MANAGEMENT COMPANY STRUCTURING

Proskauer Rose partners Scott S. Jones and Arnold P. May examine how to create the best framework for a firm.

For many private investment firms, the management company is the entity that embodies the firm itself: the management company employs the investment professionals, typically owns the firm’s branded assets (e.g., name, track record, other intellectual property and goodwill) and receives management fees from each of the firm’s investment funds.

As a result, the management company structure is extremely important in establishing governance and compensation, which in turn drive a firm’s unique culture. Yet, surprisingly, many firms – both new groups as well as firms with multiple funds under management – adopt a basic operating structure for their management company, rather than making the tough decisions necessary to build a business that will last beyond the careers of the founders. When the time comes for expansion and succession, the difficult decisions associated with the management company structure must be addressed, and without the proper planning in place at the outset, a restructuring can be disruptive, as well as very difficult and costly.

This article addresses some of the fundamental issues in structuring a management company, including issues related to choice of entity, control, economics, retirement and certain US tax considerations.

CHOICE OF ENTITY

A threshold question for any firm is the proper entity for the management company.

Historically, the C-corporation was the entity of choice for management companies. The thought process was simple: (1) although a C-corporation is taxable at the entity level, management fees were barely enough to cover expenses so there was no net taxable income, and (2) the notion that an investment firm would continue beyond the working years of its founders was inconceivable. As a result, given the ease of formation and limited liability protection afforded by a C-corporation, choice of entity was a quick and easy decision. As the private equity industry has matured, however, the core underlying assumptions regarding a management company’s value and operations have proven to be inaccurate. Indeed, investment firms today are just as much of a business as any portfolio company in which they invest.

In light of the evolving view of investment firms, the Delaware limited liability company (LLC) has become the most popular form of US-based management companies. An LLC provides the limited liability associated with a corporation, but is a “flow-through” entity for US federal income tax purposes, which means that it is not subject to US federal entity-level taxes (although it may be subject to state or local taxes). An LLC offers tremendous flexibility for structuring different economic and control arrangements. In addition, an LLC enables restructurings and the admission and retirement of members on a tax-efficient basis.

Other possible choices include S-corporations and limited partnerships. Although S-corporations generally are not subject to US federal entity-level tax, they may be subject to significant state income taxes. Furthermore, S-corporations are subject to rigid requirements that can be extremely constraining in the management company context (e.g., an S-corporation can have only one class of stock, a limited number of shareholders and a narrow type of eligible shareholders). Issuing additional interests in an S-corporation may also trigger US federal income tax liability.

Limited partnerships, on the other hand, generally have the same advantages as LLCs, but are not as popular mainly because a limited partnership must have a general partner with unlimited liability. One potential advantage of a limited partnership, however, is the
ability to reduce US federal self-employment taxes (although such a position is unclear from a tax perspective and the IRS has indicated that it is an area of focus). A limited partnership may also be subject to lower state taxes than an LLC, although the tax differential generally is immaterial.

MANAGEMENT COMPANY TERMS

Background. For many new firms, their central focus is on the fund itself. The provisions of the management company agreement seem relatively unimportant compared to the fundraising and deal-sourcing tasks, especially since the management fee for a new firm may barely cover expenses and a modest amount of compensation for the founders. For other new groups, the founders – who are excited about their new venture together – do not want to face difficult (and what they may view as theoretical) questions, such as removal of management company members.

As a consequence, new firms often opt for very basic management company structures, with equal shares among the founders, unanimous decision making on crucial issues (such as admission and removal of partners), no vesting of interests and a permanent buyback of a retired member’s interest at book value. “Keep it simple” is the guiding principle. The rationale is that they will revisit and amend the management company agreement when the firm grows.

Despite the intention of revising the management company terms in the future, many established management companies have retained the same basic governing provisions. The simple explanation for this phenomenon is that the basic mechanics have worked well to date. The more likely explanation, however, is that the founders have yet to face the difficult problems that more complex arrangements seek to address. When those problems do arise, a firm without the governance in place to address the situation is left to negotiate its way through unchartered territory, in some cases resulting in a collapse of the institution. Interestingly, newer firms with more complex management company arrangements tend to be groups that have spun out of other firms. This suggests that the management company structure of their prior firm was a contributing factor to their departure, or at the very least, something they believed was worthy of improvement.

What are these more difficult decisions? They generally can be subdivided into four broad categories: control (e.g., product lines, and admission/removal of members), current compensation, profits from a liquidity event and retirement.

Control. As a general matter, members of an investment firm have an innate sense of how the firm will be managed, ranging from a benevolent dictatorship (for a firm with one key founder) to group consensus (for a firm with multiple members who have close to equal significance).

Although all firms have their own unique considerations surrounding firm management and control, almost all management company agreements have a common theme in setting different voting thresholds for different issues. For day-to-day decisions, majority vote probably is the most feasible, with a number of such decisions delegated to officers or managers of the management company. For special decisions, a super-majority vote or other voting mechanic might be appropriate. Such decisions typically would include admission of new members (or advancement of members to a different class); retirement/removal of members; appointment/removal of officers, managers or directors; and strategic transactions (i.e., sale or partial sale of the management company). Economics considerations may make voting arrangements more complicated. For example, admission decisions might be structured so that only those members who suffer economic dilution participate in the vote.

Voting rights can also be used to further a desired firm culture. For example, a firm may view deeper participation in the management company as necessary to foster an ownership mentality. In that case, a firm could grant its junior professionals a small voting percentage, yet establish voting thresholds so that the junior professionals will
have no practical impact on firm decisions. Many groups have discovered that the “seat at the table” yields the desired result, particularly where the grants are made up front. Other firms, however, have found that the junior professionals do not ascribe any value to nominal voting rights, especially when such rights are conferred only after problems in the firm arise.

**Economics – Current Compensation.** The economic provisions of a management company are at least as important as control provisions. Although never a pleasant exercise, designing an economic framework may be easier in the early stages of a firm – when the economics may seem like an afterthought, since the fees often barely cover expenses – precisely because it is more theoretical. When a firm becomes more established, amendments to the firm economics are likely to be more controversial as those changes will have a more immediate and quantifiable impact on the dollars in each member’s pocket.

A threshold question is how to achieve the desired culture through compensation. The spectrum of possibilities range from a collaborative environment (rewarding people collectively for the success of the group) to an entrepreneurial environment (compensating people based on their individual achievements).

The collaborative approach is based on the theory that profits are a function of group efforts, and therefore shared among all members based on a formula. The formula can, and indeed frequently does, have some variability to reward the more senior members of the team. Although the formula does not necessarily need to be part of the governing documents of the management agreement, by formalizing the formula within the agreement, ownership in the management company can be seen as a real asset.

In contrast to the group approach, the other extreme is a discretionary system, with the intention of establishing an entrepreneurial environment in which individuals are compensated based on their own productivity. In this system, ownership of an interest in the management company has little value from the perspective of sharing in current income. The critical question in this approach is who determines compensation, which leads back to the control issues discussed above.

Of course, approaches with both collaborative and entrepreneurial aspects are possible, and the LLC framework provides for a virtually unlimited number of economic permutations. A blended approach might involve setting base compensation for each member and a discretionary bonus pool, with the residual amounts to be apportioned among the members based on “points” in the management company. Under this approach, points would be granted from time to time, with some expectations established within the institution that after “X” years of service or upon attainment of a particular title, an individual could expect to have “Y” points.

A further economic variation is to first determine profits on a fund-by-fund basis, and then apportion those amounts by applying the collaborative or entrepreneurial systems (or some combination of both). This structure allows for greater alignment of interests in the compensation structure as well as more transparency among the non-founder ranks. This type of arrangement can also be used to adopt a systematic approach to retirement, such as by allowing retired partners to “tail down” their share of income from particular funds over time.

Yet another way to align management company economics with particular funds is for the management company to receive a por-
A compensation arrangement can also be structured with certain protections to limit those members who have control over the compensation. Such protections could include restrictions on the amount of compensation that the control members pay to themselves or caps on the spread in compensation between the highest and lowest earners.

Economics – Liquidity Events and Third Party Financings of the Management Company. Management company economics can be further segmented to provide for a methodology to share proceeds from a liquidity event in a manner different than the sharing of income from operations. For example, members may share in current fee income based upon a certain methodology – such as completely discretionary to completely fixed – while proceeds from a liquidity event might be shared in different proportions. Different sharing ratios for liquidity events typically are intended to provide a greater reward to those who built the organization. In fact, this type of economic dichotomy has become popular in recent years, undoubtedly in light of the increased number of third-party investments in management companies.

A preestablished sharing ratio for sale transaction proceeds generally is necessary to preserve treatment of proceeds from the transaction as eligible for capital gains treatment. From an institutional perspective, a preestablished sharing ratio for sale transactions proceeds also is more likely to make a member feel like an owner, even if annual compensation is largely discretionary. In some instances, firms have successfully used this sense of ownership to encourage longer term efforts to build a franchise. An LLC provides sufficient flexibility to share sale transaction proceeds differently than current income.

Of course, firms also need to be realistic about the likelihood of a management company sale, and the time and expense necessary to work through the issues may not be well spent. Such transactions are still relatively rare, with the most common occurring among firms with multiple funds and multiple strategies. Nevertheless, a number of financial investors – from pension plans to sovereign wealth funds – continue to have a strong appetite for the relatively predictable cash flows that are generated by branded management companies.

Retirement. A discussion of ownership interests in management companies would be incomplete without addressing vesting and retirement. The key considerations are how a member can be removed and the consequences of a member ceasing to be actively involved in the business, which may vary depending on the circumstances of the departure. Not surprisingly, the variations are limitless.
Some firms take a calculated risk of basing removal upon a unanimous vote, thereby requiring the consent of the departing member and effectively delaying tough decisions for another day. This approach usually occurs when the founders are the sole members of the management company and are few in number. The working assumption in this strategy is that, because there is no ability to force the retirement of a particular member, the terms of any departure will be addressed on a case-by-case basis. Although it is an easy upfront approach, unanimity leaves the harder decisions for a time when the parties are likely to be adversarial.

For firms that do provide thresholds for the forced removal of a member, the firms must determine the consequences of removal. This raises numerous questions. From an economic perspective, does the individual participate in future income streams of the management company? Is the individual’s interest in the management company redeemed, and if so, at what price?

A buyback at book value generally is the first proposed solution. This is a sensible approach for a newer firm without much value or brand recognition, but does have the potential for inequities. For example, if an individual has invested significant efforts to establish and raise the firm’s investment fund, a buyback at book value could result in negligible proceeds and therefore not fairly compensate him or her. Theoretically, the terms of the underlying fund could provide an individual some protection against removal. This protection may have little practical value, however, depending on the terms of the fund. For instance, being included in the “key person” trigger may give someone limited safeguards against dismissal, but only within the parameters of the trigger, which may include a large group of professionals and may effectively expire after the fund’s investment period.

Another approach is to provide some continued sharing of fees (or sale transaction proceeds) with a former member. In these circumstances, such an arrangement generally would tail down over time, and could be limited to fee streams in existing funds or could include a subset of funds formed in the future. In more complex arrangements, the duration of the tail down could be a function of the individual’s number of years of service or title (or both) at the time of departure. Rights to participate in fee streams (or sale transaction proceeds) post-departure may not apply if the individual voluntarily separates from the firm or is removed “for cause.” In determining the amounts to be distributed to a former member, the parties should consider the various ways in which income could be affected (e.g., reductions in the management fee through “fee waiver” arrangements, increases in the management company’s gross revenues from portfolio company remuneration, and reductions in the management company’s net income for extraordinary expenses such as office renovations).

In addition to the economic considerations of an individual leaving the firm, the governing documents should address the key non-economic provisions, including confidentiality, non-competition, and non-solicitation (with respect to both employees and investors). When drafting these provisions, care must be taken to ensure enforceability under applicable state law.

In most situations, the terms of the management company agreement are the starting point. The document establishes each member’s leverage in the negotiations, but rarely serves as the ending point. For friendly departures, the terms can be resolved in an agreeable fashion. For hostile separations, however, the failure to establish a baseline that is favorable to the institution can be extremely costly.

CERTAIN US TAX CONSIDERATIONS

Issuance of interests raises one of the most significant tax considerations in connection with a management company. In this regard, the issuance of an interest in the management company constitutes taxable income to the recipient to the extent the fair market value of the interest exceeds the amount paid. If the interest is subject to vesting, then in certain cases, unless an election is made (a “Section 83(b) election”), the interest will be taxed when it vests in an amount equal
to the difference between the fair market value of the interest at the vesting date and the amount paid. These tax considerations impact the choice of entity for the management company as well as certain vesting provisions.

**Issuance of Interests – LLC versus Corporation.** Assume a management company has significant income streams from multiple funds and a strong brand. If the company is a C-corporation (or S-corporation), the recipient of a new interest could have significant tax exposure. On the other hand, if the management company is an LLC (or partnership), then the grant can be structured to avoid current tax liability. This distinction is significant and has resulted in a number of management company conversions from corporations to LLCs, often at considerable tax cost.

**Vesting.** From a vesting perspective, as noted above, an unvested interest in a management company may be subject to tax when the interest vests, unless a Section 83(b) election is made (and, as a general matter, a Section 83(b) election is recommended).

But what if the interest never vests, such as an interest that is subject to a fixed buyback upon an individual’s retirement? In that case, the interest is considered to be subject to a “non-lapse restriction.” Although the grant of the interest may not result in any taxable income to the recipient, if the interest is later sold (or the non-lapse restriction is otherwise cancelled), then the individual will be deemed to have compensation income at that time in amount equal to the fair market value of the interest, reduced by the buyback price of the property immediately prior to the sale (or other cancellation). For example, assume that shares subject to a permanent buyback right at book value are sold at a gain of $100. If the book value of the shares at time of sale was $60, then $40 of that gain may be recharacterised as compensation income.

Such a recharacterisation, however, applies only if the cancellation of the buyback restriction is considered “compensatory” for tax purposes. Not surprisingly, this determination is based upon a “facts and circumstances” analysis. Ordinarily, if the service provider is required to perform additional services or is subject to a salary reduction in exchange for the cancellation, then the cancellation will be treated as compensatory. On the other hand, the fact that the original purpose of a restriction no longer exists may indicate that the purpose of the cancellation is non-compensatory.

For example, if a “buy-sell” restriction was imposed on a corporation’s stock to limit ownership of such stock and is being canceled in connection with a public offering of such stock, the cancellation generally will be regarded as non-compensatory. The taxpayer has the burden of establishing that a cancellation is non-compensatory and must provide a written statement with his or her tax return in support of such determination. In addition, the service recipient must be willing to treat the cancellation as non-compensatory. However, the mere fact that the service recipient is willing to forego a compensation deduction is insufficient evidence to establish a non-compensatory cancellation.

To avoid this potential adverse tax upon a future sale of a management company, any buyback provisions should be at fair market value or should lapse (or switch to fair market value) upon some fixed schedule.

**Sale of Interests.** Another issue is the tax treatment of a sale of management company interests. If the company is a corporation, then (ignoring the non-lapse restriction issue noted above) gain from the sale of stock in the company will be treated as capital gain for US tax purposes. The analysis is not as straightforward when the management company is organized as an LLC (or partnership).

Under existing tax rules, although gain from the sale of LLC interests generally will be treated as capital gain, all or a portion of the gain will be recharacterized as ordinary income to the extent of the value of its “unrealised receivables” and certain other assets. For these purposes, “unrealised receivables” include rights to payments either for services rendered or for services to be rendered.
Accordingly, the issue that arises is whether a management company’s future fee streams are treated as unrealised receivables, potentially causing a significant portion of gain upon sale to be recharacterized as ordinary income.

The courts generally have concluded that contracts are not treated as unrealised receivables for this purpose if the contracts are terminable unilaterally by the service recipient on a short-term basis. The rationale is that a buyer must be paying for the goodwill of the management company rather than for an income stream that could be cancelled by the management company’s clients on short notice. The courts, however, have not examined this issue in the context of a typical private equity management company. If a private equity fund can unilaterally terminate the contract with the management company, this certainly is a helpful factor. Nevertheless, it is not entirely clear, under current law, that such a fact pattern would be determinative, since the general partner typically controls the fund (and usually there is substantial overlap in ownership between the general partner and the management company).

Other helpful factors in this regard include any provisions in the operative documents of the fund that could trigger a termination of the management fee without the general partner’s consent, such as “key person” and “no-fault divorce” provisions.

**Non-US Operations.** For firms with operations (an office or employees) in a non-US jurisdiction, it is often advisable – for non-US reasons – to conduct those operations through an entity organized under the laws of that jurisdiction. The entity typically would be structured as a subsidiary of the US management company, where the operations of the non-US entity are funded with payments from the US parent.

A primary concern when conducting non-US operations is to ensure that such activities do not expose the fund (or its partners) to adverse tax consequences in such jurisdiction. Local counsel should always be consulted to advise on these matters.

A secondary concern is the tax treatment of the payments from the US management company to the non-US entity. These payments generally would require appropriate “transfer pricing” between the non-US and US management companies, so that an acceptable amount of profits is attributable to the non-US entity (and therefore taxed in that jurisdiction). If the non-US entity is a subsidiary of the management company and also treated as a “disregarded entity” for US tax purposes, then any non-US tax costs from a transfer-pricing arrangement may be substantially offset through foreign tax credits in the US.

**CONCLUSION**

Tremendous flexibility is available when structuring a management company. Control, economic and retirement provisions can be separated and tailored to address many different issues. In this regard, establishing the right framework at a firm’s inception – when morale is high and cohesiveness is strong – is an opportunity to build a solid foundation for the future. In doing so, the firm will be able to establish its unique culture, set expectations for the future advancement of junior professionals and lay the groundwork for the inevitable day when the founders cease to be actively engaged in the business.

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