SIDECAR FUNDS FOR ANGEL GROUPS: A BRIEF INTRODUCTION

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Sidecar funds are an increasingly popular part of the angel investment landscape. The following is a brief introduction to them in question and answer form.

What is a sidecar fund?

For purposes of this article, a sidecar fund is a pooled investment vehicle that invests alongside an angel group. In this respect, it is different from the vehicles that some groups form for particular investments or as the principal investment structure for the group.

Why should an angel group consider a sidecar fund?

There are four basic reasons:

1. The sidecar fund opens angel investing and the activities of the group to persons who want to be passive investors or who do not feel qualified to invest on their own. The fund gives those persons access to the asset class, and may lead to new active members for the group.

2. The sidecar fund provides a way for members of the group to allocate part of their funds to angel investing in a balanced manner across all of the group's investments. This can supplement their personal active portfolio.

3. The sidecar fund gives the group additional "critical mass" when it invests with institutional investors or leads rounds of investment itself. The ability to invest more money through the group may give it a seat at the table in negotiations with institutional investors or governance or enable the group to lead a somewhat bigger investment round than the group members themselves could afford.

4. Investors in the sidecar fund typically are charged a management fee with respect to capital under management. The fee can be used to defray costs of the angel group (such as salaries of an executive director and other staff or costs of group meeting) and to lower dues.

What is the typical structure of a sidecar fund?

The structure of a sidecar fund has to satisfy two basic requirements: it has to provide strong liability protection for investors in the fund, and it must be a pass through vehicle for tax purposes. No passive investor will willingly accept financial risk beyond his or her capital commitment, and no tax should be payable at the entity level.

In practice, this means that in most states the fund will either be a limited liability company or limited partnership. Properly structured, each ordinarily provides strong liability protection and good tax attributes. The angel group must be somewhat careful using a limited liability company since the form is not treated as a pass through for tax purposes in some states.

Most frequently, Delaware is chosen as the domicile for the fund. It has modern limited liability company and limited partnership statutes that are regularly updated. Most sophisticated legal practitioners are familiar with the provisions of these statutes.

Agreements for limited liability companies and limited partnerships used for venture capital and private equity funds generally can be quite complex. It is important that documents for the angel sidecar fund be comparatively short and straightforward in keeping with the size of the fund. This will help reduce the cost of preparation of documents and also facilitate understanding by the group and investors. Many of the provisions which contribute to the length of venture capital fund documents are unnecessary in a sidecar fund context.

Who makes investment decisions for the sidecar fund?

Ideally, investment decisions for the sidecar fund should mirror the decisions of the angels in the group. In one classic model, the fund should invest if a specified number of angels (perhaps 5) invest at least a minimum amount (perhaps $250,000 in total). This assures the investors in the fund that they are benefitting from the investing expertise of the angels in the group and that their interests are truly synchronized with those of the decision makers (who are "putting their money where their mouth is"). The fund would then invest on a formula basis (pro rata in some sense) with the angels in the group. Different decision-making rules may apply to follow-on investments.

That said, the fund should also have another decision-making body which can supplement the group's decision making or overrule it. Some flexibility is desirable in any good structure. There will be times when the decisions of individual angels reflect a desire to rescue a prior failing investment, rather than a good new idea. There may also be rare times when a pro rata investment does not seem enough: the opportunity is too great. In each situation there should be flexibility to deviate from a pure rule-based investment.

The alternative decision-maker could be a board of directors or other governance body of the angel group or another specially constituted committee. Membership should rotate in order not to burden particular individuals and to provide fresh sources of ideas. Conflicted members should be disqualified for particular investments and replaced temporarily with other members of the angel group who are not similarly conflicted. Sidecar fund documentation should anticipate the possibility of conflicts of interest and deal with them directly.

Some groups follow more of a venture capital fund model in which designated individuals, perhaps including professional staff, make investment decisions. This works well for some groups, but may be somewhat less attractive to investors seeking a group perspective.

How big should a sidecar fund be and how much should the minimum contribution be?

$5 million to $10 million is a good size for a sidecar fund. Some groups target amounts between $2 million and $5 million, but the costs and administrative responsibilities may dictate a fund of more than the minimum size.

Generally, target investment commitments should be at least $100,000 and ideally at least $250,000. The angel group should avoid having too many small investors.

What are the sources of capital for sidecar funds?

Most often capital is provided by individuals seeking exposure to the asset class. In some cases, family offices may show interest for the same reason. Small institutions could be investors, but, in my experience, they have yet to show significant interest.

How long will it take to raise a sidecar fund?

This is hard to say. Sponsoring groups should certainly allow at least six months, but they should always expect that fundraising requires more time than anticipated.

What laws apply to the sidecar fund?

The fund, itself, will be governed by state limited liability company or limited partnership laws. Final documents and operations must follow such laws. Except to the extent varied in fund documents, state fiduciary duty laws will apply.

Fundraising for, and operation of, sidecar funds takes place at the intersection of numerous securities laws and other laws. The federal Securities Act of 1933, Securities Exchange Act of 1934, Investment Company Act of 1940 and Investment Advisers Act of 1940 and state Blue Sky law all potentially apply. Care must be taken to remain exempt from registration under each of those laws, and to comply with any applicable substantive provisions.

The sidecar fund also must comply with Subchapter K of the Internal Revenue Code of 1986 and complex regulations under it. These often dictate acceptable approaches to capital accounting, allocations of profit and loss and the interplay of distributions and taxable income. Failure to follow the regulations can result in disallowance of allocations or unexpected tax costs. Experienced fund accountants and tax advisors are essential.

Who receives compensation from the sidecar fund and in what amounts?

As noted, typically the sidecar fund pays a management fee to the angel group. Indirectly, therefore, it compensates employees of the group, if any. The amount of the fee varies but often resembles a typical fund fee in the 2 to 2 ½ % of capital commitment range.

Compensation based on profit (a “carried interest” or “carry”) is also appropriate. This could be allocated in part to those in charge of actual operations of the fund (senior angel group staff, for example) and in appropriate amounts to the rotating members of the decision-making group. Rights in carried interests should vest according to a formula, and portions of the carried interest that do not vest should be returned to the fund. Some funds charge outside investors a higher carry than investing angel group members in recognition of the contribution of the group members to the decision-making process.

What are the costs of a sidecar fund?

Organization, start-up and syndication costs can be high, and the angel group should be alert to scale those costs (typically paid by investors) to the size of the fund. It would not be unusual for the cost to be at least $35,000-50,000.

Principal ongoing costs are for audit and tax services. These should be discussed with the experienced accountant chosen and, again, should scale to the size of the fund.

Ongoing legal fees, other than for deal work, should be small once the fund is established.

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Sidecar funds present opportunities and advantages for angel groups and their members. However, they need to be carefully structured and planned in light of the often-complex issues they raise.