

Restrictive Covenants and Tail Right Provisions in Seed Transactions: Balancing Seeder Protection and Key Person Autonomy

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When making a seed investment in a new fund management firm, a seeder must consider and manage the risk that the firm's key personnel could, as the business grows, attempt to convert their success into a new business outside of the seeder's economic participation rights. This type of risk is especially acute in the investment management industry, where the core goodwill of the business (essentially, the demonstrated ability to generate alpha) "walks out the door" each day.

Accordingly, a significant percentage of seed deals will include a mix of restrictive covenants and/or "tail" rights that will provide the seeder with assurance that it will not be deprived of its economics, while at the same time balancing the key person's reasonable concerns for autonomy and ensuring an ability to make a living in the event the seeded business is unsuccessful.

A seed investment is premised upon the key person's ongoing participation in the seeded business. Were the key person to leave, the value of the business could be fatally compromised – particularly if the key person is able to compete with the business (e.g., by reducing the capacity in the applicable investment strategy, or by poaching talent or existing or potential investors) in a situation where the business continues following the key person's departure.

To address this risk, many seeders require covenants from the key person that are oriented to restrict any such competition and/or solicitation for a defined period time (typically up to 24 months), thus allowing the business to regain its footing following their departure.

While protecting the integrity of the business is a fair and reasonable concern, so too is allowing the key person to make a living – particularly where the reason the key person has left the business is that the business was unsuccessful. Ideally, restrictive covenants are limited such that they only restrict actions by the key person that would be reasonably be expected to harm the existing business. For example, the concept of a "competing business" may be limited to one that manages third party capital with a substantially similar investment strategy, and the non-competition clause may specify that it will only be triggered if the key person is an owner/principal of a competing business or serves in a more senior position, versus working at the analyst level or in a non-investment capacity, or being employed in an investment capacity but for proprietary capital or a family office.

Restrictive Covenants and Tail Right Provisions in Seed Transactions

In addition to restrictive covenants, another seed transaction term designed to protect the seeder's interests is the "tail" provision, which functions by providing that if the key person leaves the business and joins, within a defined period of time, another asset management business that capitalizes on the goodwill of the legacy business, the seeder would receive a revenue share in the new business that is identical to the revenue share from the legacy business – without any obligation of the seeder to make any investment in the new business. Unlike restrictive covenants designed to protect the value of a business following the key person's departure from a surviving business, a tail right provision applies regardless of whether the legacy business continues.

Rather than limiting the key person's actions following its separation from the legacy business, a tail right allows the key person to retain full autonomy, but specifies that certain actions will result in the continuation of the revenue share. While restrictive covenants are often fairly limited in time, tail right provisions often extend for up to five years.

As with restrictive covenants, key persons wish to ensure that the operation of the tail right does not prevent the manager from earning a living, and further only applies to circumstances which approximate a significant, senior role in the new business (e.g., a "c-level" position or a senior portfolio management role). In addition, the scope of what they key person is prevented from doing under a non-competition clause versus the type of activity that would trigger a tail right is often different since, as noted, a non-competition clause is designed to prevent actions that directly harm the existing business versus the tail right which is designed to ensure that the seeder gets the benefit of the goodwill it helped to create.

Overall, although it can be difficult to negotiate these provisions given the importance of the subject matter, when properly drafted, it is possible to strike the appropriate balance between seeder protection and key person autonomy.



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If you haven't yet seen it,
request a copy of Seward & Kissel's
Seed Transactions Deal Points Study (2014-2018).

