Compensation for Angel Group Leadership

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The organized angel group movement is maturing. As angel groups are growing in membership, portfolio size, experience, increased effort and involvement are required to manage each group.

Angel groups often start with volunteer members doing the work. Over time, some angel groups remain member-led and managed. Other groups compensate members who do additional work, sometimes on rotation, and still other groups hire professional managers, who may be full- or part-time.

Based on 2009 data, just over half of all 165 angel groups that belong to the Angel Capital Association are led by their member angels and the remainder are led by non-affiliated professional management.

When angel groups talk about their approach to management, some groups feel very strongly about having non-member professional managers. In other groups—especially where there are individuals willing and able to invest a lot of time—members share the work, sometimes taking turns and sometimes relying on a few participants to carry the load.

This article discusses approaches to compensating angel group managers whether they are group members or hired from the outside. It also discusses the effects of an angel group's investment structure on available methods of compensation.

It takes work to lead an angel group.

Whether an angel group is organized as a network, a network with a sidecar fund, or a fund, the type of work that has to be done to sustain membership and keep the group operating and investing successfully is similar. Virtually all groups must engage in member recruitment, communications with members and companies, investment acitivies, and relationships with legal counsel and other service providers. Many groups also engage in member activities, education, and skill-building. All of these concerns can be managed by either members (paid or volunteer) or a non-affiliated professional manager. If a hired manager is taking the lead with respect to these activities, member participation is nevertheless essential.

A variety of investment-related tasks must also be addressed in a manner that ensures continuity from reporting period to reporting period and as people make transitions and responsibilities change. These may include fund raising, deal flow, deal negotiation and management, due diligence, valuation, syndication, financial and tax reporting, and investment record-keeping. As admirable as the all-volunteer model is, continuity that depends on the will and availability of individual members may be difficult to sustain and replicate over time.

In addition to membership and investing activities, there are ongoing administrative duties in an angel group that can range from returning telephone calls and filing, to organizing and coordinating meetings and events, to maintaining member records. If the angel group has an office, there are also office management responsibilities. Many angel groups outsource these activities or hire a full- or part-time office manager or administrative support specialist to handle them.

Whether a group is member-led or professionally managed, a board of directors (or a similar group) usually provides oversight. In the case of member-managed organizations, the board also may be directly responsible for some of the membership and investment activities.

Does management compensation have a place in angel groups?

If members assume that the burdens and benefits of managing the angel group are being shared equally, then they may see no particular reason to pay anyone. However, work will always expand with the size and success of the group. At some point, especially as the angel group gains its footing, deal flow is good, and the portfolio has 10 or 12 companies or more to manage, the work involved may exceed what volunteers can or want to do. This may be true even when a very competent office manager or administrator performs the basic administrative tasks for the group.

The challenge with unpaid management is simply that it is unpaid. Donated work is great, but paying a person for doing a job assigns a certain value to the work. More effort and performance can be required from a manager who is being paid by the group, whether the person being paid is a group member or an unaffiliated professional manager. In the best sense, angel group members have a reason to expect specific commitments and certain levels of activities from paid members or managers.

It sometimes happens in member-managed groups that those bearing the unpaid management burdens may feel resentment toward those who are “deflecting” responsibility. At the same time, those members who do not participate in management of the group may feel less connected to the group and even resentful of the “power center.”

How much compensation is necessary for an angel group to attract the right manager?

Compensation must be sufficiently robust to enable the angel group to attract well-qualified individuals to assist the group, whether those individuals are members or otherwise. There is competition for the kind of talent needed, so it is important for an angel group to test the membership’s willingness and ability to create an appropriately competitive package that will interest the type of candidates they want.

A significant number of groups responding to a 2007 ACA study on leadership compensation reported total annual manager compensation of $50,000 to $100,000. According to the survey, aggregate compensation in excess of $100,000 per year is not unusual, but is in the minority. Yet, in other than extraordinary circumstances, angel group budgets probably cannot support salaries that are fully competitive with venture capital firms or match the VC incentive compensation structure. Managers looking for that level of compensation would be best served to go to a VC firm.

Fortunately, compensation is not the only reason that capable managers take jobs managing angel groups. Many very accomplished managers simply enjoy working with angel groups and the people that angel groups attract, and may prefer managing an angel group to venture capitalist positions.

For the right professional, managing an active angel group has additional appeal. The job can be a stepping stone to developing relationships in the local business community, an opportunity to be hired as an officer of a portfolio company, or a path to joining a venture capital firm.

There are also group members who want to contribute to the success of the angel group and are willing to manage the group on a part-time basis at less than venture capitalist market rates. A full- or part-time stint with an angel group also can be quite a good fit for well-qualified individuals who are gearing down but remain interested in part-time work.

What are the sources of the money to pay angel group managers?

Sources of revenue available for paying angel group managers vary but include dues, sponsorships, and management and performance fees from funds. The total compensation that an angel group can pay will be determined in part by how large the group is. Larger groups ordinarily can afford to pay more simply because they typically have more dues and sponsors; smaller groups generally have budgets that are more limited.

In certain circumstances, there may be economic development agency funds or other sources of revenue that will allow groups to pay more than dues, sponsorships, and fees would otherwise be able to support. (Compensation from portfolio companies, which can occur if the angel is hired as a consultant or employee, or recruited for the board, is subject matter for another article.)

What forms of compensation should be considered to pay angel group managers?

Effective and fair compensation for managers of an angel group can include a mix of salary, benefits, bonus, and other performance-based compensation, such as a carried interest. The amounts of salary and benefits will vary based on the time invested, the resume of the manager, the attributes of the angel group, and numerous other factors, but in each case should be set appropriately to attract the right people.

Performance-based compensation can take many forms. The easiest to describe is a simple discretionary bonus which is paid at the discretion of the angel group’s board. More complex bonus arrangements can be tied to a formula or the achievement of management objectives. The salary and bonus portion of a professional manager’s compensation is typically set through a board-approved budget process.

As will be discussed in greater detail below, it may be reasonable to make compensation of professional management more attractive by paying the management a percentage of profit from investments. This payment of profit may be built into a bonus or may be set up as a "carried interest" or "carry" similar to the carry received by venture capitalists.

Carry may be an attractive compensation alternative; availability of a carry will depend on the structure of the angel organization.

Ordinarily, a carry is a profit allocation which provides direct participation in profits from investments. Carry provisions can be fairly straightforward or more complicated, depending on how an angel group is structured. The traditional forms of carry involve allocations from a commingled investment vehicle such as a sidecar fund or investment limited liability company (LLC).

Once an angel group decides to provide a carry to managers, a series of questions follow naturally: How much will the carry be? What percentage of the carry will the member-manager or professional manager receive? How will the carry vest?

Aggregate carry percentages and the manner of calculating them vary. Some funds pay 20 percent of profit after the return of capital. Others pay 10 to 20 percent of profit after a certain hurdle rate (a threshold return to investors) is achieved. Still others pay 20 percent of profit but have catch-up provisions so that the owner of the carry earns 20 percent of the initial hurdle rate as well.

Angel group funds may have different percentages of carry that are charged to the capital accounts of angel group members and outside investors. Such differences are easy to justify. Angels in the group help with the investment and create value that is larger than the checks they write. Their work on investments and companies is good reason for angels to be charged a lower carry on their investment than other investors who do not participate in this way.

If there is a carry, who should receive it?

Even in angel groups with professional managers, those managers are often not alone in managing the fund. By their very nature and interests, angel group members are usually involved in directly advising the portfolio company or participating in the board of directors. A portion of the carry can be allocated toward compensating these angels for their increased involvement.

The boards of directors of most angel groups are staffed by volunteers. Giving these members part of the carry of a commingled investment vehicle sponsored by the group shows respect and backing for their additional contribution and special leadership role. However, if this is done, potential conflicts of interest and a loss of "volunteerism" are also considerations.

How does carry awarded to angel group managers vest?

Typically, when a carry is allocated to a manager, either time must pass or certain events must occur before the manager is fully entitled to that carry. In the terminology that is usually used, the carry “vests” either when the requisite time passes or the event occurs.

Vesting structures vary from fund to fund; however, often a certain percentage of the carry vests immediately following organization of the fund and is, in essence, compensation for the hard work of organizing the fund. The balance of the carry will thereafter vest over the life of the fund and be available to compensate management of the fund for overseeing fund investments throughout its term.

If the manager leaves before the time passes or the event occurs, the unvested carry is lost by the manager. (The carry divests.) Vesting provisions become particularly important because carry will be needed to provide incentives for a replacement manager to manage the fund and be responsible for its success. However, dealing with this unvested portion of the carry can create difficult structural issues. Often, for example, the replacement for a departing manager has not been selected at the time the departing manager loses the carry so the percentage interest represented by the carry must “go” somewhere until a new manager is on-board.

Anticipating the possibility of these circumstances, one alternative is to establish an entirely separate legal entity that effectively holds the carried interest. The people who are earning the carry and the fund itself can both be participants in the entity. When an angel group manager leaves and divests, the unearned carry returns to the fund through an increased ownership interest in this separate entity.

In this scenario, to the extent that the carry is not earned, the fund seamlessly retains the unearned carry through its participation in the separate entity that holds the carry. When there is a need to grant more carry to provide ownership to a new manager or to angel group members or directors, it can be granted directly as a new interest in the separate entity, thereby reducing the fund’s interest in the unearned carry.

Angel group structure and the existence of investment vehicles may determine whether use of carry is feasible.

In the end, the structure of an angel group and its investment approach usually determines whether carry is an effective compensation tool.

Network model: In the network model for an angel group, paying a combination of salary, bonus, and benefits is perhaps the only practical option. The investments of this type of angel network are not commingled. As a result, measuring and compensating a manager through carry or as a percentage of profit is difficult. Groups seeking to compensate managers in this way would face issues associated with asking investors to provide information about their profits and then to pay them for performance. Moreover, appropriately accounting for losses would be challenging.

Angel network with single investment LLCs: A combination of salary, bonus, and benefits is likely also the best option for angel groups that invest through single investment LLCs or partnerships. Creating a carry can be accomplished on an investment vehicle by vehicle basis. However, since carry is then paid on the gain and not repaid on losses, this will result in an overpayment to some managers in some cases. Because membership in a particular investment vehicle will likely not match membership in other investment vehicles, losses cannot simply be "charged" and accounted for.

Angel fund: Angel groups that are organized as a fund or as a network with a sidecar fund can have salary, bonus, and benefits plus additional options for funding and providing compensation. Carry works well in this structure and the participants in the fund can also be charged a management fee which is paid to the angel group for distribution as the group's board of directors determines is appropriate.

Engage experts who are familiar with legal and tax considerations of carry.

Under current law, granting and divesting carry in a fund or other commingled vehicle should not result in a taxable event. However, questions that can arise in structuring the carry are sufficiently different from the normal range of tax and legal questions that they do require specialized expertise.

Look for a sophisticated tax attorney who has a specialty in subchapter K and who deals with LLCs, partnerships, and other pass-through vehicles. Issues related to carry and these investment structures are distinctive competencies and not matters that the average attorney who structures LLCs and partnerships usually considers. The same is true on the accounting side. Choose an accountant with experience with these specific issues.

Conclusion.

There is no one management structure or compensation model that fits all angel groups. Solutions will vary based on the structure, membership, size, skills, portfolio, and maturity of the angel group.

Compensating managers and members performing management functions should be important to most groups. Good compensation provides an incentive to managers and members, an attraction to the right people, and, perhaps most importantly, a tangible reward for good work performed.

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