals often share in carried interest through an ownership interest (which ownership interest may have limited governance rights) in the GP. Larger organizations may utilize “carry plans” or other arrangements to provide payments based on performance of the fund. Those payments may actually be made out of management fees and therefore would be taxable at ordinary income rates. Some GPs use assignment agreements, where the employee has an economic interest in the carry and receives K-1s as if a member of the GP, but is not actually admitted to the LLC for Delaware purposes.
 - 2. Ownership of the management company generally consists only of the senior managers and founders of a private equity firm. That ownership may be associated with the right to receive fee income, but since fees are usually paid out as salaries and bonuses, there may be little or no residual net income available to distribute to the equity owners of the management company.
 - (a) Occasionally, the management company’s governing documents contemplate liquidity events, such as an IPO or sale of the company, in which case, the proceeds from such an event may be specially allocated to the owners of the management company. Typically in these situations, the entities acting as GPs in the structure are included in the IPO or sale and a GP holding company may be established to hold all GP entities. Alternatively, in some situations (e.g., IPOs), a single holding company may be established to own interests in both the management company and the various GP entities.

(b) Investors may care about ownership of the management company being a mirror of ownership of the GP. Governance of the management company and the GP are often alike.

3. Estate planning vehicles are often awarded a percentage of the carried interest and should be included in documents at the earliest possible time, preferably at the time of formation.

B. Third-Party Investors in GP and Management Company

1. A third-party investor (e.g., an institutional investor) may acquire a minority ownership interest in the GP and management company. Consideration for the ownership interests may be a cash investment in the management company (and sometimes, additionally, an anchor investment in Fund I or a subsequent fund).
2. A third-party investor often has a limited (or no) role in decision making regarding fund investments as fund investors often want to know that the fund's investment team (and not the third-party investor) is responsible for making, managing and exiting investments.
3. A third-party investor will typically have limited governance rights, including approval rights over certain material actions not related to management of fund investments (e.g., borrowing by the management company, replacement of senior members of investment team, sale of all or a portion of business, etc.).
4. A third-party investor's stake in the GP and management company will not be subject to any vesting. In addition, the GP and management company agreements will also typically provide economic protections to the third-party investor (e.g., anti-dilution provisions, rights of first offer/refusal on a sale of ownership interests in the GP and management company, tag-along rights, etc.).
5. Third-party investors and the managing members of the GP and management company may also negotiate put and/or call rights with respect to the third-party investor's ownership interests in the GP and management company providing each party with the right to buy and/or sell such ownership interests on or after the expiration of a pre-determined period.
6. The ownership interests in a management company and GP acquired by a third-party investor may be structured as a true equity interest (entitling the third-party investor to a fixed share of profits, i.e., management fees and carried interest after deduction for expenses) or a revenue share (where the third-party investor is entitled to a fixed percentage of management fees and carried interest on a gross basis, without any deduction of expenses).

C. "Skin in the Game"

1. The owners of the GP and management company represent the selection by investors of a team that has generated a successful track record. Investors seek to retain and incentivize that team and to make sure the team is aligned with the interest of investors by awarding economics to the team associated with profitable investments.
 - (a) Investors also expect the investment professionals to have substantial capital at risk. The amounts vary from 1-3 percent of capital to 10-15 percent of capital. What is ultimately important is that the capital invested by the senior members of the team should represent a significant amount to such individuals.

- (b) Investors are increasingly more attentive to the source of capital for the team's investment in the fund. They will inquire about whether each GP member has a stake in the fund or whether the "house" is putting up the capital for the team.

D. Key Person Provisions

1. Key person events are triggered by one of several events:
 - (a) The failure of named individuals to remain actively involved in the fund, usually based on a "substantially all" time commitment, whether by reason of departure, death or retirement.
 - (i) LP committees usually have the right to approve a replacement key person. The GP should make as many members of its team known to LPs, as such familiarity will make such approval easier to obtain.
 - (ii) As part of planning for retirement, senior members of the team usually are not subject to a "substantially all" time commitment to the fund.
 - (iii) In practice, whether a key person has satisfied his or her time commitment to a fund can be difficult to measure, particularly when multiple funds are under single management.
 - (b) The failure of the key persons and other members of the management team to own a minimum amount of the carried interest and/or capital in the GP and interests in the management company.
 - (c) A change of control of the GP or the manager.

Both of the minimum ownership and control tests have limited internal GP and management company transfers and third-party financings of the GP or management company.

2. The remedy for key person events is commonly a termination of the fund's investment period. Key person events can also trigger dissolution rights and, rarely, removal rights.

Removal rights are typically provided when a key person engages in misconduct.

3. The LPA may include multiple tiers of key persons, such as a senior executive team and a support investment professional team. Instead of naming individuals within the second support tier of the key person group, investors may permit the GP to include a requirement that there be a minimum number of investment professionals comprising that group.

When a fund only has two key persons from its origination, the departure of each usually triggers a key person event.

4. Key person clauses need to be reviewed at the time of hiring, departure and promotion of an individual to the decision-making or "control" group of persons.
5. Consider requesting an amendment to the fund's LPA to include additional key persons before an actual key person event occurs to avoid a crisis vote.

E. Vesting

1. Just as key person provisions are designed to protect investors from the departure of the investment team, vesting is utilized internally by GPs to incentivize professionals to stay with the firm. Vesting also gives the employer points to apportion to a replacement professional and to reward professionals for contributing to the value of investments while employed.
2. There is no “market” for vesting schedules; many GPs use different vesting schedules for different individuals in the same company; the same individual may have different vesting schedules for different deals.
 - (a) Vesting is more common for GP-carried interests; whereas, an individual who is not a founder is unlikely to retain an interest in the management company after departure.
 - (b) Investors are requesting information on vesting schedules as part of their diligence and in some instances have requested that GPs lengthen or otherwise modify vesting schedules.
 - (c) Estate planning vehicles should be subject to vesting in the same manner as the individual for whom such estate vehicle is related to.
3. Vesting provisions apply to the carried interest — and rarely the capital invested in a fund — whereby the carried interest paid after a person leaves is reduced to that person’s vested carried interest.
 - (a) It is rare to apply vesting to carried interest earned while the individual is still employed.
 - (b) The GP agreement addresses who receives the forfeited carried interest or allows the senior principal to decide how to reallocate forfeited carried interest.
 - (c) For tax purposes, unallocated carried interest still needs to be owned by some person (typically the founders).
4. A fund’s investment strategy often drives the GP’s vesting schedule. Venture funds have generally had the longest schedules. Strategies where the bulk of the investment management work is done in evaluating, selecting and closing an investment (rather than in managing the investment once acquired) may have shorter vesting schedules.
5. Vesting may also occur on a fund-wide basis (e.g., from the start of the fund’s investment period with respect to all fund investments) or on a deal-by-deal basis (i.e., for each individual investment commencing at the time of closing of such investment).
6. Vesting has become more restrictive, as managers now recognize getting to an exit after a departure does not justify generous vesting.
 - (a) Competitive activity by the departed individual may result in complete forfeiture of such individual’s right to receive carried interest distributions.
 - (b) Vesting may be capped at an amount that is less than 100 percent.
 - (c) Vesting may be tied to the receipt of points in a successor fund.
 - (d) Junior professionals may never vest in their carried interest when they leave.

III. Ongoing Operations and Relationships

- A. Manager operations are designed around decision-making authority and sharing of economics.
- B. Decision-Making
- C. Economic Sharing: (i) Carried Interest; and (ii) Fees
 1. The group that participates in the carried interest and investments in the fund continues to expand from the most senior/founding members to more junior professionals (including the individuals identified in the second tier of key persons).
 2. This expansion has resulted in complicated structures for apportioning the carried interest; managers should be extremely cautious in documenting grants of carried interest points.
 3. A firm may also wish to expand its overall growth potential by adding a partner who has a selective industry expertise.
 4. Employment offer letters that refer to carried interest grants should be qualified by reference to the separate documentation that will be entered into for such purpose. Similarly, carried interest plan awards should be reviewed with counsel for compliance and consistency with the GP's LLC agreement and fund documents.
 5. The carry can be paid out in several ways, typically deal-by-deal or on all deals (i.e., on a fund-wide basis).
 - (a) Most GP documents exclude a former employee/partner/member from participating in investments made after the individual's departure.
 - (b) Deal-by-deal tracking is neutralized by clawback obligations.
- D. Hiring
 1. Dilution issues arise from the grant of carried interest points to new employees in existing investments.
 2. Managers may establish a "reserve" or "unallocated" portion of the carried interest to allocate in the future or to create a bonus system. GP agreements may also provide for "floors" on the amount to which an individual's carried interest can be diluted or provide for protection from dilution for a fixed period of time.
 3. Tax counsel should address implications of unrealized gains as there can be issues with granting carried interest with respect to unrealized investments which have appreciated in value.
 4. Multijurisdictional managers have to take into account local taxation issues with respect to the carried interest.
 5. Escrows should be utilized within the GP to ensure collectability of the clawback.
 6. Other key hiring events include non-disclosure/non-compete agreements, agreement on specific disclosure, and attribution of track record.

E. Spin-Outs

1. A team of investment professionals managing a specific fund or funds focused on a specific investment strategy may wish to leave the larger firm and establish a separate management company owned by the team.
2. The team spinning out is required under the Investment Advisers Act of 1940 to obtain approvals for the spin-out from investors in each fund that will be managed by the new firm.
3. The team will have to negotiate with the management of existing firm regarding the terms of their departure, including how to communicate the proposed spin-out transaction to investors and what happens to ownership interests in the existing management company held by the members of the team spinning out.
4. A spin-out transaction may be structured as a management buyout where the team is buying out the existing firm's ownership of the business that is being spun out.
5. Existing firms may sometimes retain a minority stake in the new firm.
6. The team spinning out will need to establish new governance and economic sharing arrangements for the new firm (addressing many of the items discussed in Section II above in the governing agreements of the GP and management company).

IV. Winding-Up of the General Partner and Management Company

A. Succession Planning

1. The unplanned departure of individuals may cause not only a key person event, but also the absence of decision makers.

GP and management company agreements should include provisions for replacement decision makers, including "springing" decision makers when there is a single managing member.
2. A member (including a managing member and founder) who leaves the firm should cease to have management rights.
3. Transfers to family planning vehicles should be permitted only if the transferor retains decision-making authority.
4. Transfers by operation of law, such as in death or divorce, should be explicitly limited to economic transfers and should not pass on rights to participate in decision-making to spouses, ex-spouses or estates.

This information and any presentation accompanying it (the "Content") has been prepared by Schulte Roth & Zabel LLP ("SRZ") for general informational purposes only. It is not intended as and should not be regarded or relied upon as legal advice or opinion, or as a substitute for the advice of counsel. You should not rely on, take any action or fail to take any action based upon the Content.

As between SRZ and you, SRZ at all times owns and retains all right, title and interest in and to the Content. You may only use and copy the Content, or portions of the Content, for your personal, non-commercial use, provided that you place all copyright and any other notices applicable to such Content in a form and place that you believe complies with the requirements of the United States' Copyright and all other applicable law. Except as granted in the foregoing limited license with respect to the Content, you may not otherwise use, make available or disclose the Content, or portions of the Content, or mention SRZ in connection with the Content, or portions of the Content, in any review, report, public announcement, transmission, presentation, distribution, republication or other similar communication, whether in whole or in part, without the express prior written consent of SRZ in each instance.

This information or your use or reliance upon the Content does not establish a lawyer-client relationship between you and SRZ. If you would like more information or specific advice on matters of interest to you please contact us directly.

Schulte Roth&Zabel

New York | Washington DC | London

www.srz.com