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FUND DOCUMENTS

The Ties That Bind: Governance and Economic Terms to Negotiate in Management Company and GP Agreements (Part One of Two)

By Eileen Overbaugh, *Lowenstein Sandler*

Arguably the most important business deal that an asset manager will negotiate is with its business partners (*i.e.*, its co-founders and fellow principals) – those it relies on for complementary skill sets and the fortitude to build its business over time. Just as the dynamics among founders take many forms, so do the conflicts that arise between them over the long and challenging course of managing a business. To ensure the principals and their firm navigate those challenges appropriately, asset managers should thoughtfully document their business arrangements early in the relationship.

This first article in a two-part series identifies the unique challenges inherent in bespoke and personal business arrangements, with particular attention paid to important governance and economic considerations to address in those arrangements. The second article will address restrictive covenants, departure scenarios and buy/sell arrangements, in each case, viewed through the lens of a founder or principal.

See our two-part series "Panel Offers Perspectives on Internal Compensation Arrangements for Investment Professionals": Carried Interest and Deferred Compensation (Mar. 15, 2018); and Private Fund Compensation and Non-Competes (Mar. 22, 2018).

Importance for All Managers

Asset managers engaging in all strategies, with all structures and at all points in a firm's lifecycle, must consider and address various nuanced issues when preparing or updating the legal contracts governing the relationships among principals of the firms. Typically, those relationships are captured in the limited partnership agreements and LLC agreements governing:

- the flagship management company;
- any affiliates established to provide asset management services to particular funds or accounts of the flagship management company; and
- the various limited-purpose entities serving as GPs or managing members of flagship funds, successor funds, sidecar vehicles, co-investment vehicles or top-up vehicles.

See our two-part series on the co-investment continuum: "Structures That Give GPs More Control and Discretion" (Apr. 21, 2020); and "Direct and Indirect Structures That Empower LPs" (Apr. 28, 2020).

Emerging managers often start their asset management firms with meager agreements governing the relationship among the principals. Their focus tends to be on building a business and raising capital, rather than the then-theoretical possibility of soured relationships; the inevitable (but seemingly far off) departure or retirement of senior employees; the unlikely death or disability of a principal; or the improbable sale of the business. Before long, however, assets under management have grown, business lines have evolved, additional employees have been hired and personal relationships have become complex.

Conversely, although established managers may have comprehensive and complex agreements, they often are outdated by failing to reflect:

- the shifting of business responsibilities and time commitments;
- new product lines and strategies;
- life events such as marriage, divorce or intended retirement of key principals;
- informal succession planning and the grooming of a next generation of employees that may be happening within the business; or
- changes in law, including important tax updates.

Similarly, single-principal firms granting equity to senior employees for the first time must tackle issues of first impression such as economics, vesting, departure protection, management rights and access to information. The original founders may feel they are being particularly generous by offering employees the right to participate directly in the financial upside of "their business." In contrast, senior employees may feel it is their opportunity to reflect a more equal and balanced relationship with their employer, to protect their financial futures and to create a launching pad for future opportunities.

See "New York Appellate Court Decision Illustrates the Litigation and Publicity Risk Inherent in Sloppy Drafting of Fund Manager Operating Agreements" (Feb. 7, 2013).

The Issues

Governance and Management

A threshold issue for any business is control of decision making, management and governance. That is particularly important in the asset management industry because those decisions affect not only the firm's operations, but also the funds and accounts for which the firm acts as a fiduciary.

Governance of firms operated by a single principal or founder is relatively easy – the principal generally makes all material decisions. The primary consideration, however, is what decisions should be delegated to C-level employees. For instance, can the COO negotiate and enter into a lease on behalf of the firm? Can the CFO hire and fire the audit firm? Can a senior director enter into a letter of intent with a potential portfolio company in his or her subsector of expertise?

More complex issues arise for asset management firms with multiple principals, although governance often follows the natural power dynamic of principals – *e.g.*, one has the investment skillset while the other has operational knowledge. For instance, one principal might make nearly all decisions about management, with all principals' agreement required for a limited list of fundamental business decisions (*e.g.*, admitting another equity owner, launching another fund, hiring C-level employees, incurring debt, winding down the business, etc.). Also, principals might elect to bucket responsibilities. For example, the principal with the investment skillset has unilateral investment discretion with respect to funds and accounts, while the principal with the operational skillset has hiring/firing authority over non-investment professionals and service providers.

See "Loose Corporate Formalities of Former Fund Management Partners Result in a Messy Business Divorce" (Aug. 4, 2011).

The most challenging arrangement is between fifty-fifty co-principals who desire co-equal management rights. The greatest challenge is avoiding deadlock and proposing viable solutions for efficiently resolving any stalemate that does arise, which can be accomplished through the following techniques:

- limiting the list of matters requiring joint approval;
- requiring consultation with outside counsel or accountants;
- providing a tie-breaker vote to a C-level employee;
- permitting one principal to cast a tie-breaking vote in the event of imminent harm to the asset management firm or its funds and accounts; or
- formal mediation, if workable within the timeframe for making a decision.

Finally, if the principals remain at odds and in an unworkable relationship for a sustained period, they can consider an orderly departure of one principal. Before going down that path, however, careful consideration must be given to any key-man and change-of-control provisions embedded in the offering and organizational documents of the funds and accounts. In addition, the parties will need to consider the change-of-control requirements of the Investment Advisers Act of 1940, which require investor consent for the transfer of a controlling portion of the management company. Departing principals often will use their awareness of those legal barriers to negotiate generous departure packages.

Economic Terms

Management Fees and Management Company Expenses

Principals must determine how to share any management fees that remain after paying management company expenses, including employee salaries; bonuses; office leases; technology and other infrastructure; and research costs not otherwise paid by the manager's funds and accounts.

Perhaps more importantly, principals must agree if, when and how they will be required to infuse capital to expand or maintain the viability of the business. That is especially important for emerging managers trying to float the business before receiving management fees from their first funds or accounts.

Most co-equal principals will share those costs proportionally, and they will be treated as capital contributions to the management company. Eventually, those amounts will be returned to the co-founders by the management company as returns of capital.

Alternatively, one founder may have greater access to capital and might be the source of all cash pre-launch. In that case, the contributing founder might elect to treat those amounts as a loan to the management company or might require a priority return of his or her capital before the other founder shares in any management fees.

See "Fund Manager Business Divorce Highlights Need to Properly Document Significant Money Transfers Between Principals" (Aug. 15, 2013).

Importantly, first-time founders should be cautioned about the treatment of their monthly or bi-weekly draws (*i.e.*, salary). As equity holders rather than employees, the draw will not be subject to employer-side withholding for income tax purposes; the founder must pay all of those amounts. In addition, the founder must prepare and file quarterly estimated tax returns, which often is surprising for emerging managers previously accustomed to a traditional salary.

Incentive Compensation

Principals also must determine how to share in any incentive compensation – *i.e.*, incentive allocations, carried interest or performance fees. The nature of the underlying product can have a large role in driving how those amounts are shared, when they may be withdrawn and what may be done with those amounts once earned. The following focuses on how founders and principals structure their arrangements, rather than how to structure compensation or economic upside for employees, venture capital (VC) partners, etc.

See "Ways Fund Managers Can Compensate and Incentivize Partners and Top Performers" (Dec. 14, 2017).

In traditional hedge fund structures, principals typically share in the incentive allocation on a proportional basis (*i.e.*, in their agreed-upon percentages). Upon crystallization, barring any restrictions in the fund's offering documents, they are entitled to withdraw those amounts. Although many elect to reinvest at least a portion of the proceeds into the asset manager's funds, the principals are free to spend the amounts however they desire. Given the annual nature of the compensation, there often is no vesting component – each year's performance and economic rights stand independently.

Hedge fund principals should consider, however, that they may be required to use a portion of the incentive allocation to satisfy obligations of the management company – specifically, employee bonuses. In that instance, the principals should be required, pursuant to the terms of the management company and GP agreements, to contribute a portion of that incentive allocation to the management company to pay expenses and employee bonuses.

For PE and VC fund structures, the terms of the structuring, sharing and clawing back of the carry can be very complex. The threshold question is in what part of the economic pie does each party share? Do all participants share in profits and loss from every transaction of the underlying fund? Or, do they participate in profits and loss only from the transactions they sourced, diligenced, negotiated and exited? Depending on how labor is divided at a particular firm, the principals may share in the economics of every transaction, even if employees and VC partners share only in those they worked on.

Given the long lifecycle of PE and VC funds, and the chance that even principals may depart in that time period, carry often is subject to vesting or forfeiture terms – at least for junior principals or those with smaller ownership stakes. From a firm's perspective, the preference often is to have forfeited interests revert to the firm instead of to the other carry participants. That allows the remaining principals to reallocate those interests to new hires, including the replacement for a departed employee.

Finally, the agreement governing the GP should dovetail appropriately with the fund documents. For instance, if the fund agreement allows for tax distributions to the GP, the operating agreement for the GP also should allow for tax distributions to its owners. Similarly, if the fund agreements include a clawback provision, even if the carry recipients have signed personal guarantees to return amounts attributable to the clawback, the operating agreement of the GP also should require the clawback and should contemplate what, if any, effect that clawback has on the economics at the GP level.

See "How Carried Interest Clawbacks Preserve Investor Returns and Affect Taxation (Part Two of Two)" (Jun. 11, 2019).

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The Ties That Bind: Non-Competes and Principal-Departure Parameters to Address in Management Company and GP Agreements (Part Two of Two)

By Eileen Overbaugh, *Lowenstein Sandler*

Founders and principals of asset management firms often direct considerable attention to negotiating their economic arrangements, especially when their firms are successful. Many do not, however, consider what would happen if one of their co-founders or principals voluntarily or involuntarily were to depart the firm. That can often force firms to scramble to consider those issues without the appropriate, pre-negotiated legal framework, often when the matters at stake and tension among the parties are at their peak.

This second article in a two-part series analyzes pressure points in negotiating restrictive covenants, departure scenarios and buy/sell arrangements for founders or principals to focus on when drafting management agreements. The first article reviewed the unique challenges inherent in bespoke and personal business arrangements, with particular attention paid to important governance and economic considerations that can arise.

See our three-part series: "Why Fund Managers Must Review Their Positions on Succession Planning and CCO Outsourcing" (Apr. 14, 2020); "What Fund Managers Should Consider When Hiring and Onboarding CCOs; Determining CCO Governance Structures" (Apr. 21, 2020); and "A Succession-Planning Roadmap for Fund Managers" (Apr. 28, 2020).

Restrictive Covenants

Most agreements governing asset management firms with a single founder or principal do not limit the current and future activities of that individual. Conversely, firms with multiple principals typically protect the firm by imposing various restrictive covenants on current and former principals. Certain of the restrictions are noncontroversial, such as restrictions on the improper use or disclosure of confidential information.

See "Procedures for Fund Managers to Safeguard Trade Secrets From Rogue Employees" (Jul. 21, 2016).

Non-Competes

The most sensitive issue with respect to restrictive covenants is the scope and duration of any non-compete upon departure from the firm. Applicable law generally requires that a non-compete protect a legitimate business interest, with enforceability limited to appropriately tailored terms.

For instance, the scope typically covers any competitive activity – whether as an employee, consultant, equity holder, officer or otherwise – as to any management company, GP or managing member providing asset management services to a fund or account with a similar investment strategy as any fund or account managed by the original asset management firm.

Pressure points in negotiations include whether a strategy need only be "similar" or "substantially similar," and when those investment strategies are measured. For example, it may include all strategies historically employed by a firm; only active strategies at the time of the competitive activity; or any strategy the firm was employing, exploring or considering at the time of departure.

The length and extent of non-competes vary by firm, but they typically range from 12-24 months. Non-competes typically are longer for founders and principals because not only do they hold significant equity positions, but they also have access to proprietary information on investment positions, investment theses and investor relationships. In addition, certain firms agree – either within documentation from the outset or upon departure – to exchange a longer non-compete for additional vesting or economic terms upon exit.

An important consideration is whether the departing principal is entitled to garden-leave payments during the term of the non-compete. Although that may be expensive for the firm, it makes it more likely that a non-compete will be enforceable. Importantly, garden-leave payments typically will be forfeited by a departing principal if an asset management firm agrees to waive any non-compete restrictions.

The parties also should consider whether there are appropriate exceptions from a non-compete. For instance, a former principal may be permitted to serve on investment committees of educational, religious or philanthropic organizations, or he or she may be permitted to manage assets solely for his or her family members.

The parties also should consider whether the non-compete can or should continue after the dissolution of the firm. Although it is less likely a legitimate business interest will remain that needs to be protected, valuable intellectual property, investment strategies and investor relationships may remain that should not be simply carried forward to the principal's next opportunity without first discussing with his or her fellow principals.

See "Trending Issues in Employment Law for Private Fund Managers: Non-Compete Agreements, Intellectual Property, Whistleblowers and Cybersecurity" (Nov. 17, 2016); and "Impact on Private Fund Advisers of Obama Administration's and State Lawmakers' Actions to Restrict Use of Non-Compete Agreements" (Nov. 10, 2016).

Non-Solicitation

Additional restrictive covenants typically include employee and investor non-solicitation clauses, as well as non-interference restrictions.

Careful consideration should be given to the scope of employee non-solicits. For instance, the most restrictive variations will prohibit former principals from engaging in any business enterprise with another former employee or officer of the prior firm. That prohibits the former principal from starting a new shop with a prior team, even if the team voluntarily departed (without involvement of the prior principal) or were fired by the prior firm in accordance with the terms of their own employment arrangements. From the prior firm's perspective, that prevents a lift-out – forcing all parties to come to the table and discuss any potential spinout.

Non-interference restrictions generally prohibit a former principal from attempting to cause an employee, investor or service provider from terminating or adversely changing its relationship with the firm. For instance, it bars the departing principal from trying to convince an investor to withdraw from the firm's funds or to convince an investor to invest with the former principal, rather than in the firm's successor fund.

The length of those restrictions also varies by firm, but it typically ranges from 18-24 months.

See "Non-Competition and Non-Solicitation Provisions and Other Restrictive Covenants in Fund Manager Employment Agreements" (Nov. 23, 2011).

Departure

Trigger Events

A vital decision is when and how a principal may elect to, or may be forced to, depart from an asset management firm. Once those parameters are established, the parties must determine what will happen to the ownership interests of the departed principal.

For instance, the departed principal may remain an owner solely for economic purposes through the term of existing funds but lose all managerial, governance and consent rights. That option is particularly attractive to GPs of closed-end vehicles with limited current cash flow. Alternatively, the parties may desire a repurchase right where the firm, or some or all of its equity holders, purchases the departed principal's ownership interests. That approach often is preferred by the GP of liquid or semi-liquid vehicles.

First, the parties will need to address the death or permanent disability of a principal. From the firm's perspective, it is not ideal to continue in business with a former principal's spouse, children, trustees or guardians. From the departed principal's perspective, his or her estate or family often needs cash to settle an estate's liabilities or to provide ongoing healthcare for a disabled party.

PE and venture capital (VC) funds often allow the departed principal or his or her estate to retain purely economic rights, including any carried interest, until liquidation of the various funds existing at the time of death or permanent disability. Occasionally, there will be a reduction of economic participation, although many arrangements allow for full participation without any haircut. For hedge funds and other liquid products, however, the estate or departed principal often is subject to a prompt repurchase to prevent them from participating in any incentive allocation in perpetuity.

See "Estate-Planning Strategies for Transferring Rights to Carried Interest in PE Funds (Part Two of Three)" (Jan. 21, 2020).

Second, most parties desire a repurchase right in the event of a bankruptcy or divorce decree granting a former spouse ownership of the principal's interest in the asset management firm. As noted above, most do not want to be in business with their fellow principal's creditors or former spouses.

Third, depending on the demographic of the founders and principals, they may desire to prewire a process for retirement. Younger founders often are agnostic about that early in their career and revisit it at a later point. Typically, a retirement provision allows for voluntary departure after either a set number of years of service or a certain age. A retiring principal generally is required to provide several months' notice and is subject to a required transition period. Often, although not always, and subject to any potential vesting terms, a retiring principal is not penalized economically for his or her departure.

Fourth, aside from an orderly retirement, the parties may desire to provide for a voluntary departure of a principal. There often is an economic penalty for the right to walk away from the business, whether in the form of forfeiture of a percentage of economics or a discount on valuation.

Fifth, the parties should determine when for-cause removal of a principal would be necessary or appropriate. Although that right is beneficial for purely reputational risk and operational issues, it may also be required by the firm's regulatory obligations or the offering documents of its funds and accounts. For instance, for-cause removal rights in fund documents often can be cured if the GP removes the offending employee/officer and makes the fund whole for any losses. In addition, the Regulation D private placement regime is only available to funds without bad actors in certain management roles. Important considerations in drafting and negotiating include the scope of the definition of cause, the objectivity/subjectivity of the trigger events and whether to include cure periods.

For more on Regulation D, see "Policy Considerations and Next Steps for Fund Managers From the Revised Accredited Investor Standards" (Oct. 6, 2020).

An important corollary to for-cause removal is whether a principal can be removed without cause (*i.e.*, fired for no reason). That often turns on the dynamic between and among the principals. For instance, it would be unusual for two equal partners to be able to fire one another. On the other hand, a principal holding a significant portion of the equity may have the right to fire a C-level employee that only has a small portion of equity to participate in incentive compensation.

Terms

Once a departure event occurs, any unvested ownership interests tend to automatically be forfeited. In contrast, any vested ownership interests typically are subject to repurchase rights, which are discretionary and exercisable at the firm's discretion.

An optional repurchase allows the firm to determine whether it has available resources and funds to finance the repurchase without endangering its financial health – something neither the remaining founders or departed founder would want. Even in the case of death or permanent disability, firms typically have to decide whether to repurchase departed founder's interests unless there is life insurance or long-term disability insurance in place to provide the cash necessary.

Importantly, upon the departure of a principal, he or she should be required to resign from all board and officer positions of portfolio companies. In addition, in exchange for final payment of any repurchase amount, unless negotiated otherwise, the departing principal should provide a customary release of existing claims against the firm and its funds and accounts (other than claims for indemnification).

Valuation

If an asset management firm elects to repurchase a departed principal's ownership interests, the most complex component of the process is valuation.

Interests in PE and VC funds may be particularly difficult to value given the long-term horizon for potentially earning carry. Therefore, those ownership interests might be:

- valued by a third-party independent valuation firm;
- measured as if the underlying fund were to liquidate and sell all positions on the date of departure; or
- determined based solely on the departing principal's capital account balance (*i.e.*, carry received to date), which may be equal to zero early in the fund's lifecycle.

For hedge funds and other liquid products, the departing partner might receive only the economics he or she is entitled to in the year of departure.

See "Independent Valuation Firms: Rising Prominence of Third-Party Valuations and Factors to Consider When Engaging a Firm (Part Two of Three)" (Oct. 6, 2020); and "Investor Suit Against Fund Manager Illustrates the Perils of Valuing Illiquid Securities" (Oct. 8, 2015).

In any structure, following a for-cause trigger event, the interests might instead be subject to forfeiture without consideration so the offending principal does not have an economic boon as a result of his or her bad act.

Further, as an alternative method of valuation, the departing principal instead might be provided a trailing payment, receiving a percentage of what he or she would have received if he or she had remained a principal for a period of determined years after departure.

Conclusion

Perhaps uniquely, there is no established market standard or one-size-fits-all approach for agreements or arrangements between principals. What is appropriate for a New York-based investment firm with a traditional management fee and incentive allocation structure likely is unworkable for a Silicon Valley-based, late-staged VC shop with step-downs in management fees and tiered carry on a deal-by-deal basis. What makes sense for two co-equal founders spinning out of a bulge-bracket investment bank will not be tenable for a single founder, seeded by his or her prior firm and granting a small share of equity to attract the best possible COO.

Advisers to those types of clients (*e.g.*, corporate lawyers; accountants; trusts and estate professionals) should identify and understand the various issues presented by those relationships; appreciate the multitude of options for achieving the business objectives; and select, suggest and tailor those options to best fit the needs of the particular parties.

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