The Structure of a First-Time Venture Fund

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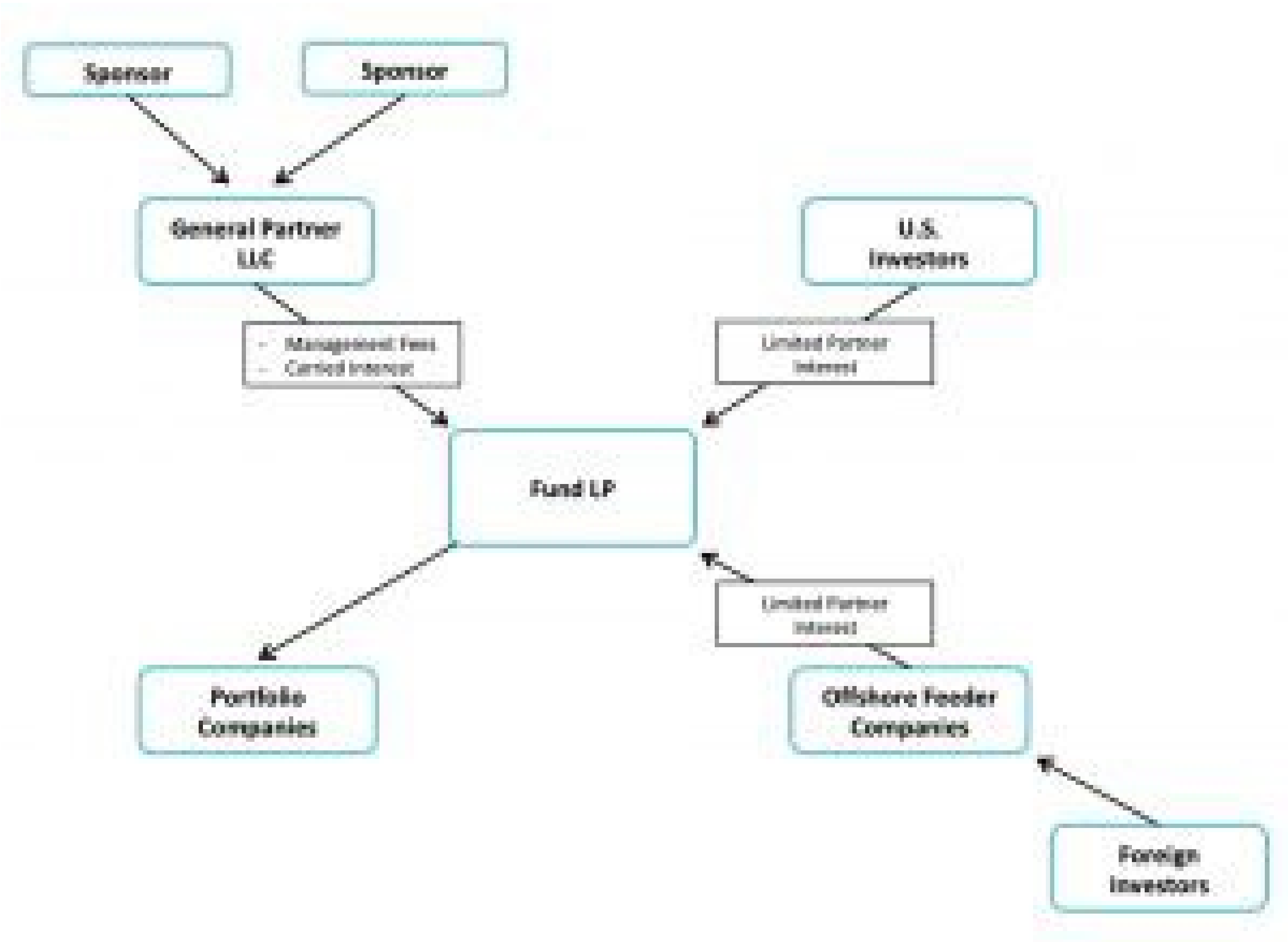
It has been over a decade since the onset of Web 2.0 has reduced the money needed to launch a company as well as the size of funding rounds. With technology enabling smaller funds to become more lucrative through better access to good deal flow, an increasing number of entrepreneurs are entering the venture fund business, often for the first time.

However, first-time venture fund managers must first close a credibility gap — without a track record, it will be hard to find investors. Many such managers create these records by helping to syndicate one-off investments in a single offering. At Royse Law Firm, we will sometimes form an entity — a special purpose vehicle, or SPV — to accommodate that offering. Occasionally, a fund promoter can go straight to an actual fund.

Recent changes in law have altered how venture funds are regulated and how fund managers are taxed on their share of gains, which is also known as “the carry” or “carried interest.” Despite these changes, the basic fund structure remains the same: it typically consists of (1) a limited partnership or limited liability company (the “Fund”), usually formed under Delaware Law, and (2) a separate entity which acts as a general partner or manager of the Fund. Oftentimes, and especially with later funds, a third entity will be formed to hold the management fee. There may also even be a fourth entity that acts as a paid consultant to the portfolio companies.

Schematically, the fund structure will appear as follows:



Theoretically, only one entity (not two to four) is required to form a fund. A separate general partner entity will be formed to isolate the economic arrangement between the fund managers from investors. By creating a separate general partner entity, the managers need not involve their investors in managerial matters, such as compensation, dividing the carry, and granting additional interests in the carry.

Similarly, the management fee can be transferred to a separate entity that would be responsible for the overhead expenses for the Fund and possibly other funds. Not only can separate entities function as a shield against bankruptcy, but they can also serve as vehicles for dividing different income streams.

The managers may be determined to act as investors and general partners in their own funds, but under current tax rules, they would be advised to invest separately from their general partner interest to avoid being subject to a longer capital gains holding period.

This article was written by Roger Royse before joining Haynes and Boone.”