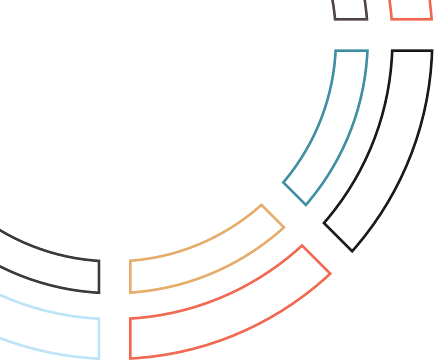

Schulte Roth & Zabel

Asset Manager M&A Deals

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Table of Contents

Asset Manager M&A Deals

I. State of the Market: Current Drivers and Deal Types 1

II. Market Participation by Banking Institutions 1

III. Motivating Non-Seller Management 3

IV. Spinouts 5

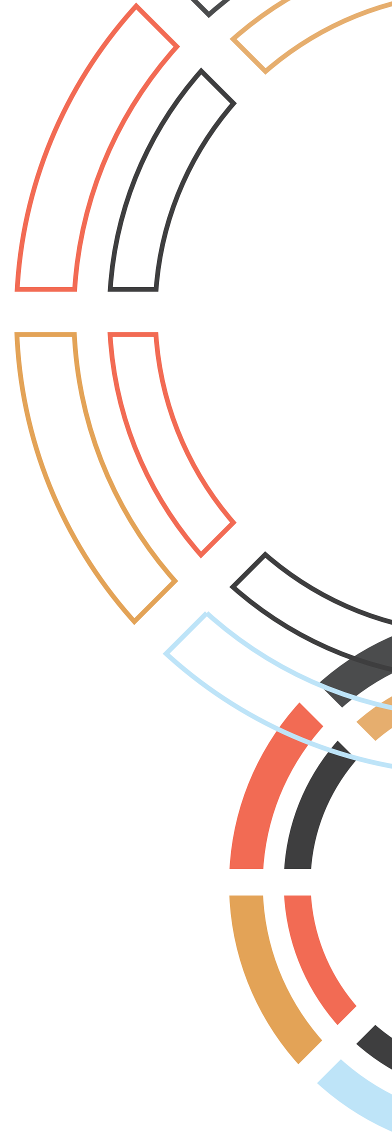
V. Consolidation of Fund Managers 7

VI. Issues Arising In Minority Deals 9

VII. Looking Forward: Will the Uptick in Deal Activity Continue In 2013 11

Endnotes 12

Authors 12



I. State of the Market: Current Drivers and Deal Types

A three-year look back of worldwide asset management M&A transactions shows an uptick in activity in 2012. The uptick is largely a result of growth concentrated in Europe and the United States.

European deals saw activity evenly spread throughout the whole year. In contrast, activity in the U.S. saw a marked uptick during the last quarter, which was driven in part by U.S.-based asset managers reacting to an anticipated increase in U.S. tax rates.

Overall there are two major drivers of the uptick in activity in 2012. One such driver is a general consolidation trend in the industry: smaller asset management firms rolling up together or joining larger institutions. The other driver of the activity is bank activity. Banks have been active participants both on the buy side and the sell side. Although, for the most part, in the last year, banks have been much more active as sellers.

Asset management M&A transactions generally fall into one of three categories:

- Spinouts,
- Control (or majority) acquisitions, or
- Minority acquisitions.

First, banks are currently divesting a number of asset managers through spinout transactions. These spinouts are primarily driven by regulatory factors, including existing and expected bank capital requirements.

Second, financial institutions and other asset managers are acquiring control of other managers. In some cases, increasing compliance costs and complexities for smaller managers are driving those smaller managers to join forces and spread compliance costs across revenues derived from a greater AUM base. In other cases, large financial institutions (generally those that are not bank holding companies) are acquiring smaller managers as the larger entities seek to expand their platforms and provide further diversified offerings of products. In those cases, the smaller manager may then take advantage of the distribution platforms of the larger manager, and benefit from compliance protocols in place at the larger manager.

Third, some principals are seeking to "take money off the table" (at current capital gains rates), and selling minority stakes in their management companies in order to do so. These are typically 10 to 20 percent sales. As a result, a number of businesses have sprung up that are structured to purchase such minority stakes in managers and their related general partners. Occasionally, sovereign wealth funds and pension funds are the acquirers of these minority interests.

II. Market Participation by Banking Institutions

Recent changes to banking laws have presented several reasons that may motivate a bank or its affiliates to sell an asset management business. The most commonly mentioned factor is the Volcker Rule. While the Volcker Rule is referenced in virtually every asset manager spinout or divestiture of a bank, in most cases it is unlikely to be the motivating factor.

A. The Volcker Rule

To determine whether or not the Volcker Rule is relevant to a particular transaction, one must understand what the rule does and what it does not do. The Volcker Rule requires banks and their affiliates to cease most proprietary trading activity by July 21, 2014, subject to certain potential extensions. It also requires them to divest of most proprietary investments in hedge funds or private equity funds by the same date.

As a result of the looming shutdown of proprietary trading, many proprietary trading teams have left banks in recent years to start their own funds or join existing asset managers. This trend is likely to continue as the effective date of the rule creeps closer. However, nothing in the Volcker Rule requires a bank or its affiliates to divest an asset management business.

B. Dodd-Frank Impact on Activity

1. Forthcoming Capital Requirements May Be Driving Activity

Unlike the Volcker Rule, other aspects of the Dodd-Frank Act do provide an incentive for banks to divest of asset management businesses. The first and most important reason relates to capital. Under Dodd-Frank, as well as the Basel III Accord, capital requirements applicable to banks and their affiliates will increase. While the specific rules are not yet finalized, one thing is known: compliance will be more difficult. As a result, banks will need to reserve greater amounts of capital than they do today.

In most cases, banks will be unable to comply with these changes given their existing balance sheets. Some are considering selling off non-core activities or less profitable businesses, including, potentially, asset managers. The cash derived from such sales will allow these institutions to shore up their capital and increase their capital ratios.

Because there is pressure to increase capital reserves, unlike in other transactions, there is pressure for upfront cash consideration and pure earnings (as opposed to earnouts and other contingent consideration). This is also driven by banks becoming increasingly cautious of the risks arising from earnout and contingent consideration, including retained equity.

2. Retained Equity By Banks Can Subject the Divested Business to the BHCA

In addition to the need for cash to shore up capital reserves, the desire to avoid retained equity is also driven by the Bank Holding Company Act ("BHCA"). That is because under the BHCA, if a bank owns or controls an entity, that entity is deemed to be part of the bank and subject to the same regulatory treatment as the bank itself. To divest control of an entity (and thus escape the BHCA regulatory regime), the bank will have to divest much more of an interest than one might assume, i.e., it is not as simple as divesting a 51 percent interest. For a manager to avoid the BHCA regulatory regime, the bank would need to reduce its interest to less than 25 percent of any class of voting securities and, in some cases, to as low as 4.9 percent of any such class.

Such a sale benefits the buyer and seller. The selling bank will not have to count such a divested business on its balance sheet. From the buyer's perspective, it is generally best to avoid being "controlled" by the bank and, therefore, not subject to banking law, Dodd-Frank and the regulatory issues that banking institutions are facing these days.

From the M&A lawyer's perspective, all of these problems with retained equity stakes have a silver lining: deals without retained equity are much easier to negotiate. Those types of provisions tend to bring much complexity to the transactions and negotiations, and co-ownership creates enormous governance issues. Without those provisions (whether because of regulatory or other reasons), many of the struggles in negotiations can fall away.

3. Volcker Likely Means That Upon the Sale of An Asset Management Business, the Bank Will Also Need to Divest of Limited Partnership Stakes

   Another feature in bank divestitures is that, in addition to divesting the manager, banks are typically also looking to divest their limited partnership interests in the underlying funds as well as any accrued but unrealized carried interest. Though this may be done to increase capital as much as possible in the sale transaction, it is also motivated by the Volcker Rule.

   As noted above, under the Volcker Rule, banks and their affiliates will need to divest most of their interests in private equity funds and hedge funds. As a result, if a bank is in the process of selling off an asset management business, it may want to sell its limited partnership stake in the funds as well in order to make sure that it is in compliance with the Volcker Rule, rather than taking the chance that it will be unable to divest its limited partnership interests to another party before the Volcker Rule takes effect.

   Of course, the sale of a limited partnership stake to the buyer is also in line with investor expectations that the buyers have some "skin in the game" going forward by investing in the underlying funds.

4. Dodd-Frank's Compensation Rules May Be Driving Talent Out the Door

   Dodd-Frank's compensation rules may also be driving banks to divest of asset management businesses. Banking entities with more than $1 billion in assets are prohibited from paying any incentive-based compensation that is deemed to be "excessive" or that encourages undue risk taking with the bank's capital.

   As a result, managers are motivated to leave banks to avoid such restrictions, and to be in a position to receive the kind of compensation to which they have become accustomed.

   Unfortunately, the statute does not define what compensation is "excessive." Regulators have declined to do so as well. Instead, the regulators have adopted a "we know it when we see it" approach. The lack of an objective standard may result in a chilling effect where banks move away from attractive incentive compensation schemes, even those that may not be excessive.

C. Tax Is Not a Likely Driver

Banks are corporate sellers. Because there is no expectation of any increase in tax rates on corporations in the near future, tax changes are not causing banks to divest of asset management businesses.

III. Motivating Non-Seller Management

One problem that banks face in selling a wholly-owned asset management business is motivating the management team to participate in the deal. If a group of founders form their own hedge fund and they sell out, they are the sellers and they receive the purchase price (and the money motivates participation). In contrast, when an institution is selling, the institution receives the purchase price and management would not see a clear financial benefit. Nonetheless, because an intact management team (with a good track record) is a significant component of most asset manager transactions, retaining and motiving management is paramount.

A. Motivating Management with Carrots

One way to motivate management participation in the deal process and provide long-term retention is to design attractive employment arrangements going forward that reward profitability and long-term employment.

Another way is through payments made in connection with the deal itself, i.e., a transaction incentive agreement. Such an agreement allows a seller to simulate equity incentives that a selling stockholder would have, by allocating a portion of the purchase price to a bonus payment to management.

1. Certain Tax and Accounting Matters Should Be Considered

   Such a bonus does create some issues, mostly from a GAAP perspective and from a tax perspective. First, payment of a portion of the purchase price to management as a "bonus" could convert purchase price into a GAAP expense for the buyer. As a result, this could present an issue for some publicly-traded buyers.

   From the recipient's perspective and tax perspective, once a seller decides to structure the payment as a bonus, it must make sure that the bonus plan qualifies for the deferral rules under Section 409(a) of the Internal Revenue Code.

2. A Vesting Schedule May Incentivize Retention

   To incentivize retention, the bonus payment can be subject to a vesting schedule and the vesting can be conditioned on continued employment. Unlike earnouts for non-corporate sellers, retention packages can be conditioned on employment without jeopardizing capital gains treatment[1] because retention payments received by management constitute ordinary income (and not capital gains) for tax purposes in any event.

B. Motivating Management with Sticks

Management may also be motivated by certain penalties in the event that they do not participate in the sale process. This shows up most commonly in the form of a non-compete. Of course, non-competes may not be overreaching. In New York, at least outside of the sale of business context, a non-compete is enforceable only if (i) it is reasonable in scope and duration and (ii) it is being used to protect an employer's legally protectable interest, e.g., its trade secrets. If the basis for a non-compete is only to prevent an employee from leaving, it probably will not be enforced by a court. In the sale of business context, however, the protectable interest requirement falls away. Managers who get bonuses as part of a deal are technically not sellers. Nonetheless, it is likely that a court would be more willing to enforce a longer non-compete against a manager who signs a non-compete in consideration for a sizeable bonus received in connection with a transaction.

C. Management Has Leverage

Where an institutional seller is divesting a business run by a professional management team, management has significant leverage. One of the things management can do with its leverage is force the sale to itself. Such deals are referred to as spinouts. They are generally structured such that the current professional management team acquires the equity in the management company (and related general partner) it is currently running from its institutional owner.

Negotiations of such transactions in management buyouts tend to be somewhat simpler than third party buyers because (obviously) management has significant knowledge about the business and the assets and liabilities of the enterprise — oftentimes more knowledge than the actual seller. As a result, representations and warranties are limited, and in some cases are limited to only fundamental representations. In addition, indemnities and other recourse to sellers are also limited.

IV. Spinouts

Spinout activity has been relatively stable over the last few years, with no meaningful uptick in 2012. This is likely a result of the same factors that are driving industry consolidation, and a result of the difficulty for management to come up with more purchase price in up-front cash.

A. Spinouts Run Counter to Consolidation Trend in the Industry

A spinout runs counter to the general industry trend of consolidation. In a spinout, a new manager is being created. In contrast, consolidation is driving small managers into larger institutions, so the motivations to exist as a standalone manager may be hampered by the same facts that are driving consolidation.

B. Management May Have Difficulty Coming Up with the Cash to Fund a Spinout

When the buyer is the management team, the individuals need to actually come up with the purchase price, and these individuals may not have sufficient cash to effect the acquisition.

This leaves two options: a financed acquisition or contingent consideration. A financed acquisition is difficult given the current credit markets; risky credit is still constrained for these types of buyers.

With respect to contingent consideration, an earnout is one good way to push off much of the purchase price into the future. In fact, it allows management to essentially finance the purchase price with the profits of the business that it just acquired. Another way to reduce the upfront capital that management must raise is to forego purchasing the entire business — i.e., leave the seller with a minority stake. In some cases, the management team may also have a call right to acquire the retained stake at a later date. As discussed above, this runs counter to the idea that bank-sellers (who are often the sellers in a spinout) desire, or even need, an all-cash purchase price.

Another challenge is that a spinout structured as a buyout does not provide a tax deduction. Therefore, the buyers need to come up with the cash using after-tax dollars. At best, the buyer will get a 15-year amortization on the purchase price. From a value perspective, it is tax inefficient to structure a spinout as a buyout.

C. Engaging with Management in Spite of These Impediments

Given these impediments, one may think that sellers would be reluctant to deal with the management team and a management buyout. Nevertheless, management has meaningful leverage to buy their own management companies from corporate and bank sellers. Management is key to being able to sell any asset management business. If management is seriously pursuing a buyout, it can be difficult for a seller to resist management's desires and seek other buyers who may not want to buy into an unhappy management team.

Management will, however, be attentive to limitations on its leverage. For example, the members of a management team may be subject to existing non-competes that would prevent the team from being able to manage investor money for some period of time upon separating from the corporate sponsor or the business. Members of the management team may also forfeit deferred compensation or restricted stock if they compete with the corporate sponsor or the business, or otherwise leave the corporate sponsor or the business. Members of the management team may also be subject to non-solicitation provisions that prevent them from hiring or soliciting members of the team to a new enterprise.

As a result, even when the parties agree on a spinout, both the management team and the employer/seller will need to focus on the obligations from which management and the sponsor should be released. At one extreme, a great team with a profitable business that the employer wants to retain and grow will have a difficult time convincing a sponsor to release the team members from their restrictive covenants. At the other end of the spectrum, a team that an employer wants to divest, perhaps due to performance, will likely have an easier time being released from their restrictive covenants.

1. Use and Ownership of the Track Record of the Business

   Spinouts tend to involve significant negotiations over the track record, as the employer/seller asserts ownership of the track record and management asserts a claim to unrestricted and exclusive use of the track record. The better the track record, the more difficult and expensive it is going to be for management to be able to obtain the exclusive right to use it.

   If the spinout involves proprietary traders leaving a bank, then this issue is going to be further complicated. The data used to compile and demonstrate the track record likely involves sensitive, confidential information of the bank. There are strict rules as to what the bank can do in this context, how much information it can share, and when that information can be used to benefit a third party.

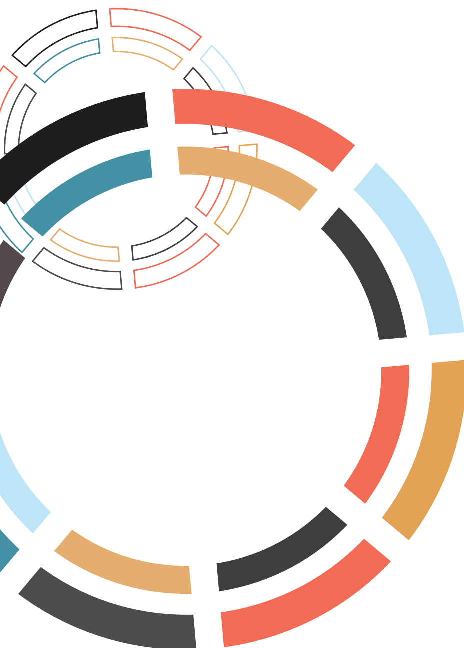
2. Both Seller and Buyer May Be Motivated to "Play Nice" Because of the Mutually Beneficial Ongoing Services

   When a spinout occurs, the relationship between the institutional seller, on the one hand, and the management company and the management team, on the other hand, is severed. Yet, at closing, there exists a new management company with the need for the services which the institutional seller has previously provided, and continues to be capable of providing. The new management company's need for services often drives the parties back together.

   In many cases, the management team wants to lock in those services — particularly distribution — from a party it knows it can work with. The seller may also want to lock in a revenue stream — especially for prime brokerage services. As a result, ongoing service arrangements often become part of the deal negotiations in these transactions.

   If the sellers want to be in a position to provide distribution or prime brokerage services to the spunout business, that institution likely is going to want to treat management well on the way out the door and, therefore, will be more inclined to release management from restrictive covenants in that case. Similarly, management will likely be inclined to deal fairly with the institution if it desires to lock in services from the institution after closing.

   Unfortunately, if one of the parties to the deal is a bank, continued relationships post-spinout are more complicated. Under the BHCA regime, such services are an indicator of control; if the bank continues to provide material or essential services to this spunoff business, the regulator may take the position that the bank continues to control that business. In other words, the regulators are concerned that, for instance, if a bank is providing distribution services to a manager, the bank could threaten to curtail such services as a way of gaining leverage over the manager and getting it to take any actions requested by the bank. As a result, a seller-bank will need to carefully consider each aspect of the transaction to ensure that, in whole, the ongoing relationship between the bank and the new manager does not result in the bank being deemed to control the manager.



V. Consolidation of Fund Managers

The general consolidation of the industry is a key driver in the uptick in deals in 2012. In other words, other fund managers are themselves the largest buyers of asset management firms.

One reason for consolidation is the increasing cost of compliance. A consolidated entity can allocate compliance costs over multiple lines of business. In other cases, the consolidation is driven by asset managers seeking to diversify their sources of revenue. Consolidation can expose smaller managers to new, and larger, distribution channels.

Most of the consolidation deals are "control" transactions, where a buyer acquires a majority or controlling stake in the target manager. Generally speaking, such control deals are most common for smaller and mid-size asset managers. For the largest managers, "minority" deals tend to be a good way for ownership to take money off the table with favorable tax treatment. Notably, majority deals showed a meaningful uptick in 2012.

A. Economics and Governance in Majority Deals

There is a significant interplay between economics and governance in the negotiations in majority deals. That is because, outside of the banking institution context, the long-term earnout has become the primary method to address valuation and longevity concerns in majority deals (and, to some extent, in minority deals).

Earnouts push out the purchase price payments over time, and also permit a buyer to know that the purchase price it is paying is aligned with the growth it is expecting to see in the business after closing. Because an earnout is contingent on success of the business, however, the sellers will want to maintain some level of control over the business to ensure that the earnout targets are met.

1. Financial Metrics and Governance

There are a variety of methods to structure the earnout. Earnout periods generally last in the range of three to seven years following closing. The financial metric may be based on revenue of the business, AUM, EBITDA, net income or some other negotiated metric.

Pricing the earnout based on AUM or revenue avoids the need to measure expenses as part of the earnout, and avoids the governance negotiations discussed below. However, pricing the earnout on those measures can mean that an earnout gets paid when the business is in fact less profitable than anticipated. If AUM is used as the metric, the parties must consider the impact of general changes in pricing in the industry (i.e., pressure on the "2 and 20" model), as well as the impact of the target manager taking on large amounts of AUM at discounted rates. Revenue naturally takes those issues into account. In some cases, AUM can be adjusted based on the fee rates associated with the AUM (which is straightforward for management fees, but somewhat more complicated for incentive fees).

If the earnout is priced off of EBITDA, earnings or anything "below" the expense line, then the seller will want to have some control over spending. Sometimes that control is in the form of negative rights, such as limits on compensation. Sometimes that control is affirmative, especially when the sellers are the management team who will run the business going forward. If the earnout is tied to the revenue rather than the profits of the target manager, then the seller has less need for control over expenses.

In many deals, the balance of governance rights tends to shift over time with the earnout. During the period from closing to the end of the earnout period, the management team sellers often retain contractual control over the business they have sold. After the earnout period, as a practical matter, the management team

may maintain operational control, but they usually lose the contractual right to do so. These earnout provisions as well as the related governance rights combine into purchase that provides incentive for management to stay with the business it just sold.

In accepting an earnout, a seller needs to consider the tax consequences. From a seller's perspective, unless the seller elects out of the installment method, the seller will not pay taxes on an earnout until the money is paid — such a seller will not pay taxes on the earnout in the year of the sale, but will pay when earnouts are paid. The benefit is that the seller may defer payment of taxes. The bad news is that if the tax rates increase (as they did this year), such a seller would not benefit from the lower tax rate that would have been paid on the initial purchase price.[2]

B. Retaining Talent In Majority Deals

1. Where Management is the Seller, Long Term Non-Competes and Employment Agreements are Common

Restrictive covenants are very common in majority deals. In the sale of business context — where managers are selling their equity — longer, broader non-competes are routinely enforced by the courts. The restrictions still need to be reasonable, but the buyer does not need to show a legally protectable interest (e.g., trade secrets).

In majority deals, it is common for non-competes to cover the full period of the earnout, which may be as long as seven years. In the event of breach, the remedy will not be forfeiture of the earnout because, as discussed above, doing so is inconsistent with ensuring capital gains treatment for the earnout.

Perhaps as a result, there is a trend toward buyers insisting on long-term employment agreements in which managers commit to remain at the firm for a long period of time. If the manager were to resign before the term of such an employment agreement expires, the remedy is obviously not to force the individual back to work. Instead, it will be a breach of contract remedy, which could have major financial consequences, particularly if performance of the business suffers after the departure of that manager.

2. Creative Methods for Retaining Talent

Because one cannot specifically enforce an employment agreement, buyers are finding other creative methods to retain management.

In some instances, management companies are broadly defining what constitutes confidential information and work product. As a legal matter, those are assets of the management company, which do not belong to the team members. As a result of this ownership allocation, the team members simply may not use any such information outside of employment in the business.

Taken to an extreme, some management companies broadly define such terms to include industry knowledge in general and, frankly, anything in the heads of management. One would be right to question whether such a provision is enforceable, but the threat of litigation is often a deterrent itself.

Another creative retention mechanism is the springing equity stake. This is where the management company has the right to receive a seed capital-like stake in a departing manager's future business without having to pay cash for such a stake. For example, if a few team members decide to split out on their own to start their own management company, the former employer would automatically have a stake in the new venture. That creates a disincentive to leave the employer because the departing talent will not be able to gain the entire economic upside that they may have desired.

C. Put Options and Call Options

Buyers of management companies may also make creative use of puts and calls. If a team sells out to an institution, stays around for a few years, has some success and decides to break off to start a new fund (yet again), a buyer may negotiate for a put arrangement — where the buyer may put its acquired stake back to breakaway management.

Such a put option disincentivizes a breakaway for a couple of reasons. First, departing managers are unlikely to want to have their capital tied up in a business for which they have no continuing engagement in management or operations. Second, a put may be priced at less favorable terms than the business would be valued generally.

From a seller's perspective, a put and a call is also not tax efficient. The seller paid tax when it sold the business. When a seller buys back that same stake pursuant to the put, that seller may not deduct the purchase price (at best, this will come with a 15-year amortization). As a result, it is a challenge to arrive at a put price that is desirable for both parties. A buyer will want to sell the interest back at its cost. Because a seller paid tax on the cost, the seller only has the cash net of taxes; so a buyback at cost would mean a seller is to come out of pocket for the difference.

Some buyers are also insisting on puts triggered by insider trading, fraud, breach of fundamental representations or other catastrophic events. This is often in addition to indemnity provisions. There are clear issues with an buyer enforcing an indemnity against sellers if they are your current management in charge of continuing to run the business. This means that the people the buyer is trying to incentivize to grow the business are having to come out of pocket to pay the claims. In contrast, when a buyer puts an interest back to the sellers, it is effectively unwinding the original transaction.

Puts are sometimes priced at the original purchase price, some discount to purchase price, or take into account distributions that have been made post-closing to the buyers.

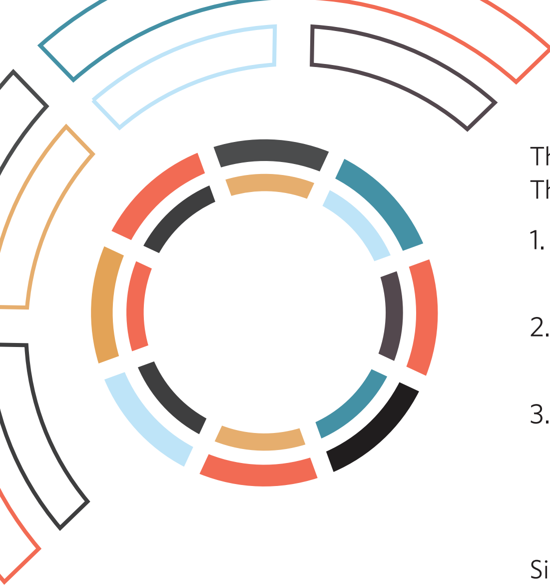
Puts and calls are also common in deals involving banks, where they are primarily used as a mechanism to resolve issues that arise from unanticipated changes in law. For example, if a bank is divesting a manager but retains an equity stake, the bank may want the ability to force the manager to buy out its remaining interest if, in the future, that interest causes unintended regulatory consequences for the bank — e.g., it causes the bank to be deemed to control the manager. Relatedly, if bank ownership causes unintended regulatory consequences in the future, a manager may want to the right to purchase the bank's remaining interest.

VI. Issues Arising In Minority Deals

The activity level has remained relatively stable for minority deals from 2011 to 2012. However, there was increased activity in the U.S. in the fourth quarter of 2012 due to the scheduled increase in the U.S. capital gains tax rate noted above.

A. Firm Culture and Minority Protections

In many minority deals, there is inherent tension between preserving the entrepreneurial culture of the firm, on the one hand, and the minority protections sought by the buyer, on the other hand. Moreover, many fund investors place a high value on managerial control and firm culture and, therefore, may need reassurance that the successful management and culture will be preserved. Nevertheless, it is very important that a manager understands up-front the degree of control, information and other rights that a buyer will expect to have. Consequently, these transactions often take on many of the traits of a joint venture.



There are three basic economic structures that accompany minority transactions. These are defined by the type of economic entitlement the buyer receives:

1. ***Net Profit Deals***. In a net profit deal, the buyer acquires a general percentage interest in the manager, and shares in all of the expenses and profits of the business.

2. ***Pure Gross Deals***. In a pure gross revenue deal, the buyer acquires a percentage of the revenue "off the top," without any deductions for expenses.

3. ***Modified Gross Deal (and other hybrids)***. Between the first two structures fall a range of hybrids, including the modified gross revenue deal. In a modified gross revenue deal, the buyer shares in expenses, but those expenses are capped at a percentage of net income.

Similar to earnouts in majority deals, the type of economic structure drives the governance negotiations.

For example, in a net profit deal, the buyer shares in all or substantially all of the investment manager's expenses, which raises sensitivity to the management team's day-to-day decision-making with respect to expenses. Since the operations have a direct impact on the buyer's revenue stream, buyers often require greater consent rights over various acts by the investment manager. Consent rights may relate to key employee hiring and termination, compensation, retention of third-party marketers, capital expenditures and other significant costs.

At the opposite end of the spectrum a pure gross revenue deal — expenses should not affect a buyer's return, which is directly tied to a percentage of revenue. That means the buyer has less reason to be concerned about spending decisions, and protective rights can be limited to extraordinary corporate actions, such as sales of the business and changes to the business plan, or actions that impact value. (However, from a tax perspective, such a structure risks being viewed as a purchase of a revenue stream and not equity.)

In a modified gross revenue deal, where only certain specified expenses — or expenses capped at a percentage of revenues — are netted out of the investment manager's revenues, there is a balance of protections.

B. Employment Issues in Minority Deals

On the employment side, many of the issues that arise in control deals are also present in minority structures. As a result, often the sellers (and some other key personnel) may be required to enter into employment agreements in connection with closing, which agreements will include restrictive covenants, temporal terms of employment and rights and obligations upon termination of employment. Instead of the management company negotiating with the relevant personnel, generally the buyer will be the counterparty, even though the management company will also be a signatory to the agreement.

C. Transfer Restrictions in Minority Deals

Depending on the importance of an exit to the buyer (some deals are purely financial or may sunset after a period of years, or after a specified return has been achieved), transfer rights may be an issue.

Investment managers want to choose their partners and do not want to unwillingly become an affiliate of a competitor or other "unsuitable" partner. In some deals, prohibited transferees are specified by name. In others, the investment manager may achieve a desirable result through a right of first refusal or right of first offer.

Similarly, buyers are interested in knowing that the sellers continue to retain the majority of the equity in the business. In some cases, a buyer will negotiate for restrictions on any ability for sellers to transfer their controlling interests. In other cases, the buyer simply negotiates a tag along right, such that if the controlling stockholders transfer their interests to below majority, the minority buyer can tag along their entire interest in the sale. In many cases, this lets the buyer sell out its entire stake first (i.e., not just *pro rata*). This permits a minority stockholder to exit the business if the sellers will no longer control the business.

VII. Looking Forward: Will the Uptick in Deal Activity Continue In 2013

It seems likely that asset management deal activity will continue its upward trend, as many of the drivers continue to persist.

Consolidation is a solution for two problems facing principals of small and mid-size asset management businesses: spreading compliance costs over a larger AUM base and increasing distribution capabilities. Simply put, there will be more profits for principals if compliance costs are spread over greater revenue or AUM base. And one can expect that compliance costs will continue to increase as the industry remains the target of regulatory reform and the rules promulgated under Dodd-Frank take effect. Similarly, there will be more profits for principals if funds are able to increase distribution channels. The quickest way to increase distribution channels for a small or mid-size fund is to join forces with other managers. As a result, small and mid-size managers may seek to become a part of a larger enterprise.

Larger managers, too, are seeking to add small and mid-size managers to their offerings. As the industry matures, these larger managers are seeking to diversify the investment strategies for two reasons. First, managers are seeking to bring in additional capital from their long-standing relationships by offering multiple investment strategies, thus allowing clients to maintain diverse portfolios under the umbrella of a single institution. Second, diversifying investment strategies is a hedge against changes in the economy. Adding a management team with a track record in an investment strategy that is not offered is a quick and efficient way to diversify offerings.

In addition, one can expect banking institutions to continue to be significant players in the asset management transaction space as they continue to divest non-core activities in an effort to boost capital and increase liquidity.

Endnotes

[1] In contrast, when management-sellers receive earnouts, they may want those earnouts to be treated as purchase price (capital gains) for tax purposes. To ensure that such treatment is preserved, receipt of the earnout should not be conditioned on the seller continuing his or her employment with the target business after it is sold to a buyer.

[2] An example:
A transaction closed in 2012, with anticipated earnout payments in 2015 and 2017. That seller has a choice: (i) elect out of the installment method and pay tax on day one or (ii) pay taxes when the earnout is paid. In the event that the seller elects to defer the tax payments, if tax rates increase (as they did), the seller is subject to the higher tax rate on these payments. On the other hand, if the seller elects out of the installment method, it would have to generate a valuation as to the value of the earnout at close, and pay tax on that amount in the year of closing (in this example, 2012). Obviously, the seller will need cash to pay those taxes. In addition to paying taxes without having received cash for the relevant amount, if the earnout targets are not met (resulting in a capital loss), the seller may not carry back the capital loss to 2012, it can only carry it forward.

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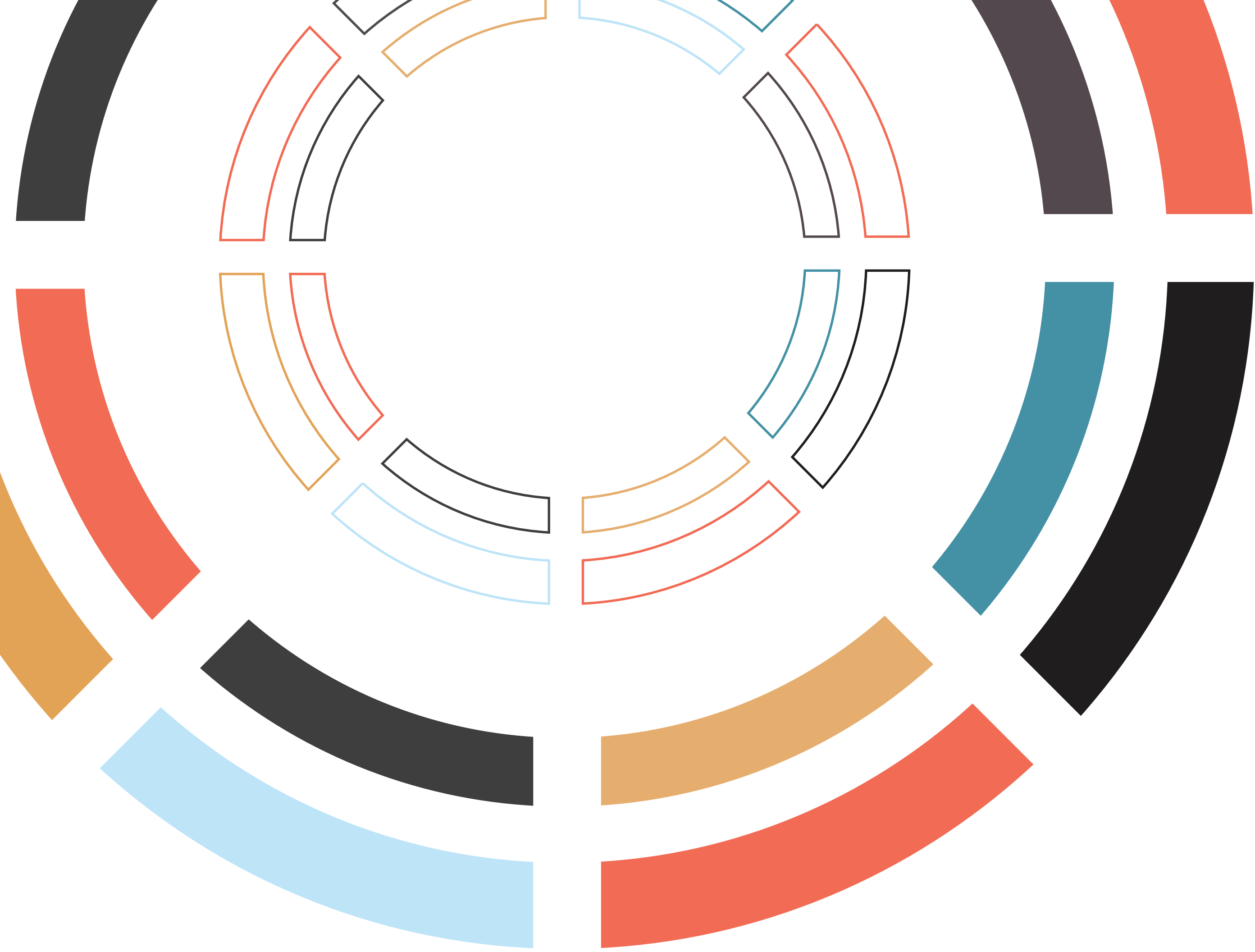

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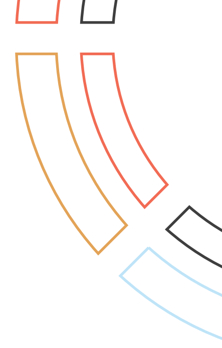

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