Organizational Considerations for New Private Equity and Venture Capital Funds

Introduction

It is impossible to have a successful fund launch without an investment in planning and structuring. The purpose of this document is to discuss the considerations a manager must make in launching a new fund. It is a good idea to have a basic understanding of these issues before meeting with legal counsel.

Structure

Most venture capital funds are structured as limited partnerships. Limited partnerships generally have two types of investors: limited partners and a general partner. Limited partners are generally non-active investors who commit to invest a fixed amount of money to the fund (capital commitment) in exchange for a pro-rata share of the economics of the fund (e.g. proceeds from sales, dividend income, interest income). The liability of each limited partner is limited to his, her, or its commitment to the fund. Funds usually have one general partner, whose job is to manage the fund's investments. Typically, a general partner will make a capital commitment of 1 percent of the commitments of all partners. For example, if the limited partners were to commit $99 million to a fund, the general partner would commit $1 million.

I have seen funds that are structured as Limited Liability Companies (LLCs) and Small Business Investment Companies (SBICs) as well as Business Development Companies. You should speak with your lawyer about the pros and cons of each structure.

Life of Fund

Most venture capital and private equity funds are structured with a ten-year life with the option to extend for up to two or three years if deemed necessary by the general partner. The general idea is that a ten-year fund will survive a seven-year business cycle and should provide enough time for portfolio companies to be funded, enhanced, and sold.

Recycling Provisions

Once an investment is sold, most funds are required to distribute the proceeds of the sale to their limited partners. Some funds are allowed to reinvest (recycle) all or a portion of the proceeds from the sale of a particular investment into a new portfolio investment. Recycling provisions can be of particular benefit to small funds, as fund commitments may be limited and additional funds helpful.

Fees

Typically, a general partner gets paid in two ways:

- Management Fee: The general partner receives an annual management fee (usually through its affiliate, the management company) equal to 2 to 2.5 percent of committed capital. For example, if the fund had total commiments of $100 million and a 2 percent management fee, the fund would pay the management company $2 million per year. The management fee is intended to cover the operating costs of the management company, including salaries, rent, utilities, etc.

- Carry: The general partner usually receives 20 percent of the profits of a fund. The idea is that if the fund is profitable, the general partner will receive a reward. For example, if a fund was able to pay $200 million in distributions to investors who contributed $100 million, 20 percent of the $100 million gain ($200 million in distributions minus $100 million in contributions), or $20 million, would be allocated to the general partner. An outside administrator provides investors with additional comfort in that the books and records of a fund are being maintained by an independent third party. In addition to using a credible, known independent audit firm and having an established banking relationship, hiring an independent administrator to keep your books and records will further improve your investors' comfort level.

Some funds will have hurdle rates that require that the fund not only pay back the contributions of the limited partners but also provide them with some return on their investment (e.g. 8 percent per year) before a carry allocation is paid.

Most funds will have a provision called a clawback that requires the general partner to repay any carry received in excess of 20 percent of fund profits.

Other Expenses

Some other expenses that are not related to the management company are as follows:

- Audit and Tax Fees: These are the amounts paid to an outside CPA firm to have the fund audited and tax forms (referred to as Schedule K-1s) prepared. (Side note: Limited partnerships are pass-through entities for tax purposes, which means the income and expenses are passed on to the partners. The Schedule K-1s tell each partner how much he or she owes.)

- Due-Diligence Expenses: These are out-of-pocket expenses for travel and advice that the employees and members of the management company or general partner incur when looking at companies to invest in.

- Legal Fees: These are the legal fees incurred by the fund.

- Organizational and Syndication Costs: These are the costs related to structuring a fund, including legal costs and the costs of recruiting limited partners to invest in the fund.

Legal Documents

The lawyers usually prepare three main legal documents for a fund:

- Partnership Agreement: This agreement spells out all of the operational rules of the partnership. It would include the formulas for calculating the carry and the management fees. It would also detail limitations in the amounts and types of investments that the general partner is allowed to make.

- Offering Document (Private Placement Memo): This is the marketing document for the fund. Unlike mutual funds, which are heavily regulated, venture funds are generally not registered. In exchange for the lack of regulatory burden, venture funds must avoid marketing. Venture funds are allowed to put together private placement memos that are designed to provide a potential investor with all of the information such investor may require, including explanations of the fund structure, its strategy, and its management.

- Subscription Documents: These are the documents an investor must fill out in order to invest in the fund. Investors are asked for personal information, including contact information and tax identification numbers, and the investor's commitment amount. The documents include a questionnaire designed to determine whether the investor is qualified to invest in the fund.

To get these documents right, it is important that you hire lawyers with fund knowledge and experience.

About the Author

Rob Herlihy is a Member of IPS. Rob has been servicing investment partnerships and their related entities since 1995. Prior to founding IPS in 2001, Rob was a Manager at KPMG where he serviced clients with millions to billions in assets under management. Rob has provided services to various entities, including partnerships, limited liability companies, offshore entities, subchapter S corporations, small business investment companies, and business development companies.

About IPS

IPS Fund Services (IPS) is an administrator that focuses on the accounting and compliance needs of small and mid-sized venture capital and private equity funds. Learn more about IPS and our capabilities at www.ipsfundservices.com