Vesting for Fund Managers

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PROFESSIONAL CORPORATION

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Agenda

- Overview of vesting provisions for individual venture capital and private equity fund managers
- Topics
  - Introduction
  - Rate of Vesting
  - How Vesting Works / Retroactive and Prospective Vesting
  - Vesting of Management Fees
  - Amending Vesting Provisions

Purposes of Vesting

- Vesting serves two main purposes
  - Incentivize fund managers to remain at the firm
  - Provide a source of compensation for a new fund manager admitted to replace a departed fund manager
- Vesting rates generally should reflect the rate of value creation and effort required to manage the Fund
- Fund managers' choice of vesting provisions often is influenced by their sense of fairness

Definition

- Vesting is the accumulation of an interest in a profit stream (or property more generally) by virtue of continued service
- Following the departure of a fund manager, the fund manager is entitled to the *vested* portion of the profit stream, but not the *unvested* portion

Different Profit Steams

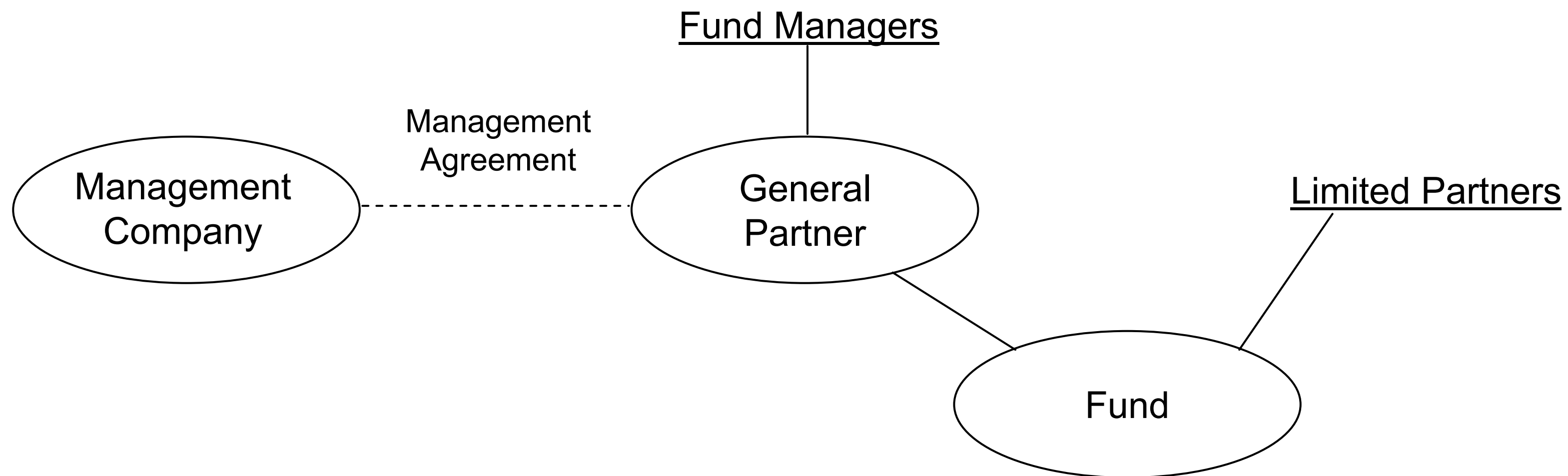
- Fund manager profits can be divided into three streams, which may vest on different terms
  - Return on Investment: the return on invested capital
  - Carry: the share of a Fund’s net profits not based on invested capital
  - Management Fee: the periodic payment of a fixed amount
- Return on Investment typically is not subject to vesting (i.e. it is fully vested)
- Carry typically is subject to vesting
- Management Fee may be subject to vesting similar to carry, but fund managers often have no vested interest in management fees earned after their departure

Focus on Vesting of Carried Interest

- This presentation is focused on vesting of carry
- Generally, concepts applicable to carry can be applied to management fees and return on investment
- Special considerations applicable to vesting of management fees are covered below under “Vesting of Management Fees”

Assumptions/Structure

- Individual fund managers serve as members of an LLC which is the General Partner of a Fund
- Each firm may have several different Funds under management by different General Partners
- Vesting occurs on a Fund-by-Fund basis within each Fund's General Partner
- General Partner LLCs use mark-to-market accounting and make final distributions in accordance with capital account balances



Variation

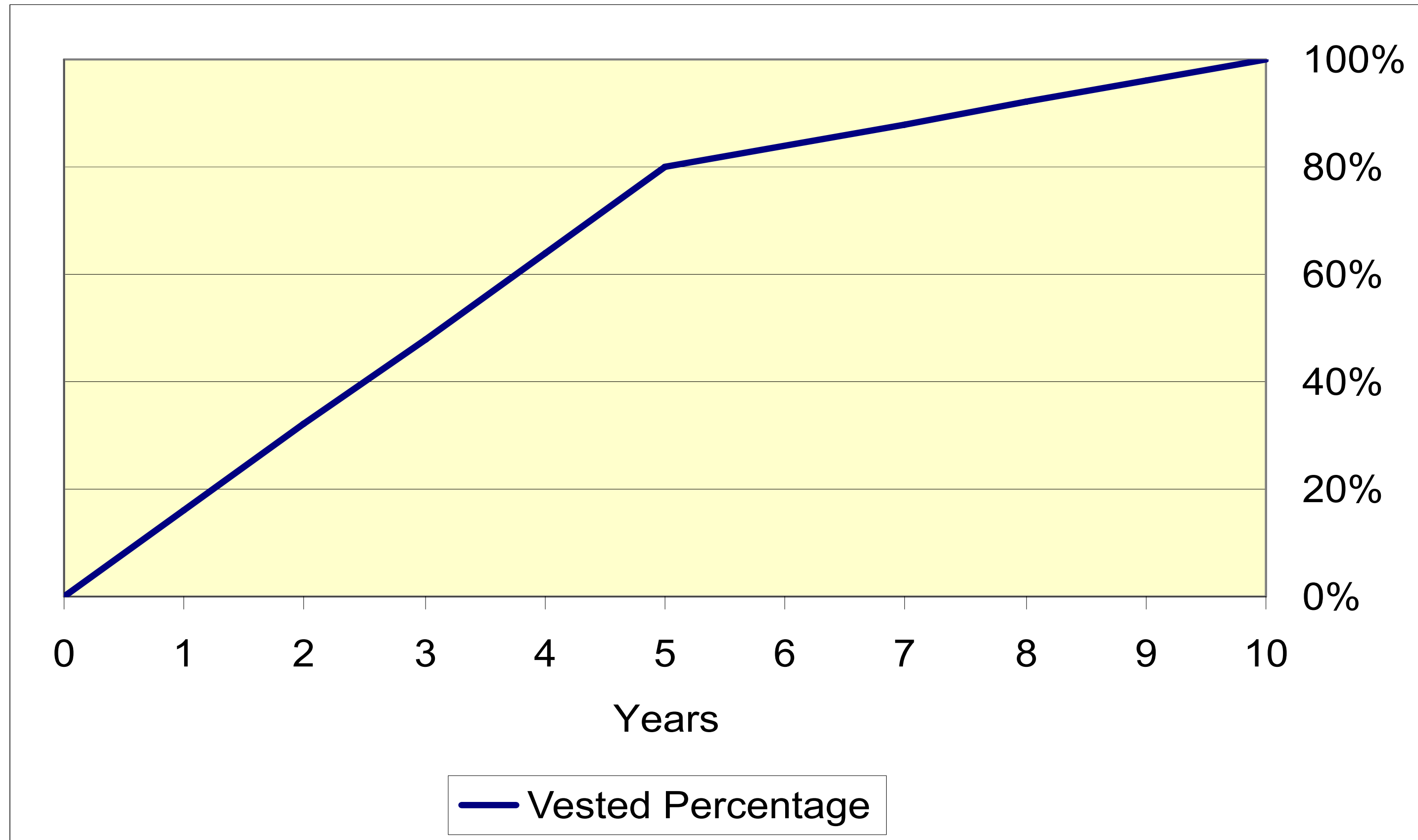
- Within the venture capital and private equity industry, vesting provisions vary widely
- Likewise, law firms use different terminology and may recommend different provisions to fund managers
- Methods described in this presentation can be combined or modified

Rate of Vesting

Vesting Rates

- Vesting rates vary widely in the venture capital and private equity industry
- Vesting rates generally should reflect the rate of value creation and effort required to manage the Fund
- One common schedule provides that fund managers vest 80% over a Fund’s first 5 years and the remaining 20% over the next 5 years
  - This “front-loaded” schedule reflects the life cycle of a typical Fund, where most of the work and value creation is presumed to occur during the initial 5 year investment phase

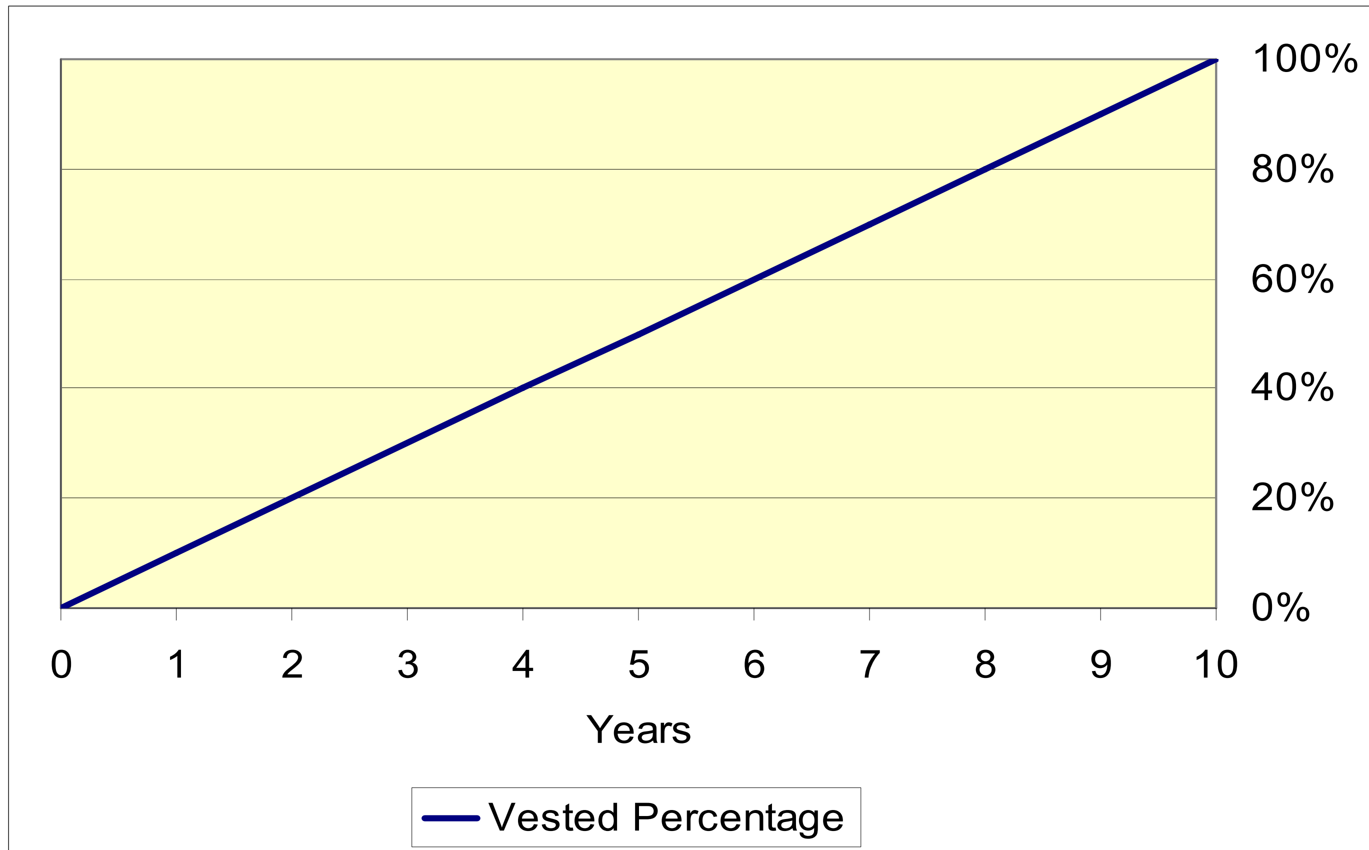
Example Vesting Schedule: Front-Loaded



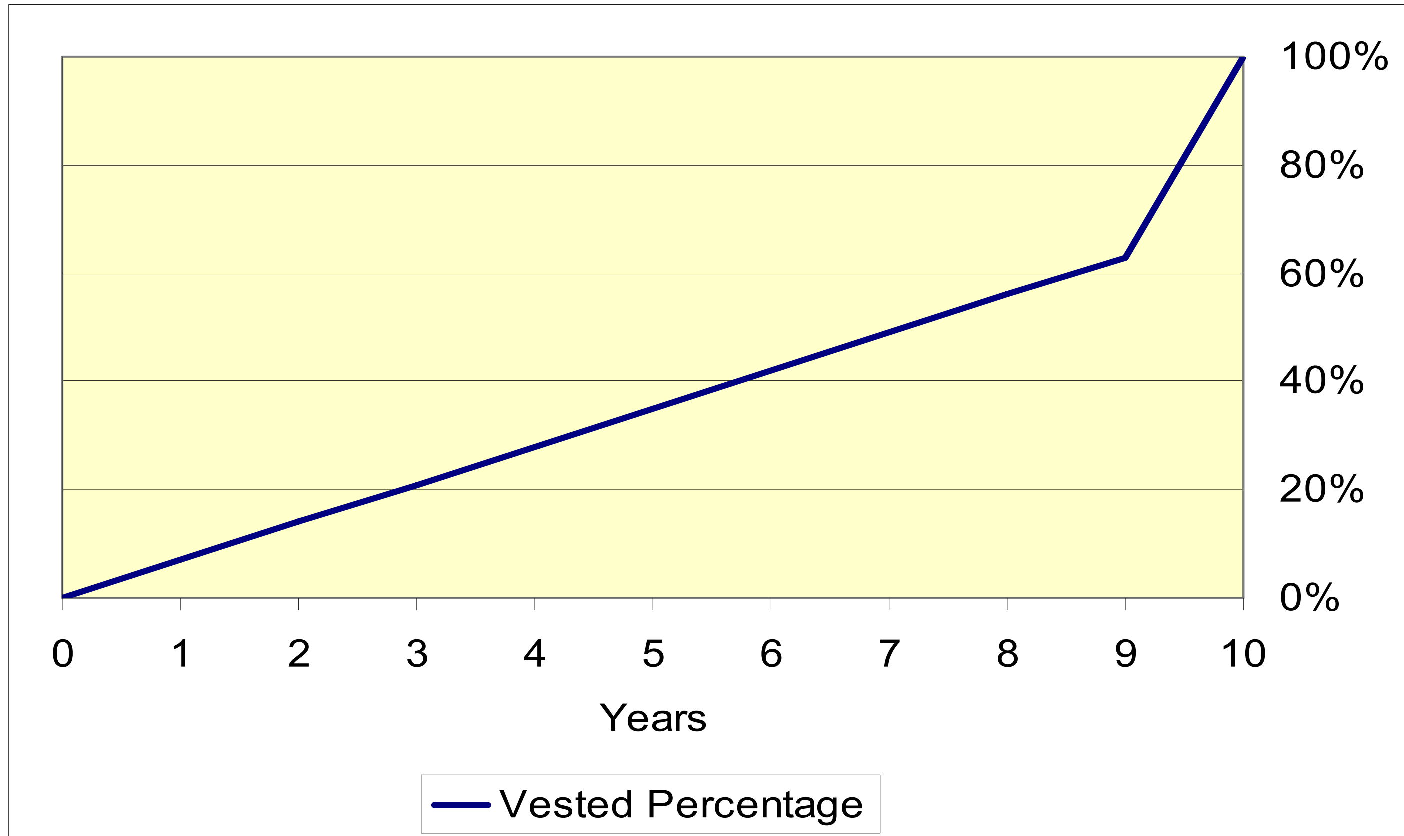
Variations: Periodic Vesting Schedules

- Vesting schedules can be weighted to emphasize important periods
- Front-Loaded
  - E.g. vest 80% in first 5 years; remaining 20% in next 5 years (shown on previous slide)
  - Rewards effort for fundraising and initial investing
- Straight-Line
  - Vest 10% per year for 10 years
  - Balances rewards for effort at beginning and end of Fund's life
- Back-Loaded
  - E.g. vest 70% during Fund's life; remaining 30% only at end of Fund's life
  - Encourages fund managers to remain until end of Fund's life
- Front-Loaded and Back-Loaded
  - E.g. vest 50% in first 3 years; 30% in next 7 years; remaining 20% only at end of Fund's life

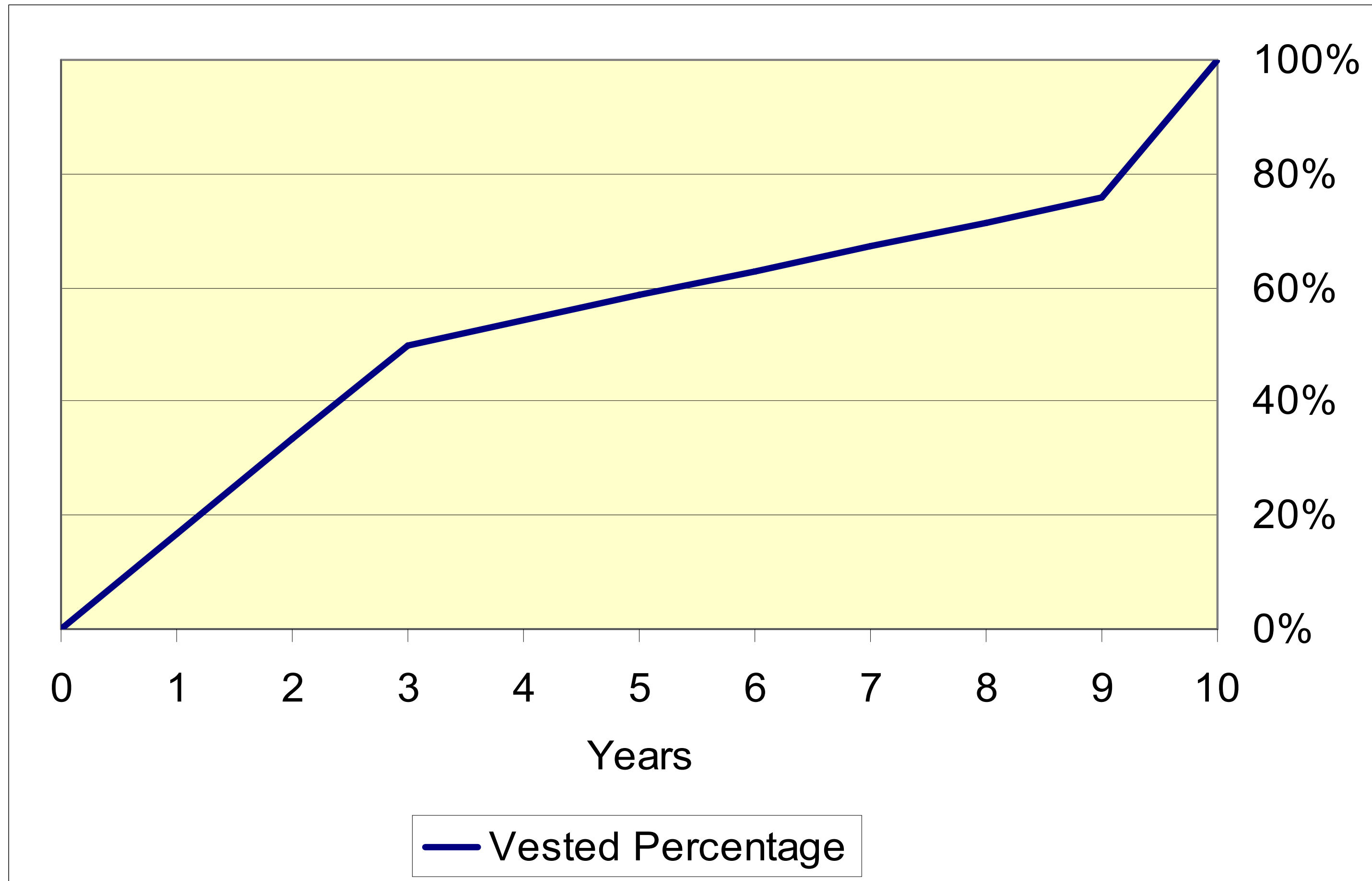
Example Vesting Schedule: Straight-Line



Example Vesting Schedule: Back-Loaded



Example Vesting Schedule: Front- and Back- Loaded



Variations: Non-Periodic Vesting Schedules

- Deal-by-Deal Vesting
  - Different vesting percentage for each investment
  - For each investment, vesting begins at date of investment
  - Because a typical Fund's carry is calculated on a net basis over all investments, adjustments may be required (example on next slide)
- Milestone Vesting
  - Vesting occurs upon specified milestones
  - May be appropriate for fund managers charged with specific responsibilities or performance targets
- Discretionary Vesting
  - Vesting occurs at discretion of senior fund managers
  - May be appropriate for junior fund managers
- Non-periodic and periodic vesting schedules may be combined
  - E.g. Vest 6% per year for 10 years; remaining 40% at discretion of senior fund managers

Potential Problem with Deal-by-Deal Vesting

- Dorothy is a member of the General Partner of Yellow-Brick Fund I, which uses deal-by-deal vesting
- Yellow-Brick Fund I makes two investments
  - $1,000 profit in X-Co.
  - $1,000 loss in Y-Co.
  - Since Yellow-Brick Fund I calculates the General Partner's carry on a net basis, the General Partner has $0 carry profits
- Dorothy's share of General Partner profits
  - Without taking vesting into account, Dorothy's share of carry profits and losses is:
    - $100 profit from X-Co.
    - $100 loss from Y-Co.
  - Dorothy departs when her share of profits and losses is:
    - 100% vested in X-Co.
    - 0% vested in Y-Co.
  - Ostensible result: (100% x $100) + (0% x -$100) = $100 net carry profit for Dorothy
- Even though Dorothy appears entitled to $100 carry profits, the General Partner cannot deliver since it has no net carry profits. Should Dorothy receive $0 or do the other members of the General partner pay her out of their own pockets?
- Moral: True deal-by-deal vesting is not always possible if carry is calculated on a net basis

Variations: No Vesting

- No Vesting
  - In some circumstances, it may be appropriate for a member of a General Partner to be 100% vested upon formation
  - E.g. “Sponsor” member provides branding and limited partner introductions, but is not expected to participate in deal sourcing, investment decisions or other aspects of Fund management

Modifications to Base Rate of Vesting

- Many firms impose a one- or two- year cliff on vesting
  - i.e. if a fund manager departs during his first/second year he will have no continuing interest in profits and losses
- Some firms provide for a degree of acceleration upon death or disability
  - However, excessive acceleration may deprive the General Partner of profits needed to attract a replacement fund manager
  - As an alternative, consider purchasing life/disability insurance for fund managers

Modifications to Base Rate of Vesting

- Contingent vesting can be a powerful tool to control inappropriate behavior by a fund manager
- Consider reducing a fund manager’s vested percentage if he:
  - Fails to execute a general release upon departure
  - Is removed/removable for cause
  - Joins a competing firm*

* Restrictions on competition may not be enforceable in some jurisdictions

Modifications to Vesting Cessation Date

- Similarly, if a fund manager is removed for cause, consider a provision that would have vesting cease as of the date of the act constituting cause, rather than the actual date of removal
  - In some circumstances, a long period may pass between a wrongful act and its discovery
  - May be unfair to allow a fund manager to profit from concealing his wrongful act

How Vesting Works:
Retroactive and Prospective Vesting

How Vesting Works

- How does a fund manager's vested percentage interact with profits and losses that make up the stream subject to vesting?
- At the most basic level, there are two common answers:
  - Retroactive: All profits and losses, whenever allocated, are subject to reduction if the fund manager departs
  - Prospective: Only profits and losses allocated after a fund manager's departure are subject to reduction; past profits and losses are fully vested

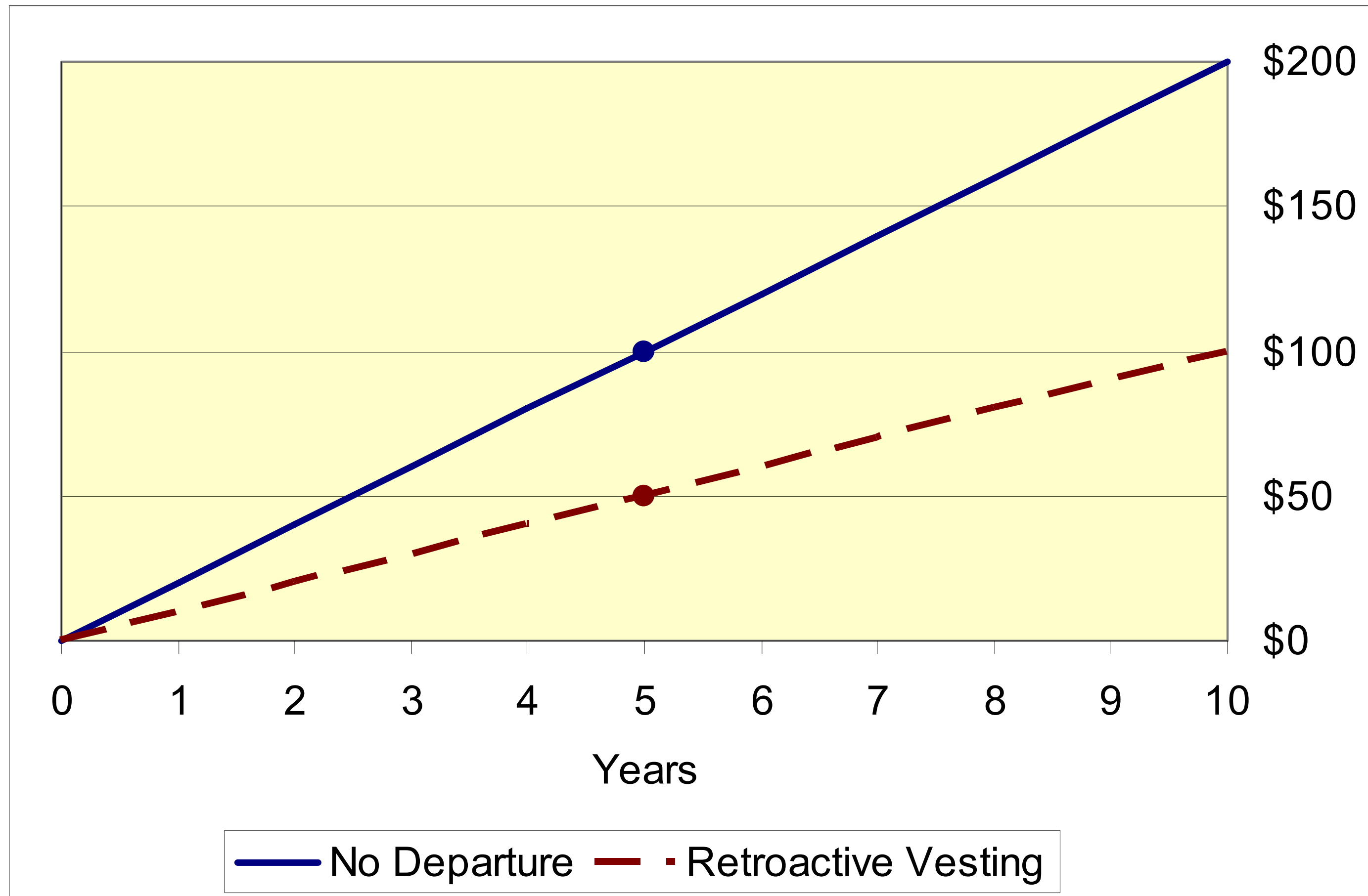
Example

- Dorothy is a member of the General Partner of Yellow-Brick Fund I which uses 10-year straight-line vesting
- Dorothy leaves the General Partner in year 5 when she is 50% vested
- Dorothy's share of net profits if she had not departed would be:
  - $100 prior to her departure, plus
  - $100 following her departure
  - Totaling $200 over the Fund's entire life
- How does her departure affect her share of net profits from the General Partner of Yellow-Brick Fund I?

Retroactive Vesting

- With Retroactive Vesting all profits and losses are reduced to the fund manager's vested percentage, regardless of whether the profits and losses arise before or after departure
- If the General Partner of Yellow-Brick Fund I uses Retroactive Vesting, the $200 net profit that would have been allocated to Dorothy over the Fund's life is reduced by 50% to $100

Retroactive Vesting

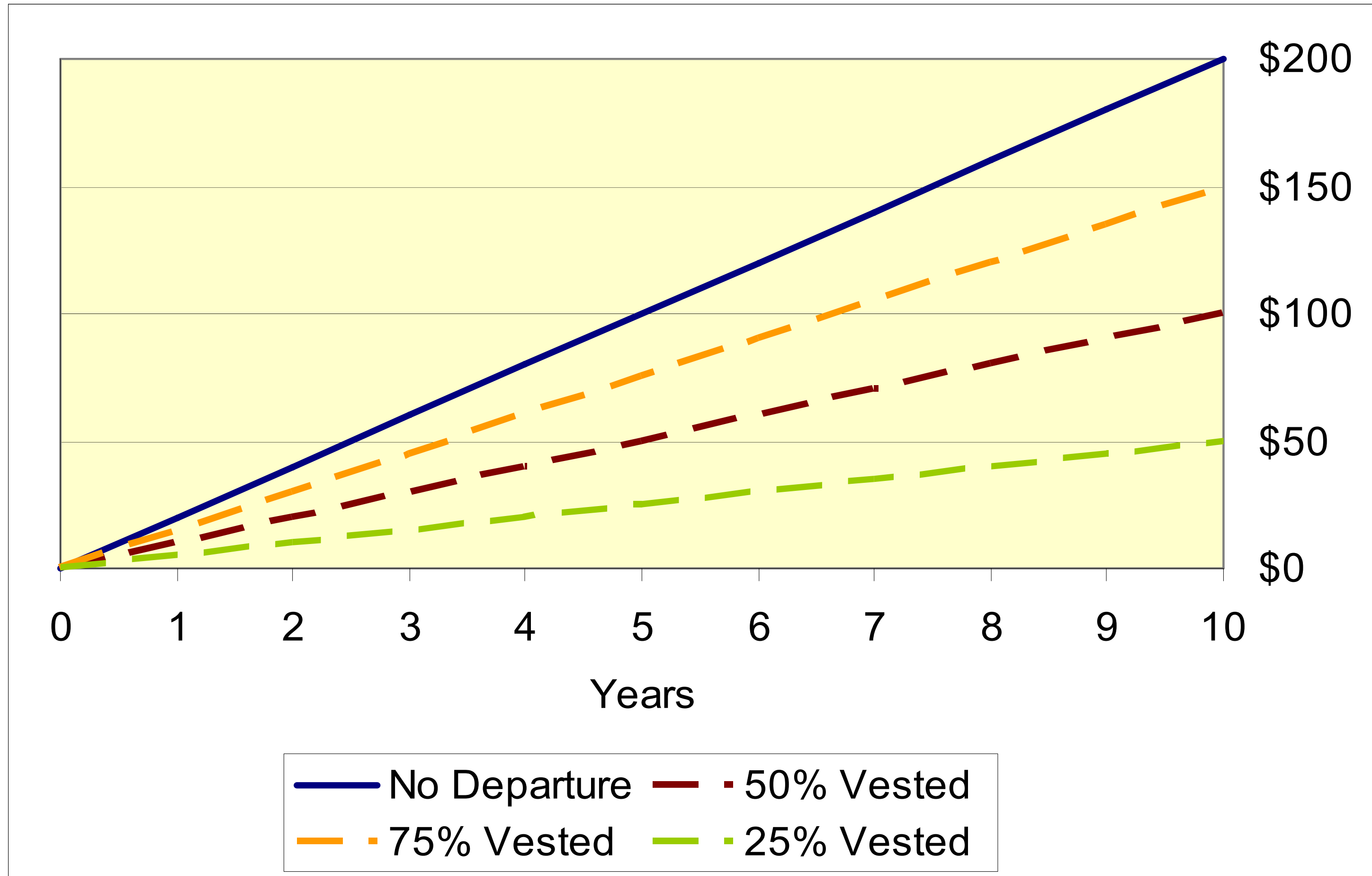


Retroactive Vesting

- With Retroactive Vesting, a fund manager's total net profits are equal to:

(Net Profits if no Departure) x (Vested Percentage)

Retroactive Vesting



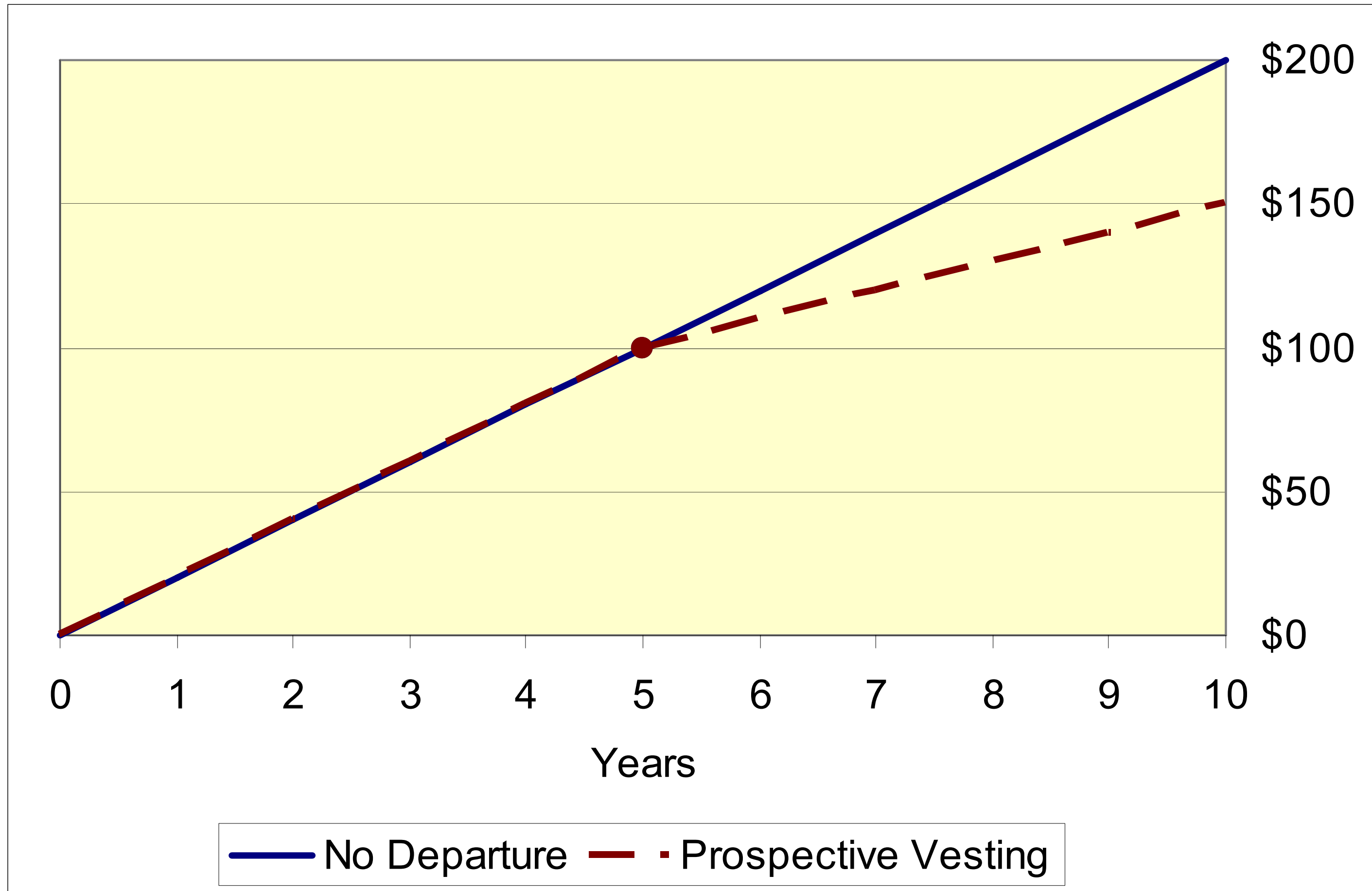
Similar to Portfolio Company Vesting

- Many firms view Retroactive Vesting as most fair because it is economically similar to restricted stock plans used by portfolio companies to compensate corporate executives
- Under a restricted stock plan, a corporate executive is not entitled to keep appreciation in the value of unvested stock; similarly, with Retroactive Vesting, a fund manager is not entitled to keep unvested net profits that arise before his departure

Simple Prospective Vesting

- With Simple Prospective Vesting, profits and losses arising after a fund manager's departure are reduced to his vested percentage, but prior profits and losses are fully vested
- If the General Partner of Yellow-Brick Fund I uses Simple Prospective vesting, the $200 net profit that would have been allocated to Dorothy over its life is reduced to $150
  - $100 net profit prior to her departure is unchanged
  - $100 net profit after her departure is reduced to $50

Simple Prospective Vesting

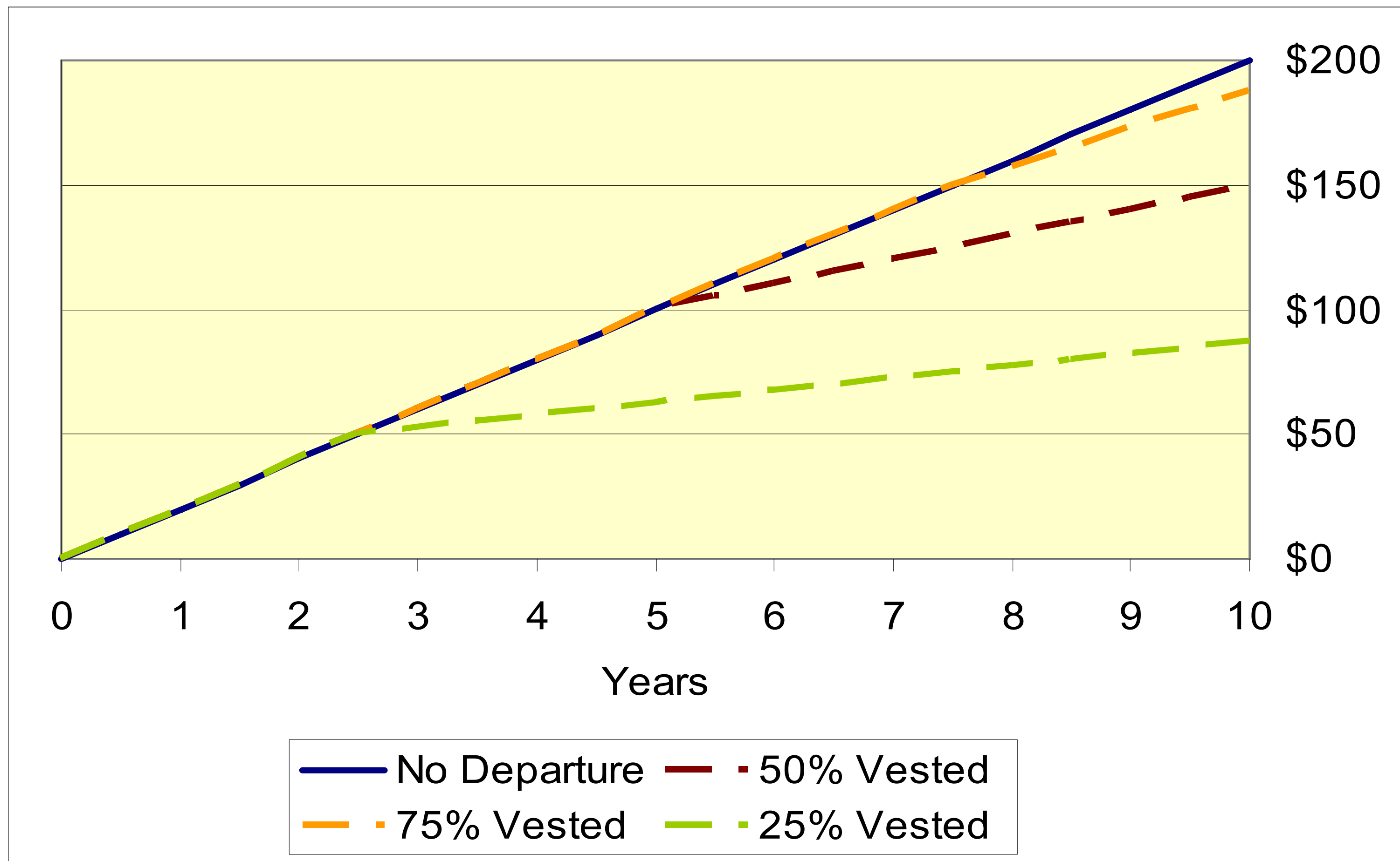


Simple Prospective Vesting

- With Simple Prospective Vesting, a fund manager's total net profits are equal to:

(Net Profits prior to Departure) +
((Net Profits after Departure) x (Vested Percentage))

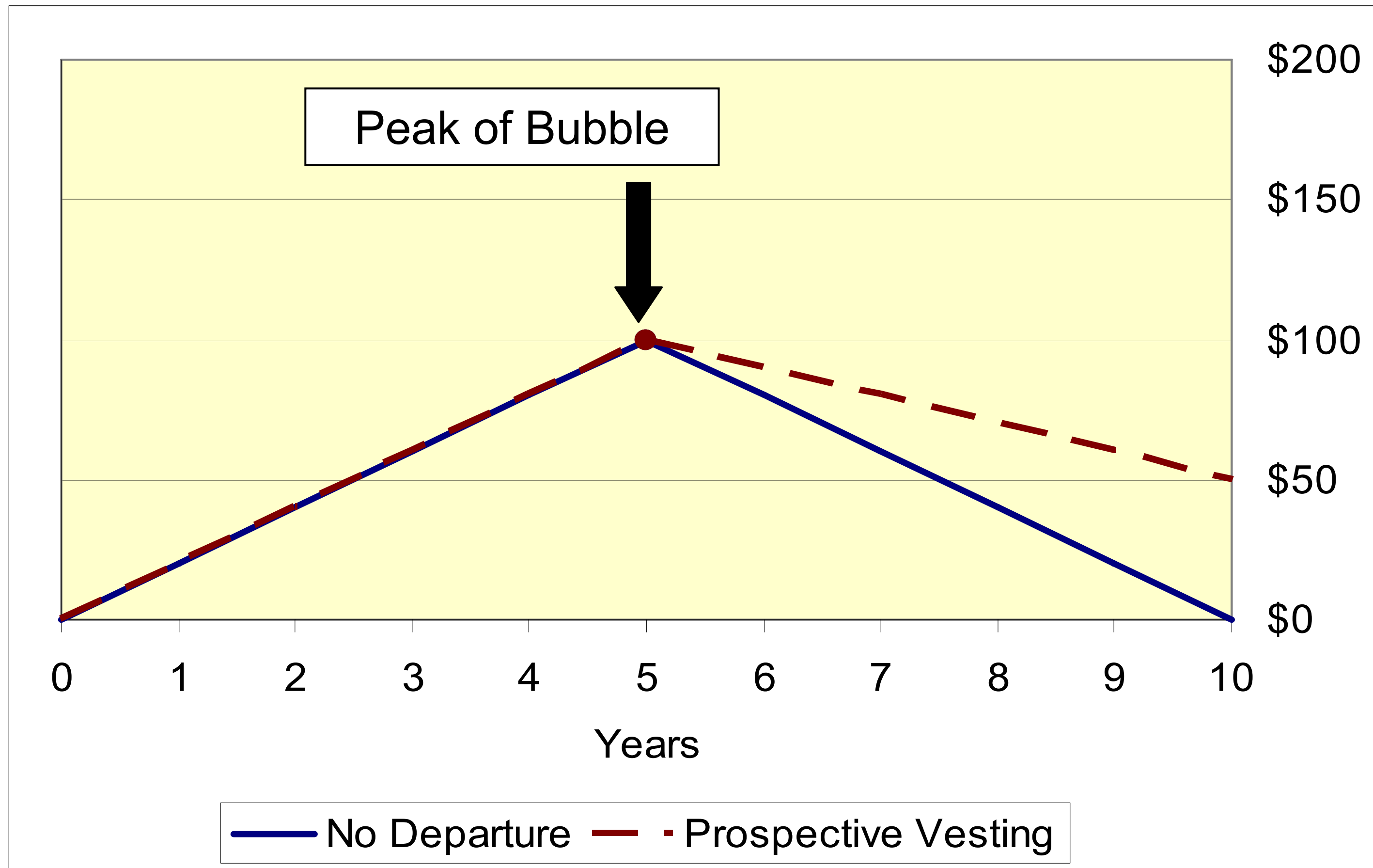
Simple Prospective Vesting



Problem with Simple Prospective Vesting

- Yellow-Brick Fund I invests during a speculative bubble; it is profitable for its first 5 years, but losses in the next 5 years reverse all profits
- Dorothy leaves the General Partner of Yellow-Brick Fund I at the peak of the bubble when she is 50% vested
- Dorothy's share of profits accrued prior to her departure is $100; but because of the bursting of the bubble, had Dorothy remained she would have suffered a $100 offsetting loss
- Because Simple Prospective Vesting reduces post-departure profits and losses, Dorothy's post-departure losses are reduced from a $100 loss to only a $50 loss (i.e. Dorothy avoids $50 of loss)
  - If Dorothy avoids a $50 loss, that loss must be borne by the other fund managers

Simple Prospective Vesting Following Bubble



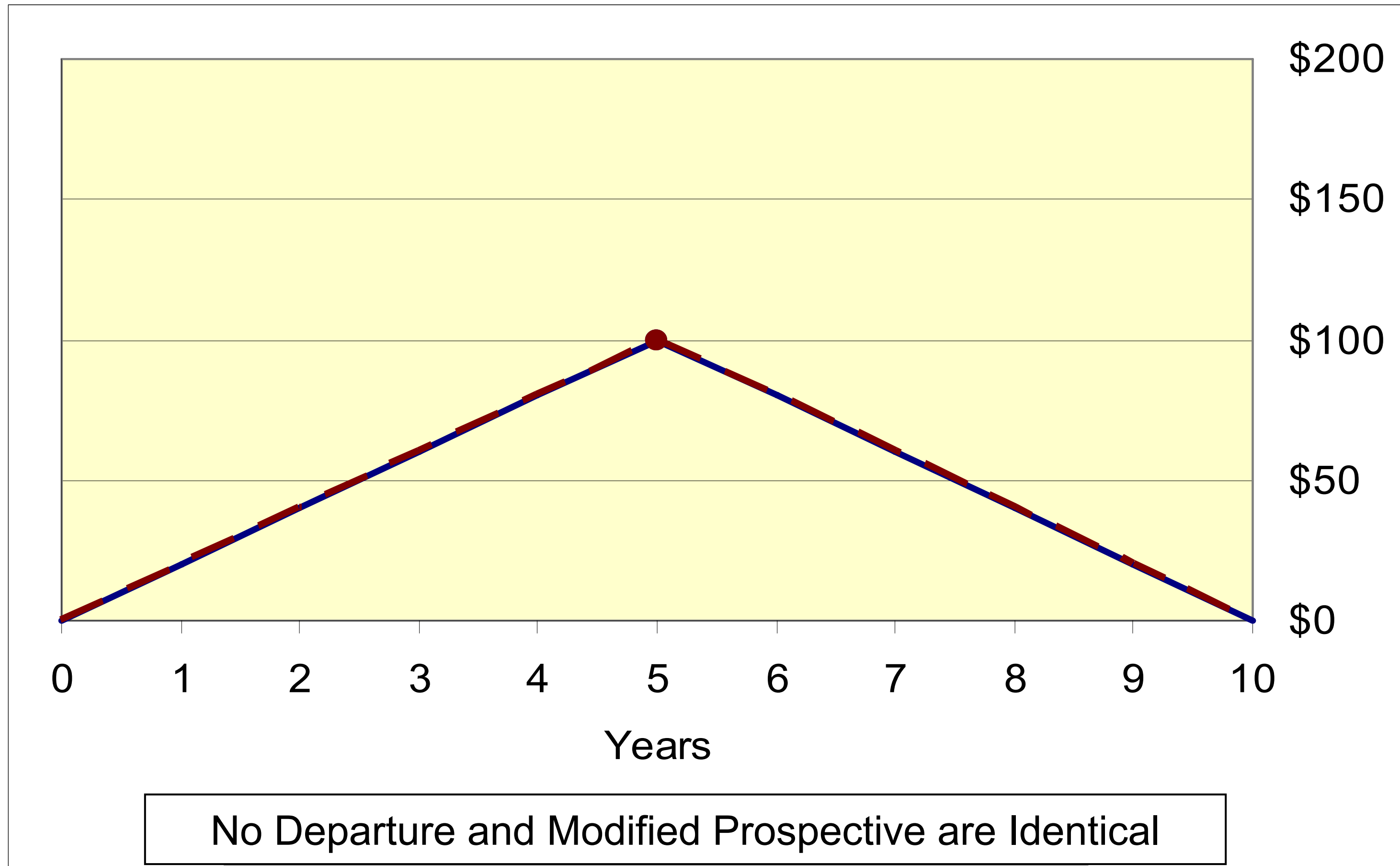
Problem with Simple Prospective Vesting

- By leaving Yellow-Brick Fund I at the peak of the bubble, Dorothy is better off than if she had stayed
- Many firms view this result as unfair
- In addition, this result may contribute to instability in the membership of the General Partner following a peak

Modified Prospective Vesting

- Modified Prospective Vesting addresses this problem
- Similar to Simple Prospective Vesting except that future losses are not reduced to the extent they offset past profits
- In the bubble example, if the General Partner of Yellow-Brick Fund I uses Modified Prospective Vesting, Dorothy will earn $0 total because post-departure losses completely offset pre-departure profits
  - Optionally, offset may apply on a deal-by-deal basis so that pre-departure profits are only offset by post-departure losses in the same investments

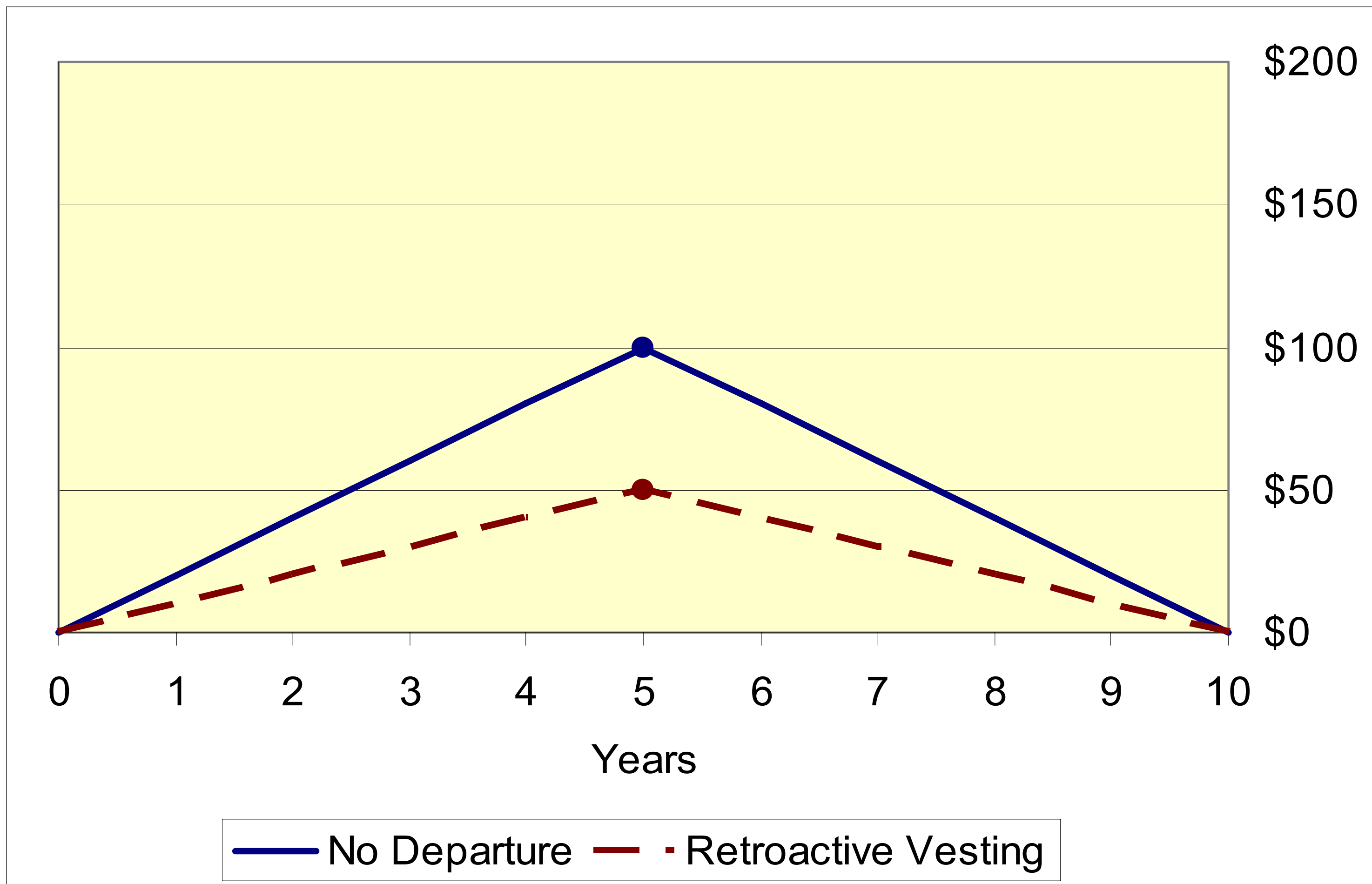
Modified Prospective Vesting Following Bubble



Retroactive Vesting Following Bubble

- Under Retroactive Vesting, fund managers cannot receive a windfall by avoiding losses because all profits and losses are subject to vesting
  - i.e. the reduction of pre-departure profits is not dependent upon post-departure losses

Retroactive Vesting Following Bubble



Distribution Issues

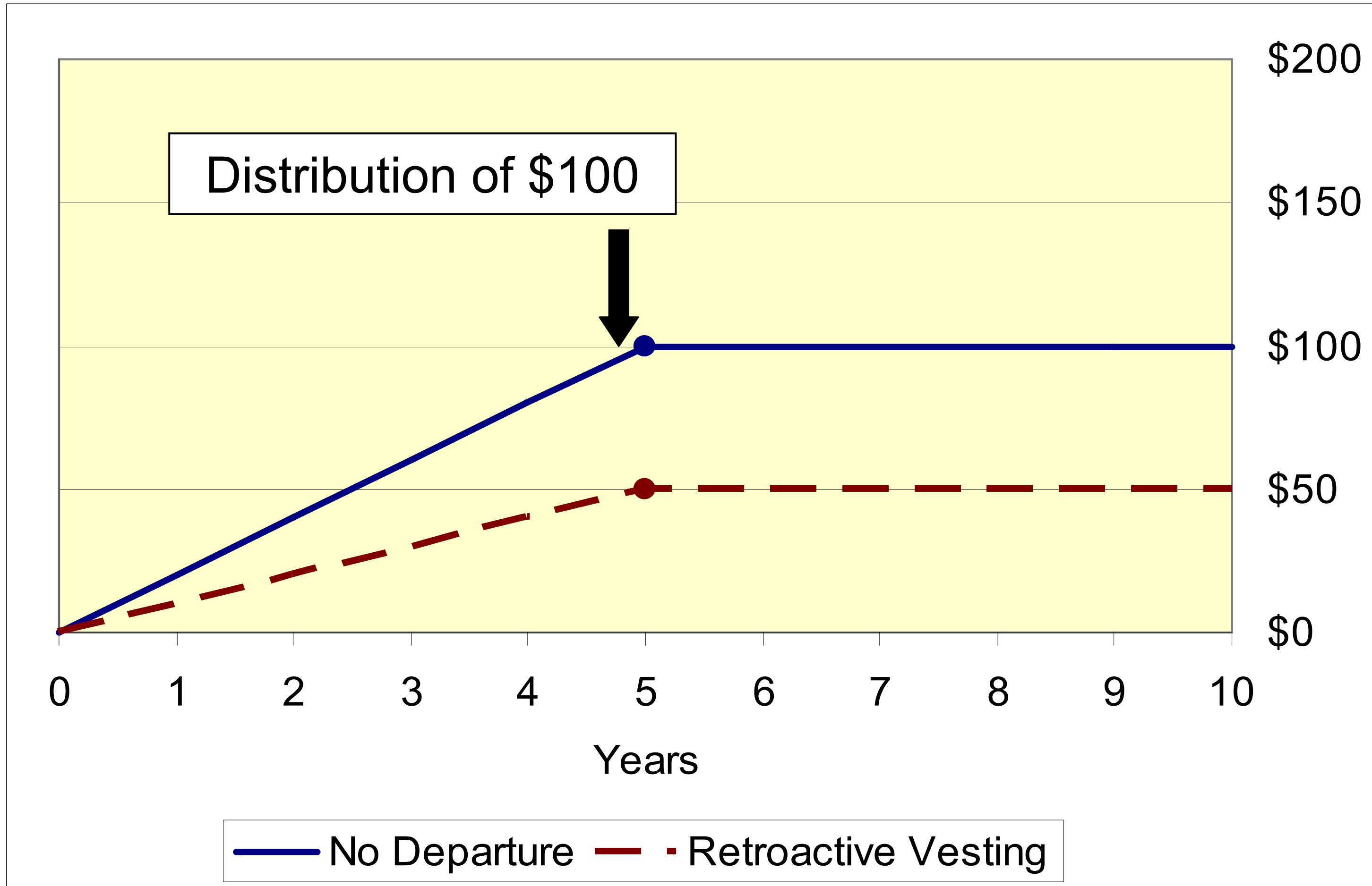
- Retroactive and Prospective Vesting describe how allocations of profit and loss are made for departed fund managers*
- Distribution provisions generally govern when a fund manager receives profits, but not a fund manager's total share of profits
- Because distributions often are not simultaneous with profit and loss allocations, issues can arise if, due to vesting, a fund manager's share of profit allocations differs from his share of distributions
  - Default rule is that operating distributions also are reduced to vested percentage
  - Final distributions continue to be made pro rata by capital account balance

* Distribution issues are connected with assumptions re accounting; see slide 7

Distributions of Unvested Profits with Retroactive Vesting

- Under Retroactive Vesting, profits may be distributed to a fund manager before he is fully vested in those profits
  - Distributions made prior to departure typically are made in proportion to a fund manager's share of profits as if they were fully vested, even though, because of vesting, he may not ultimately be entitled to the entirety of that share
- For example, suppose that $100 of profit is allocated and distributed to Dorothy the day before she departs (50% vested), and there are no further profits to allocate
- Dorothy will be distributed $100, even though, in retrospect, she was only entitled to have received $50

Retroactive Vesting and Distributions



Retroactive Vesting and Distributions

- Two primary ways to treat past distributions of unvested profits:
  1. Upon departure, Dorothy must return distributions to the extent she received unvested profits
  2. Dorothy is not required to return distributions, but her future profits are reduced to offset the distribution of unvested profits
     - If there are no future profits to allocate, Dorothy will have received a windfall

Undistributed Vested Profits with Prospective Vesting

- Prospective Vesting may introduce a delay in the distribution of fully vested profits
- Default rule is that a fund manager's operating distributions are reduced to his vested percentage
- As a result, a fund manager may have a higher share of profits allocated prior to departure, but a lower share of distributions made after departure
  - For example, suppose that $100 of profit attributable to X-Co. is allocated to Dorothy before she departs (50% vested), but the X-Co. stock is distributed the day after she departs
- Under default rule
  - Dorothy is entitled to all $100 of allocated profit (as a result of Prospective Vesting)
  - But, Dorothy only receives a $50 distribution
  - Remaining $50 of profit is retained by General Partner until final liquidation, when distributions are made in proportion to capital account balances
  - Remaining $50 distribution likely will not take the form of X-Co. stock

Methods to Address Undistributed Profits

1. (Default rule) Dorothy's undistributed profits are retained by the General Partner until its final dissolution
   - During liquidation, the final distribution is made in accordance with capital account balances, which includes undistributed profits
   - This method may be unsatisfactory because it forces Dorothy to wait until the end of the Fund for her $50 distribution and the form of the distribution likely will not match the asset that gave rise to the profits
   - Also, if, for whatever reason, there are insufficient assets available, Dorothy may not receive her $50 of vested profits
   - This method has the advantage of being simplest, because the issue doesn't need to be specially addressed

Methods to Address Undistributed Profits

2. Dorothy receives a special distribution of the undistributed profits simultaneous with the distribution of the other investment proceeds to which the undistributed profits correspond
   - The special distribution may be mandatory or discretionary
   - This method has the advantage of preserving the "identity" of the profits because the special distribution will consist of the same assets which generated the undistributed profits
     - However, the identity of profits may be disrupted in any event because distributions from a Fund to its General Partner may not preserve the "identity" of profits, e.g. because the Fund must return capital to limited partners before the General Partner receives carry distributions
   - This method has the disadvantage of requiring some judgment on the part of remaining fund managers as to the "source" of specific distributions, which may expose them to claims from a hostile departed fund manager

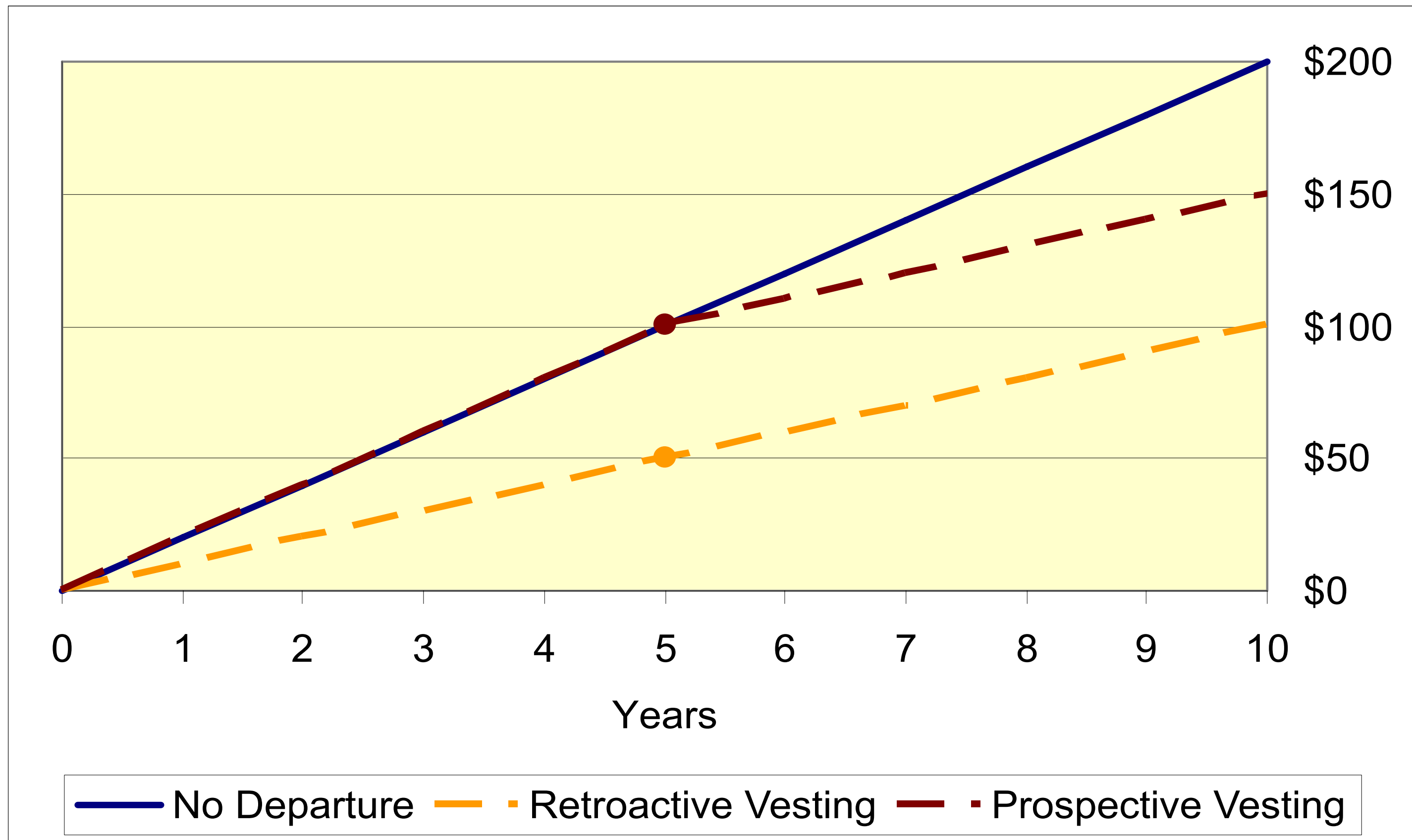
Methods to Address Undistributed Profits

3. Distributions are made in proportion to capital account balances
   - This method is objective and requires no judgment on the part of the remaining fund managers
   - This method has the disadvantage of disrupting the "identity" of the undistributed profits
4. Other Methods
   - Many other ways to address undistributed profits are possible

Comparing Prospective and Retroactive Vesting

	Pre-Departure P&L	Post-Departure P&L	Distribution Issues
Retroactive Vesting	Reduced to vested percentage	Reduced to vested percentage	Pre-departure distributions may have included unvested profits
Simple Prospective Vesting	Fully vested	Reduced to vested percentage	Under default rule, distribution of vested profits may be delayed
Modified Prospective Vesting	Fully vested	Reduced to vested percentage, but fully vested in losses offsetting pre-departure profits	Under default rule, distribution of vested profits may be delayed

Comparing Prospective and Retroactive Vesting



Prospective vs. Retroactive Vesting

- Relative Benefit (assuming the same vesting rate)
  - Prospective vesting favors departing fund managers
  - Retroactive vesting favors remaining fund managers
- Simplicity
  - Retroactive vesting generally is simpler because all profits and losses are treated the same
  - Prospective vesting introduces complexity by treating pre- and post- departure profits and losses differently

Vesting of Management Fees

Different Profit Steams (Repeat of Slide 5)

- Fund manager profits can be divided into three streams, which may vest on different terms
  - Return on Investment: the return on invested capital
  - Carry: the share of a Fund's net profits not based on invested capital
  - Management Fee: the periodic payment of a fixed amount
- Return on Investment typically is not subject to vesting (i.e. it is fully vested)
- Carry typically is subject to vesting
- Management Fee may be subject to vesting similar to carry, but fund managers often have no vested interest in management fees earned after their departure

Vesting of Management Fees

- Different views on management fees drive differences in vesting
- Most Common: Management fees are earned by providing services on a current basis; a fund manager who ceases to provide services stops earning management fees
  - Management fee income earned prior to departure is completely vested, but no vesting in fees earned after departure
- Less Common: Management fees represent a return on goodwill or similar ongoing proprietary interest in a Fund
  - Management fee income is subject to vesting similar to carry
  - May be appropriate for founders or other key personnel

Management Company

- Note that management fees typically are received, and operating expenses are incurred, by an affiliated "Management Company" instead of the General Partner
- The Management Company and the General Partner should have identical vesting provisions relating to management fees received from a particular Fund
  - If the relationship between the Management Company and the General Partner is severed for any reason, fund managers' interest in management fee will not be disrupted

Vesting in Extraordinary Losses

- If large operating losses (such as litigation costs) are visible before they will be allocated, fund managers may have an incentive to depart the firm and reduce their share of future losses
- This can be addressed by providing that fund managers are fully vested in nonrecurring “extraordinary” losses that arise during a reasonable period after departure (e.g. two years)
  - Note that the designation of losses as extraordinary requires some judgment on the part of remaining fund managers, which may expose them to claims from a hostile departed fund manager

Amendments and Vesting

Amendments and Vesting

- After Dorothy departs the General Partner of Yellow-Brick Fund I, the remaining fund managers have difficulty attracting a new fund manager to replace her
  - The unvested interest that Dorothy left behind is too small to attract a new fund manager
- The remaining fund managers decide that the vesting rate has been too generous and decide to slow the rate of vesting for all fund managers, including Dorothy
- As a result of the new vesting rate, Dorothy's vested percentage drops from 50% to 35%
- Dorothy objects that it is not fair to reduce her interest because it has already vested

Amendments and Vesting

- Can an amendment to the operating agreement of the General Partner reduce a fund manager's vested economic interest?
  - Yes, to permit maximum operating flexibility
  - No, reductions in a vested interest are inconsistent with the concept of vesting
  - Possible Compromise, amendments that reduce a vested interest are permissible, but only if two-thirds of the fund managers certify that the amendment is in the best interests of the General Partner entity and not merely to enrich remaining fund managers at a departed fund manager's expense

Conclusion and Summary

Conclusion

- There are many different varieties of vesting; no one variety is correct for all firms
- Vesting should reflect the rate of value creation and effort required to manage the Fund
- Fairness is always a concern

Summary: General

- Vesting rate
  - Should reflect the rate of value creation / effort required
  - Rate
    - Periodic: Front-Loaded, Straight-Line or Back-Loaded
    - Non-Periodic: Deal-by-Deal, Milestone or Discretionary
  - Features
    - Cliff
    - Acceleration
    - Contingent Vesting for bad behavior
- Vesting in different types of profit streams
  - Usually, return on investment is not subject to vesting
  - Often, no interest in post-departure management fees
- Amendments to vesting
  - How secure should a vested interest be against amendments?
- Remember purpose
  - Align incentives for fund managers to remain
  - Provide compensation for replacement fund manager

Summary: Retroactive and Prospective Vesting

- Retroactive Vesting
  - Both pre-departure and post-departure P&L are subject to reduction
- Simple Prospective Vesting
  - Only post-departure P&L are subject to reduction
- Modified Prospective Vesting
  - Like simple prospective vesting, but no reduction in losses that offset prior profits
- Distribution Issues and Approaches
  - Retroactive: Unvested profits may have been distributed prior to departure
    - Return unvested profits upon departure
    - Reduce future profits until fully offset (windfall possible)
  - Prospective: Distribution of vested profits may be delayed
    - Retain a portion of profits until liquidation
    - Distribute profits at same time as remainder of investment
    - Distribute profits in accordance with capital account balances

This presentation is intended only as a general discussion and should not be regarded as legal advice. For more information, please contact your Fund Services Group attorney.

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