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Caplan Law is a business law firm dedicated to providing quality legal services to the private equity industry. The firm has experience in the energy, entertainment, technology, and agribusiness sectors, among others.

Letter from the Editor

This newsletter addresses legal issues relevant to the private equity industry. The term "private equity" refers to venture capital, project finance, leveraged buyouts, hedge funds, and other types of investments.

This newsletter has a focus on venture capital and project finance. Venture and project funds provide acquisition and development capital in the energy, entertainment, technology, and agribusiness sectors, among others.

Best regards,
Jeffrey E. Caplan, Esq.

Formation of Fund Manager

Funds are usually managed by separate business entities. If the fund is a limited liability company (LLC), the fund manager is the "managing-member" and the investors are "members". If the fund is a limited partnership (LP), the fund manager is the "general partner" and the investors are "limited partners".

The formation of a fund manager requires the following steps, among others.

Choosing a Name

The new business must have a name. The name should have marketing appeal but not conflict with the names of existing companies, especially potential competitors. Check for name conflicts in government databases and other sources.

For maximum trademark protection, make up a new word or a new meaning for an existing word. Then, add extra words that suggest the type of business, such as "Ventures", "Capital Partners", or "Investments".

Trademark registration is not mandatory but provides additional benefits under the law.

Choosing an Entity

The next step is choosing the entity type. The choice of entity depends on legal, financial, and business factors. Most fund managers are organized as corporations or LLC's.

From a legal perspective, the corporation and LLC forms provide a similar level of protection against personal liability. However, corporations must comply with more formalities and, therefore, present a greater risk of personal liability for failure to follow the formalities.

Place of Organization

The founders must decide where to organize their company. Delaware is a popular choice due to its favorable laws and other advantages. Another popular option is the location of the headquarters.

A company organized elsewhere may need to register in its home state. In that case, the home state may, to a certain extent, apply its own business laws to the "foreign" company.

Government Filings

The formation of a business entity requires the filing of various documents with government agencies.

First, the founders must file "articles" or a "certificate" with the Secretary of State in each place of organization or registration. It is usually not necessary to file the bylaws or other governing documents.

Second, the company may need to file periodic reports. For example, California corporations and LLC's must file a one-page "Statement of Information" within 90 days after filing their articles, and then annually or bi-annually thereafter.

Third, if a company raises capital from investors, the company may need to file securities forms with federal and state agencies.

Fourth, companies must file tax documents at the federal and state level. For example, "S corporations" must file their elections with the IRS by the specified deadline.

Permits and Licenses

The typical fund manager does not need any permits. However, local law usually requires a business license.

The fund manager may also need an "investment adviser" license at the federal or state level. Federal law requires fund managers with at least 15 clients and \$25,000,000 under management to register with the U.S. Securities and Exchange Commission (SEC). (Usually, the "clients" are the funds, not the fund investors.) The states regulate investment advisers with less than \$25,000,000 under management, but exemptions from registration may apply.

A fund manager may need a "broker-dealer" license at the federal or state level. The federal regulator is a non-governmental organization, the Financial Industry Regulatory Authority (FINRA).

Internal Documents

The founders will need to create various internal documents. A corporation may need bylaws, shareholders' agreement, shareholder register, stock certificates, and minutes and resolutions for the initial meetings of the shareholders and directors. An LLC may need an operating agreement, member register, and membership unit certificates. Other documents may be required.

Record-Keeping

Business and tax laws at the federal and state level require companies to maintain certain records. These records may include tax returns, financial statements, governing documents, and ownership registers, among other things. A company should keep

these documents in a binder at its principal place of business.

Personnel

Like any start-up company, a new fund manager should have a well-balanced management team. The company may also have a board of directors or advisors. California law generally requires corporations to have a board of directors.

The company should categorize every individual as an "employee" or "independent contractor". The difference is significant because various tax and labor laws apply to the former but not the latter. The company should execute written agreements with everyone and perhaps distribute policy handbooks.

Compensation and Distributions

The founders should make plans for compensating the personnel and making distributions to the owners. These issues are usually addressed in the bylaws or shareholders' agreement of a corporation, or the operating agreement of an LLC.

If your company lacks the cash to pay "fair market value" to its service providers, consider alternative forms of compensation such as deferred salaries, equity interests, profits interests, special allocations, stock options, warrants, stock appreciation rights, phantom stock, revenue share, free publicity, and bartered services. Not every form is available to every company.

Risk Management

Managing private equity funds is a high-risk business activity. Wealthy investors have both the motivation and the means to sue for damages when investments fail to meet expectations.

Doing business as a corporation or LLC is one method for managing risk. However, the liability protections of those entities are not airtight. The business managers and owners may incur personal liability under certain circumstances, such as (i) commission of a crime, tort, or statutory violation; (ii) breach of contract; (iii) breach of fiduciary duty; and (iv) treating the business as an "alter ego".

The following steps may reduce the risk of personal liability:

- capitalize the company sufficiently to meet initial expenses
- obtain liability insurance, especially "Errors and Omissions"
- execute written agreements for all transactions
- act in compliance with applicable law and agreements; amend the agreements as necessary
- avoid commingling funds, keep separate records, and pay company expenses with company funds

Summary

The formation of a new fund manager requires many steps and inevitably takes longer than expected. The earlier you begin the process, the better.