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Ready to Sell All or a Portion of your Management Company? – A Checklist of Asset Manager M&A Considerations

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Many closely-held asset management firms are considering selling their business or bringing in outside investors. Taking this next step in the life cycle of a firm can bring needed liquidity to the founders, provide capital to expand the business beyond existing platforms, provide a path to management succession to the next generation, or increase distribution opportunities to new investors. This article summarizes certain issues that should be considered by potential sellers and buyers of a private investment fund management business, with a particular focus on a transaction that involves the sale of all or substantially all of a registered investment adviser.

Deal Structure Considerations

Purchase Price Considerations

Buyers often structure the purchase price in a manner that is expected to align incentives and interests post-closing. Common features include:

- Earnouts – Requires negotiation of control over key post-closing business matters, which can affect earnout metrics (e.g., upcoming fundraises, how to deal with competing products, access to LPs, personnel changes).
- Deferred Purchase Price – Requires consideration of the creditworthiness of the buyer.
- Rollover Equity for Sellers – Requires consideration of appropriate minority rights and protections and tax considerations for sellers (e.g., ensuring such rollover equity may be received on a tax-deferred basis or be eligible for long-term capital gains treatment).

Deal Considerations for Non-Owners

Buyers often seek to align interests of non-owner investment professionals (i.e., the "next generation") and may make their participation a condition to the transaction. Common points of negotiation in this respect include:

- Carry participation post-closing
- Role within the combined organization post-closing
- Bonuses and equity incentives

Generational control transfers through these types of transactions can result in tension between owners and next generation professionals, which will need to be managed throughout the process. This can lead to "side" negotiations regarding carry protection, participation in managing subsequent funds, etc.

Tax Structure Considerations

- Generally, in the case of a sale of the entire business, these types of transactions are structured as asset sales for tax purposes (although typically an "entity sale" for non-tax purposes, e.g., a sale of LLC or LP interests). In the case of a partial sale, certain tax elections may be made to give the buyer the equivalent of an asset purchase.
- Key considerations in this regard include the following:
    - Buyer may obtain a tax basis step-up for the acquired assets of the business which may provide the buyer with go-forward tax benefits. Some buyers may price this tax benefit into the purchase price and well-advised sellers should communicate that benefit in the deal negotiation process.
    - Generally, sellers will receive capital gains treatment for goodwill, franchise value and brand value.
    - However, the value of so-called "hot assets" such as the value of fees to be paid under existing management agreements will generally be taxable to sellers as ordinary income. Valuation of these assets is a critical issue.
- The impact of carried interest taxation rules will need to be considered, including the three-year holding period for long-term capital gains. There is currently uncertainty as to whether this longer holding period applies to the sale of interests in a management company.
- Sellers will also want to ensure that the purchase price is not treated as compensation. If deal proceeds may be forfeited in the event of the termination of a seller's employment with the buyer, there can be issues with this treatment.

- Finally, “non-lapse” restrictions in the operating agreement will be relevant. Sellers should consider who the tax owner of interests in the management company will be at the time of any sale and consider ensuring that agreements include long-term vesting for such persons.

Other Deal Structure Considerations

- Issues can arise during the “gap period” between signing and closing (when client consents are being sought and other closing conditions are being addressed), including negative reception by LPs, changes to AUM, and impact on fundraising process. Additional discussion of LP-related issues is below.
- Indemnification obligations may generally be set off against earnouts and/or deferred purchase price amounts. This can affect the alignment of interests between sellers and buyers.
- Buyers may require sellers and/or “next generation” members to enter into employment agreements. These agreements are separately negotiated and can be closing conditions, which may raise issues if there are holdouts. Surfacing any potential issues (and, ideally, agreeing to the agreements) prior to signing can alleviate this risk.

Fund-Related Considerations

Client Consents

- The Investment Advisers Act of 1940 (as amended, the “Investment Advisers Act”) requires “client” consent for the assignment of a management contract (i.e., the transfer of the management relationship between each “client” and the management company). Each fund is a “client.” Certain fund documentation permits the LPAC to provide consent to the transfer of the management relationship; otherwise, LP approval for each fund is required in accordance with the governing documents of the applicable fund. These approvals are a customary closing condition. Frequently, formal outreach to LPs begins after signing (and any accompanying press announcement) with a “consent package” that contains information about the transaction and the manager’s plans going forward.
- Depending on the circumstances, LPs may seek to negotiate various LP-favorable term changes related to active funds in exchange for their consent. Note that “fund-of-one” and Separately Managed Accounts (“SMAs”) structures with institutional LPs lead to particularly strong LP negotiating positions.
- If fund documents provide for “negative consent,” that can be relied upon with adequate disclosure.

- “Back-up plans” may need to be considered if any difficulty in obtaining consents is anticipated (e.g., with old funds, funds with less engaged LP bases, funds-of-one and SMAs). With large fund complexes, purchase agreements may include automatic purchase price adjustments to accommodate a failure to obtain a limited number of required LP consents.

Other Contractual Consents

- Side letters with investors may include “change of control” consent or notice provisions that will need to be considered. Depending on the extent and nature of such provisions, waiver may be included in the general consent package.
- Outside of the specific “funds” context, other contractual consents may be required (e.g., real estate leases, equipment leases, credit lines and other debt-related documentation). Outreach to relevant parties will generally be conducted between signing and closing.
- Obtaining these contractual consents will generally be a condition to closing, and both parties will likely undertake significant diligence with respect to contractual consents.

Fund Documentation Amendments

- Buyers may request amendments to fund documentation; such requested amendments would frequently be related to governance issues, but may also involve other terms.
- Discussions with LPs during the consent process may lead to side letters, softer “diligence letters” containing representations and warranties about the transaction, and/or fund document amendments.
- Negotiating and seeking approval of these amendments may extend the period between signing and closing. Depending on the nature of the amendments being sought, buyers may be more or less involved in the process.

Disclosure Considerations

- Disclosure of a transaction to prospective investors during an ongoing fundraising process will need to be considered; the nature and extent of disclosures will depend on the degree to which planning and negotiation regarding the transaction have progressed.
- If the buyer or its affiliates are publicly traded, careful attention to issues related to material nonpublic information will be required throughout the process of a transaction.

LP Relations Generally

- Informal discussions with key LPs may occur prior to the formal consent process, but the outreach will need to be coordinated with buyers. Note that buyer disclosure issues may be a factor, particularly if the buyer is affiliated with (or is itself) a publicly traded entity.
- The degree of buyer involvement in LP-facing communications and discussions may vary depending on factors like platform overlap, LP overlap, and how LP relations/fundraising are expected to be handled post-transaction.

GP-Related Considerations

Carry Preservation

- The buyer’s involvement in carry grants, forfeitures and dilution will be a key negotiation point. Sellers should seek covenants from buyers not to modify existing carry grants (vested or unvested) and not to amend existing carry documentation in a manner that would adversely affect current carry recipients, and should expect that this could be a difficult subject of negotiation with buyers.
- In addition, carry allocation in subsequently raised funds will likely be negotiated with both buyers and “next generation” investment professionals.
- In general, sellers should consider whether to make any changes to governing documents (including with respect to vesting of economic interests) prior to entering into significant discussions with prospective buyers. Making changes to these provisions after a potential buyer is engaged (or in connection with a transaction itself) will almost certainly become more difficult.

Control

- With parties mainly focused on control of the management company and on carry arrangements, the question of control over existing general partner entities may not be raised in initial negotiations, but sellers should understand the buyer’s intentions in this regard – they often seek to take control of each fund’s general partner entity, regardless of whether carry is changing hands, in order to have ultimate governance rights over each fund.
- Because ultimate control of each fund is generally housed at the same legal entity as control over the vesting, forfeiture and dilution of sellers’ (and others’) carry, having buyers take control of those entities can raise concerns for sellers about maintaining control over carry. As noted above, covenants from buyers not to take adverse actions can be part of the transaction documentation process.

GP Capital

- Buyers often want investment professionals to be obligated with respect to GP capital, both for existing and future funds. These negotiations often occur together with negotiation over carry economics. Selling partners and "next generation" investment professionals may negotiate rights to invest in future funds on a "no fee no carry" basis.
- Buyers may request that sellers "turn off" any deemed contribution or "fee waiver" provisions that reduce future management fees as post-closing only sellers would receive the benefit of those provisions.
- In addition, sellers should consider obtaining credit lines or other liquidity support for partners, especially "next generation" investment professionals, to meet any additional commitments requested or insisted on by a buyer.

Business Integration Issues

The issues described in this section are generally more relevant in transactions that would result in a change of control of an investment adviser's business, although one or more of them may arise in certain circumstances in other transactions as well.

Personnel

- Resource redundancy and changes to planned platform focus can lead to a situation in which employees of the selling firm may have their employment terminated. This can lead to disputes with departing employees and other difficulties.
- Track record usage (by both remaining and departing personnel) will need to be discussed between buyer and sellers. The ability to use an investment adviser's track record is limited under Investment Advisers Act. The track record of any adviser is the property of such adviser, and not of any employee. Departing employees may request to use track record information with respect to deals in which they participated, and the adviser should be prepared to respond to such requests.
- Compensation and incentive packages (including participation in "friends and family" investment vehicles and similar programs) may be harmonized between firms or, to some extent, retained separately.
- "Key person" provisions should be reviewed in connection with any planned changes to personnel, including allocation of the time and attention of investment professionals.

Policies

- Sellers and their employees should be prepared to migrate to buyer policies in various respects.
- Policies regarding political contributions can raise particularly significant issues due to state and local pay-to-play laws. If buyer’s funds have government investors from jurisdictions that sellers’ funds do not, it is possible that contributions by seller personnel to candidates in those jurisdictions (even prior to the transaction) can have serious implications for buyer, including a freeze on the ability to charge management fees with respect to such investors. Diligence with respect to this issue should be undertaken early in the process.
- Risk, compliance, regulatory, governance, and litigation/dispute policies, among others, may need to be harmonized.
- Large institutional buyers often have extensive onboarding procedures that will require cooperation of employees between signing and closing.

Conflicts

- Policies (and potentially legal documentation) regarding allocation of investment opportunities and other conflict-of-interest issues will need to be carefully reviewed, and possibly modified, to reflect post-transaction investment platforms.
- The possibility of buyers consolidating with competitor firms or structuring other exits can create conflicts of interest between the buyer and investment professionals.

Any new, different or exacerbated conflicts of interest, which can arise due to existing or future relationships or transactions among fund managers, funds, portfolio companies, and employees, should be reviewed and any required disclosures should be assessed.

Systems, Other Assets and

Resources

- Technology resources, human resources functions, finance and accounting, and other back-office services may be consolidated or integrated to varying degrees.
- Sellers and their personnel may retain their existing office space or be asked to relocate and consolidate in buyer office space. Physically relocating (whether immediately post-closing or down the road) can be particularly disruptive, so expectations regarding this topic should be established early and, preferably, documented.

- Ownership of intellectual property and any necessary licensing arrangementsshould be reviewed and clarified in connection with the transaction.

These considerations are a starting point for a successful negotiation of an asset management M&A transaction. We have found that closely-held asset management firms often have non-standard management company structures and documentation. The final arrangements are often complex and bespoke, requiring significant advance planning and advisors familiar with a variety of deal structures. A thorough analysis of the current state-of-play, and consideration of pre-transaction steps is recommended before engaging with an investment banker and potential investors. If you are considering taking this next step, and have any questions relating to the topics discussed in this article, we recommend you engage with counsel early in the process.

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