

# Private Fund Departures and Upper Tier Arrangements

## Introduction

Private funds often face complex challenges when a key individual departs, whether it be a founding partner, a principal, or another critical member of the upper tier of management. The implications of such departures can be profound, affecting not only the management and operations of the fund but also its financial stability and investor relations.

## The Importance of Early Planning

### Early Agreements

At the inception of a fund, it is crucial to anticipate potential departures by crafting comprehensive agreements. These agreements should clearly define the terms of departure, compensation, and the handling of equity stakes. Failure to do so can lead to costly litigation and destabilize the fund.

### Avoid Handshake Agreements

Informal agreements or understandings in the early stages of a fund's formation can lead to significant legal disputes if not properly documented. Funds should ensure that all key terms are formalized in enforceable legal documents to prevent misunderstandings and protect the interests of all parties involved.

## Key Considerations for Upper Tier Arrangements

### Governance Rights and Economic Interests

Upper tier arrangements, including those related to governance rights and the division of economic interests, should be carefully documented. These arrangements are often bespoke and vary significantly depending on the specific circumstances of the fund and its principals. Attorneys should ensure that these agreements are comprehensive and account for potential changes in leadership and ownership.

### Compensation Structures and Tax Implications

The compensation structure within private funds can be complex, with various elements such as equity, carried interest, and deferred compensation coming into play. These structures must be designed with careful consideration of tax implications and the timing of payouts. Attorneys should collaborate with tax experts to ensure that the compensation arrangements are both legally sound and tax-efficient.

## **Managing Departures: Legal and Practical Considerations**

### **Good Leaver vs. Bad Leaver Provisions**

It is standard to distinguish between good leavers and bad leavers in the upper tier arrangements. Good leavers typically retain their entitlements to compensation and equity, while bad leavers may face forfeiture of these benefits. Clearly defining what constitutes a good or bad leaver, along with the associated consequences, can prevent disputes and ensure a smoother transition.

### **Key Person Provisions**

Key person provisions in private funds should be carefully negotiated and narrowly tailored. These provisions should outline the specific events that trigger a key person event, such as death, disability, or resignation, and the subsequent rights of investors, such as the ability to withdraw from the fund or suspend the investment period. As a result, detailed attention to the drafting of these provisions can mitigate the risks associated with key person departures.

### **Confidentiality and Non-Compete Clauses**

To protect the fund's proprietary information and maintain its competitive edge, confidentiality and non-compete clauses should be standard in all upper-tier and employment agreements. These clauses must be carefully crafted to comply with current legal standards and enforceability issues, particularly in light of evolving state laws and federal regulations on noncompetes. Forfeiture for competition provision may be a reasonable alternative.

## **Dispute Resolution Mechanisms**

### **Mandatory Arbitration**

Including mandatory arbitration clauses in upper-tier and employment agreements can keep disputes out of the public eye and reduce litigation costs. However, it is essential to be aware of the limitations and exceptions to mandatory arbitration under state laws and the Federal Arbitration Act.

### **Cooperation Provisions**

To ensure continuity and the preservation of institutional knowledge, cooperation provisions should be included in agreements. These provisions require departing individuals to assist with ongoing investigations or other fund-related matters post-departure.

## **Practical Tips for Attorneys**

### **Power of Attorney Provisions**

Incorporating a power of attorney clause in employment agreements can streamline the administrative process when a principal departs. This allows remaining principals to execute necessary documents on behalf of the departing individual, reducing delays and ensuring the smooth operation of the fund.

### **Tailored Drafting**

Given the bespoke nature of upper-tier arrangements, attorneys should focus on tailored drafting that reflects the specific needs and circumstances of the fund and its principals. This approach reduces the likelihood of disputes and ensures that the fund's operations can continue seamlessly in the event of a departure.