Proskauer

Proskauer's Hedge Start: Seed Investments

May 6, 2024

Seed investment deals between a new hedge fund manager and a seed investor can be a key first step to launching a first fund. In a typical seed investment deal, the seed investor commits to make a founding investment in a new hedge fund in exchange for a share of the manager's future revenues or profits. Key terms of seed deals vary significantly but generally include:

Lock-up of Investment

Typically, the seed investor invests anywhere from $25 to $200 million and, typically, may not redeem its investment for two to three years.

- **Exceptions**: Exceptions to the lock-up are typically negotiated. Examples include investment performance below an agreed benchmark, the departure of key personnel, material withdrawals of capital from the fund by the key principal(s) of the manager, or if the manager or its key personnel commit certain agreed bad acts or are subject to certain agreed regulatory or other events. In these circumstances, the seed investor typically has the right to retain its revenue or profit share, so long as it maintains an agreed minimum investment in the fund.

Revenue or Profit Share

In addition to the return on its investment, the seed investor also typically receives a percentage of the revenues or profits earned by the manager, usually ranging from 5% to 25%.

- **Scope**: In most seed deals, the revenue or profit participation applies to all revenues or profits of the manager from all sources, including new funds and strategies developed by the manager and its affiliates in the future. But the participation can be limited just to the revenues or profits generated by the fund being seeded or just to the fund and any parallel funds or managed accounts using the same strategy.

- **Revenues v. Profits**: Seed investors generally prefer to receive a participation in (gross) revenues, rather than profits, since that avoids the need for the seed investor to worry about expenses being borne by the manager. On the other hand, managers generally prefer a participation in net profits, but that usually comes with the seed investor having more say on expenses.
- **Structure**: The revenue or profit share can be structured as an equity interest in the manager, but for tax, regulatory and limited liability purposes, it is more typically structured as part of the incentive allocation payable by the fund to the manager or an affiliate. Therefore, the seed investor's receipt of the revenue or profit participation is typically contingent on the fund generating a profit in a given year (and any shortfall is carried forward to future years, subject to limits imposed by tax rules).
- **Duration**: The seed investor's revenue or profit share might expire after an agreed number of years (a "sunset clause") or after an agreed amount of revenue has been generated for the seed investor, although it is not uncommon for the deal to continue indefinitely.

Put and Call Options

The seed investor and the manager may each (or both) have the option (or obligation) to require the manager to repurchase the seed investor's revenue or profit share under certain circumstances.

- **Time or Amount**: The repurchase right or obligation could be triggered after an agreed number of years or after an agreed amount of revenue has been generated for the seed investor.
- **Certain Events**: The repurchase option could be triggered by the occurrence of any of certain agreed events (often many of the same events that trigger the termination of the lock-up described above).
- **Repurchase Price**: The repurchase price can be determined based upon a formula, typically a multiple of the seed investor's actual revenue or profit participation received over the 2- or 3-year period prior to the repurchase, or it can be based on an appraisal or other agreed method.

Other Rights and Obligations of Seed Investor

The seed investor may negotiate other rights or obligations, including:

- **Capacity**: The seed investor often has the right to invest an additional amount in the fund or other investment vehicles managed by the manager or its affiliates,

typically upon terms no less favorable than those granted to any other investor of comparable size (i.e., subject to an “MFN” clause).

- **Minimum Investment by Manager**: The manager and its key principal(s) are often required to make and hold a minimum agreed investment in the fund and are sometimes required to reinvest in the fund an agreed percentage of any future compensation earned by the manager.
- **Time Commitment**: The key principal(s) of the manager may be required to devote their full business time and attention to the management and operations of the manager and the fund for an agreed period of time and not to engage in or invest in any competing business.
- **Seed Investor Consents:** Some seed investors may require prior approval of certain actions by the manager, such as changes of material fund terms, launch of new funds or other investment products, changes of key service providers or other agreed operational controls over the manager.
- **Participation in Sale of Business**: The seed investor typically receives the same percentage of the net proceeds of any sale of the manager’s business (but the structuring of such a participation must take into account certain key tax considerations).
- **Working Capital Loan:** The seed investor might agree to lend working capital to the manager to be repaid on agreed terms, often out of excess cash flows above agreed amounts.
- **Access to Information:** The seed investor may receive access to agreed performance and financial information, subject to appropriate confidentiality obligations and sometimes time delays.
- **Restrictive Covenants:** The key principal(s) of the manager often have to agree to a non-compete, a non-solicit (both as to employees and investors) and other restrictive covenants which may continue for an agreed number of years after they are no longer associated with the manager.
- **Tail Rights:** The seed investor may have the right to participate on the same terms in any investment businesses the key principal(s) sponsor or control that begin operations within an agreed period of time following the termination of the seed deal.

Tax Considerations in Seed Deals

Tax issues can be particularly important if the seed investor is either a non-U.S. investor that wishes to avoid being engaged in a U.S. trade or business for U.S. tax purposes or a U.S. tax-exempt investor that wishes to avoid or limit “unrelated business income tax” (UBIT) or a seed investment fund that has such investors.

- Structuring a revenue or profits share carefully as part of the manager’s incentive allocation can be essential in order to avoid certain adverse tax consequences that would otherwise apply if a non-U.S. investor or U.S. tax-exempt investor simply acquired an equity interest in the manager.

The Takeaway: Seed investment deals can provide huge potential benefits to a new manager launching a fund and can also impose very significant future obligations. Negotiation of seed investment deals involve many complex business issues that are typically heavily negotiated between the parties and complex structuring issues that require, in particular, advice on very technical tax issues.

Related Professionals

- **Caryn J. Greenspan**
  Partner
- **Jennifer Dunn**
  Partner
- **Kelli L. Moll**
  Partner