Private Investment Fund Team Compensation Arrangements: Continuity Considerations

A Practical Guidance® Practice Note by Nathaniel Marrs, Jessica McKinney, Aalok Virmani, Richard Ashley, and Thomas Geraghty, DLA Piper LLP

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This practice note addresses legal and economic consequences for private investment fund compensation arrangements when a member of an investment team departs, with a particular focus on industry-specific structuring, certain tax, and other considerations.

The private fund industry continues to grow at a record pace, with $9.2 trillion under management as of March 2021, according to the 2022 Preqin Private Capital Compensation and Employment Review. As the industry has grown, private fund principals and employees have become increasingly well compensated through a variety of sources, including salary, bonus, long-term incentive plan (LTIP) compensation, fund co-investment participation, and carried interest awards. In order to retain and recruit talented individuals, private fund sponsors are well served by ensuring their team members are appropriately compensated. Likewise, as the marketplace has become ever more competitive for top talent, private fund sponsors must consider appropriate conditions and restrictions to protect their interests in connection with departures.

This practice note will address the legal aspects of these arrangements. It is not intended to provide a market overview of current levels of employee compensation or focus on the more general elements of employment arrangements. Certain federal income tax issues associated

with the taxation of carried interests, and the various nuances associated with such rules regarding the characterization of gains as short-term or long-term capital gains, are beyond the scope of this practice note. It will also not focus on employment tax considerations or any state-specific legal considerations, such as state-specific tax implications or state-specific limitations on employee non-compete restrictions.

For the first part of this practice note that deals with structuring and negotiating private fund team compensation, see Private Investment Fund Team Compensation Arrangements: Structuring and Terms.

Consequences of Departure (for Both Fund Co-investment and Carried Interest)

The interest in the GP that represents each participant's funded amount of the GP Commitment is called a "Capital Interest." The circumstances of a carry or co-investment participant's departure from a sponsor will determine whether such individual is entitled to retain all or a portion of such participant's Capital Interest and carried interest and whether such interests are subject to a repurchase right in favor of the sponsor. However, except for senior founders in certain cases, a departing participant will not be entitled to participate in carried interest or Capital Interest with respect to investments made by a fund after such participant's departure (unless, in the case of a Capital Interest, the participant is permitted or obligated to fund such participant's share of the GP Commitment with respect to future investments). Senior founders may negotiate the right to receive a "legacy" interest in future carried interest and Capital Interest, including with respect to a certain number of future funds. In some circumstances, this type of "legacy" interest may be perpetual and apply to all funds formed by the sponsor in the future.

Common circumstances for departure and related consequences may include the following.

Involuntary Termination with Cause and Voluntary Termination Other Than for Good Reason

The involuntarily termination of a participant's employment or other service for cause will usually trigger a repurchase option that permits the sponsor to repurchase the Capital Interest of the participant discounted to cost (as opposed to fair market value, and perhaps with a further percentage discount of up to 50% to cost), and all carry points, vested and unvested, will automatically be forfeited. Typical elements of "cause" often include fraud, willful misconduct, material breach of agreement, securities law violations, bad faith, and gross negligence. The definition of cause typically also captures certain post-employment covenants (e.g., covenants not to compete, non-solicitation of employees and investors, confidentiality requirements, and non-disparagement covenants) such that a breach post-employment will also trigger a forfeiture of carry points. In some circumstances, the sponsor is permitted to apply a lookback period with respect to events that might have happened prior to the participant's departure. In that situation, a participant may initially be viewed as having departed without cause and then subsequently be determined to have departed with cause. Finally, the participant will not be entitled to fund any further amounts with respect to such participant's share of the GP Commitment.

Voluntary termination by the participant (i.e., the participant quitting) without good reason often triggers similar consequences, except vested carry points may be retained and the purchase price to be paid in connection with the sponsor's exercise of its Capital Interest repurchase option will typically be based on fair market value, rather than discounted at cost—and if at cost, then usually without a discount. In most cases, the participant's vested carry points, if retained, are not subject to a repurchase right in favor of the sponsor. If the repurchase option applies to vested carry points, it may be subject to a lockout period or minimum price threshold, in order to ensure the participant's vested carry points retain some value. Certain important federal income tax consequences result from the repurchase of a terminated participant's GP interest, including the recognition of capital gains or losses resulting from the repurchase. The federal income tax characterization of any gains or losses of the repurchased interests will be subject to tax treatment of carried interests, in general.

Involuntary Termination without Cause and Voluntary Termination for Good Reason

The Capital Interest of participants involuntarily terminated without cause typically is still subject to a repurchase option in favor of the sponsor; however, the purchase price is almost always based on fair market value. The determination of fair market value can be subject to interpretation, and a participant may be entitled to invoke a dispute resolution mechanism in the event the participant disagrees with the sponsor's initial assessment of such

value. If the participant's Capital Interest is not repurchased, the participant may or may not be permitted or obligated to continue funding the participant's share of the GP Commitment In addition, typically only unvested carry points will be forfeited. In many cases, the participant will be entitled to retain the participant's vested carry points, and such vested carry points usually are not subject to a repurchase right in favor of the sponsor. If a repurchase option applies to vested carry points, it may be subject to a lockout period or minimum value threshold, in order to ensure the participant's vested carry points retain some value.

Some participants may negotiate consequences that are similar to those triggered upon involuntary termination without cause in the event they voluntarily terminate their relationship with the sponsor for "good reason" (i.e., are constructively terminated). "Good reason" is often narrowly defined to address adverse changes to the participant's position, location, and employee duties. For example, good reason may include the material reduction in the employee's authority, duties, or responsibilities, relocation of the employee's principal place of business, or a material reduction in compensation. As noted in the section above, certain important federal income tax consequences result from the repurchase of a terminated participant's GP interest, including the recognition of capital gains or losses resulting from the repurchase. The federal income tax characterization of any gains or losses of the repurchased interests will be subject to tax treatment of carried interests, in general.

Termination due to Death or Disability

Termination for death or disability is often treated similarly to involuntary termination without cause with respect to the potential repurchase of the deceased or disabled participant's Capital Interest; however, the repurchase option may be at the election of the disabled participant or, in the case of death, the participant's estate. In some cases, vesting of carry points may continue for a period following the date of death or disability (often an additional year), or such vesting may be otherwise accelerated (perhaps fully and immediately).

In all circumstances, vested or unvested carry points that are forfeited or repurchased are subject to potential reallocation in a variety of ways, ranging from automatic pro rata allocation to all continuing participants to option reallocation as determined by the sponsor.

Management Company Ownership

A fund's management company (ManCo) is often the entity that employs the members of the investment team and other professionals, and that is responsible for investment identification and execution.

Typical Ownership

Over time, interests in the ManCo can become very valuable as the ManCo accumulates the benefit of multiple management and other fee streams resulting from the management of multiple funds. In addition, the ManCo will benefit the most from strategic transactions such as an IPO or the sale of stakes to a third party. Finally, firm-wide decisions with respect to a sponsor's business are usually made at the ManCo level or via other entities that share common ownership. As a result of these factors, ManCo ownership is usually reserved for only more senior principals and employees of the sponsor.

Other Fees

In addition to the fund management fee, the ManCo may also be entitled to receive other fees with respect to the fund's investments, such as breakup, transaction, or monitoring fees. When such fees are not completely offset against fund management fees, or the ManCo otherwise becomes entitled to receive fees beyond the fund management fees, thought should be given to how the economic benefit of such other fees should be distributed. Most often, that economic benefit is distributed in the same fashion as fund management fees, but that is not always the case.

Management Fee Waiver

As mentioned in the first part of this practice note, Private Investment Fund Team Compensation Arrangements: Structuring and Terms, a sponsor may utilize a management fee waiver program pursuant to which a fund's GP has the right to waive management fees in exchange for a deemed profits interest in the fund. Since the waiver of a fund's management fee directly affects the ManCo (as the ultimate recipient of the management fee), participation in such a management fee waiver program may be reserved for the ManCo owners. If participation in such a program is more broadly granted, thought should be given to how a waiver may or may not ultimately affect the relevant participant in relation to the ManCo. For example, if an employee participates in such a program, the employee's salary or

annual bonus may be reduced by the employee's fee waiver participation. If salary and bonus are directly or indirectly completely paid by the ManCo (which is often the case), then the employee's participation in the waiver program should be neutral to the ManCo, and the ManCo owners should not be adversely affected.

Future Allocations

As with carry points, sponsors must determine how future allocations of ManCo interests are effectuated and the effect of such allocations on existing owners. Unlike carry points, there is no predominant approach to dilution in this scenario, although, if there are less senior owners, such owners may be entitled to some form of dilution protection in recognition of their smaller stakes. In all cases, in order to avoid adverse federal income tax consequences for both the prior and new owners, care must be taken to ensure that such future allocations do not result in the issuance of interests that are treated as capital interests (versus "profits interest") for federal income tax purposes. Since ManCo interests often rapidly accrue long-term value, a sponsor will want the right to apply a "distribution threshold" concept (mentioned in the discussion of carry points above) to such interests.

Management Company Expenses

Finally, as the manager of multiple funds, the ManCo typically is a true operating company and has ongoing annual operating expenses, such as payment of rent, employee salaries, and other overheard associated with operating a sponsor's business. From time to time, such annual expenses may exceed annual fee revenue, particularly at the early stages of a ManCo's existence. When this occurs, the ManCo owners may be required to fund capital to cover such shortfall. As with dilution of prior owners in connection with the allocation of new interests to new owners, there is no predominant approach to who is required to fund such shortfalls and how such funding occurs; different approaches include treating a portion of the funding up to a cap as mandatory and any excess funding as nonmandatory, treating the funding as a priority loan, and/or treating the funding as a capital contribution, with non-funders diluted on a nonpunitive basis (or on a punitive basis to the extent of any mandatory portion of funding). Again, however, if there are less senior owners, such owners may not be required to make capital contributions in this circumstance at all.

Other Considerations for End of Employment

In addition to the type (and amounts) of compensation, there are a number of other considerations that a private funds sponsor should keep in mind when planning for employee departures, particularly in the current competitive environment.

Restrictive Covenants

Without addressing the details of these arrangements, private fund sponsors should ensure that they have, or at least have considered, contractual restrictions for departing employees with respect to non-competition, non-solicitation of other employees and sponsor investors, non-disparagement, and non-disclosure/confidentiality. The laws governing these covenants vary significantly from state to state, and certain states, such as California, present challenges for sponsors seeking to enforce certain restrictions, particularly in relation to non-competition.

Key Person Trigger

The departure of a senior principal of the GP could trigger a key person event under the terms of one or more fund limited partnership agreements, producing negative consequences for the sponsor, such as early suspension or termination of the fund investment periods, or, less frequently, removal of the GP or early termination of the applicable funds. Since there is little that can be done to avoid these results, the best course of actions is to try to ensure that key person provisions in fund limited partnership agreements are subject to reasonable conditions and limitations, such as the ability to replace a departing key person with a reasonably acceptable replacement.

Change of Control Restrictions

The departure of one or more senior principals may result in the violation of change in control provisions contained in fund or loan-related agreements entered into by the sponsor. Even if no contractual provisions are triggered, the Investment Advisers Act of 1940 may require the sponsor to obtain investor approval of such an event.

Direct Agreements

In some circumstances, a departing principals may be a direct party to certain agreements such as guarantees of loans, requiring a negotiation with the applicable lenders unless addressed in the underlying loan documentation.

Release of Claims and Offset Rights

As a condition to the receipt of certain benefits, fund sponsors will often require a departing employee to execute a release of claims the employee may have against the sponsor. Similarly, the sponsor may require any amounts the employee is required to pay the sponsor (post-departure or otherwise) to be offset against the compensation to which the employee is otherwise entitled. From a sponsor's perspective, such offset rights are particularly important after an employee departs as the sponsor may have limited recourse against the employee.

For example, even if a departing employee has provided a guarantee with respect to any required clawback of carried interest the employee has previously received, such a guarantee is obviously limited to the clawback of such amounts. In addition, if the employee has no significant additional assets, the guarantee may be worth nothing at all.

Ownership of Track Record

A departing employee, particularly more senior principals, may want to use a sponsor's investment track record when joining a new sponsor employer in order to facilitate capital raising. If the new sponsor employer is registered as an investment adviser with the SEC, the use of that track record will be subject to certain conditions. Registered investment advisers must comply with the SEC's new Marketing Rule, which includes certain general prohibitions that apply to all advertisements (such as the requirement that performance be presented in a fair and balanced manner). See Implications of the New SEC Marketing Rule for Private Fund Sponsors. In addition, a registered investment adviser that would like to present performance information achieved at a predecessor adviser in an advertisement must also meet following requirements: (1) the person or persons who were primarily responsible for achieving the prior performance results manage accounts at the advertising adviser; (2) the accounts managed at the predecessor investment adviser are sufficiently similar to the accounts managed at the advertising adviser that the performance results would provide relevant information to investors; (3) all accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance and the exclusion of any account does not alter the presentation of any prescribed time periods; and (4) the advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity. However, irrespective of these restrictions, the former sponsor has an economic interest in ensuring it retains ownership of its investment track record to the greatest extent possible. As a result, a sponsor will often impose strict limitations on the use of that track record by departing employees. In that circumstance, a departing employee may need to negotiate with the former sponsor to use any part of the sponsor's track record, including in relation to investments where they may have acted as the primary decision-maker.

Ownership of Intellectual Property / Goodwill

Similar to the investment track record, a sponsor has an economic interest in ensuring that it has the right to use the sponsor's name, image, brand, and related trademarks; as a result, a sponsor will want to ensure that departing employees agree that any such items are owned exclusively by the sponsor. Similarly, the sponsor will want to ensure departing employees are subject to clear contractual restrictions with respect to any patents, copyrights, trade secrets, and similar items developed during the employees' employment by the sponsor.

Public Communications

Although departing employees will likely be subject to non-disparagement and similar restrictions that discourage negative communications about their former employer, sponsors will usually want to ensure that there is a more scripted message to be delivered by all parties post-departure. With the prevalence of social media, this approach may include specific messages to be released on specific websites such as LinkedIn.

Community Property

Finally, some states, such as California, have marital laws that deem certain property to be jointly owned as "community property" by spouses. As a result, a spouse of a sponsor employee located in such a state will have an automatic legal right to joint ownership of the sponsor employee's carried interest, Capital Interest, and any interest in the ManCo. In order to avoid that result, the sponsor may provide for a special repurchase right with respect to an employee's spouse's community property interest following divorce. However, in all events, the sponsor will want to require the spouses of employees located in such states to execute an agreement pursuant to which they acknowledge any repurchase rights (whether triggered by divorce or otherwise), vesting, and other terms and conditions imposed by the sponsor with respect to the employee spouse's carried interest, Capital Interest, and interest in the ManCo.

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Nathaniel Marrs is a Partner in the Chicago office of DLA Piper and Co-Head of the Firm's Investment Funds Practice.

His practice is focused on the structuring and formation of private funds and their management companies, with a particular focus on real estate, infrastructure and energy firms. He also represents such firms in a variety of corporate transactions, including roll-ups, joint ventures, co-investments, the formation of portfolio and other operating companies, and investment management M&A transactions.

Jessica McKinney, Associate, DLA Piper LLP

Jessica McKinney advises investment fund managers in connection with private fund formation and ongoing operations. Jessica helps managers navigate applicable regulatory and securities laws compliance. Jessica has experience working with established fund managers as well as first-time and emerging fund managers across a variety of asset classes and investment strategies, such as private equity, venture capital, real estate and other alternative investment strategies. Jessica also has experience representing high-net worth individuals, family offices and other institutional investors in the course of investing in private investment funds.

In addition, Jessica advises investment advisers on regulatory compliance matters, including SEC registration requirements and available exemptions, Form ADV and other regulatory filings, and SEC examinations.

Prior to joining the firm, Jessica served as Special Counsel in the US Securities and Exchange Commission's Office of the Advocate for Small Business Capital Formation. During her time at the SEC Jessica worked to advocate for small businesses and their investors from startup to small cap, with a focus on issues facing investors who pool capital through venture and other funds.

Aalok Virmani, Partner, DLA Piper LLP

Aalok Virmani has more than 20 years of experience advising fund sponsors and investors on federal income tax matters.

Aalok represents US and non-US fund sponsors on the tax aspects of forming, organizing and operating private equity funds, private equity real estate funds, venture capital funds, hedge funds, debt funds and secondary funds. Aalok's practice includes counseling family offices with respect to establishing investment platforms and management incentive arrangements. He also regularly advises on GP-led fund restructurings, US and non-US investor representations, secondary transactions and minority investments in fund sponsors.

Aalok spent significant time in-house as a principal at Equity International, a private equity firm that invests in non-US real estate companies. He was responsible for all tax aspects of the firm's portfolio-level transactions, fund formations, sponsor-level tax planning, tax compliance and financial statement reporting. Aalok also held board and audit committee positions at various portfolio companies to help Equity International support and oversee its investments.

Richard Ashley, Partner, DLA Piper LLP

Rich Ashley's practice includes advising both public and private companies on the design, implementation and administration of qualified retirement plans, nonqualified retirement plans, welfare benefit plans, equity incentive programs and executive compensation arrangements.

Rich's practice includes advising professional asset managers, registered investment advisors, plan fiduciaries, and service providers with respect to fiduciary obligations, reporting and disclosure obligations, recordkeeping, and compliance with the prohibited transaction rules under ERISA and the Code. Rich regularly advises private funds and hedge fund sponsors with respect to ERISA Title I matters, and regularly consults with clients with respect to managing plan assets and structuring venture capital and real estate operating companies

Rich regularly works with plan administrators on benefit plan compliance and testing issues. Rich has experience with IRS and DOL correction procedures and has represented clients on a variety of compliance issues in connection with government audits.

Rich has extensive experience in the benefits and compensation issues that arise in connection with the transactions, including Code Sections 162(m), 280G and 409A compliance. Rich regularly advises Plan fiduciaries with respect to their duties, best practices, matters relating to the ERISA plan assets regulations and ERISA issues arising under credit agreements. Rich also works with Section 16 officers with respect to their legal obligations.

Rich regularly represents public companies, executive officers, and management teams in connection with potential mergers and acquisitions. Rich also designs and assists in the implementation of Change in Control Agreements and executive continuity and protection programs. Rich has represented professional athletes and executives of professional sports' organizations with respect to employment and compensation matters.

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Tom advises clients on structuring and tax aspects of complex domestic and cross-border business transactions, including mergers and acquisitions (including SPAC and up-C structures), joint ventures, public and private offerings of securities, debt and equity restructurings, real estate transactions, the organization and operation of investment funds, and investments in cryptocurrency and digital assets.