Private Equity Funds Clawbacks and Investor Givebacks

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LPA Economic Provisions

- The economic provisions in a LPA set out how fund managers are remunerated and how profits are shared between investors and the GP. The relevant concepts (many of which have, or will be, discussed in other presentations) are:
  - Distribution waterfall
  - Preferred return (i.e., 80/20 distribution of the carry with which we are concerned)
  - Clawback / Giveback / Escrow provisions (i.e. protecting against overpayment of the carry to the manager)
  - Transaction fees
  - Management fee
- When considering distribution provisions there is a tension between the need to incentivize the GP while protecting the LPs from overpayment of distributions (e.g., a deal-by-deal distribution waterfall for a fund that performs well initially, makes distributions and then makes loss-making investments).

There are references in this presentation to the "ILPA Principles." ILPA is the Institutional Limited Partners Association that provides a set of private equity principles for the best practices of general partners and limited partners with respect to the private equity industry. To date, there have been two versions of the ILPA Principles, and they can be found at http://ilpa.org/ilpa-private-equity-principles/.

Reminder Example – Distribution Waterfall – US Based PE Fund*

- Distributions of Distributable Cash Attributable to Portfolio Investments. Distributable Cash attributable to any Portfolio Investment (including income from Permitted Temporary Investments realized pending investment in such Portfolio Investment or pending distribution of Distributable Cash relating to such Portfolio Investment) shall initially be apportioned among the Partners (including the General Partner) in proportion to their respective Percentage Interests relating to such Portfolio Investment. The amount apportioned to any Limited Partner pursuant to the preceding sentence shall then be immediately reapportioned as between such Limited Partner on the one hand and the General Partner on the other hand and distributed as follows:

  (i) Return of Capital and Costs. First, 100% to such Limited Partner until such Limited Partner has received cumulative distributions from any dividends or interest income received by the Partnership and paid to the Partners pursuant to any other provision of this Agreement and from distributions attributable to all Realized Investments in an amount equal to the sum of: (A) the aggregate of such Limited Partner's Capital Contributions relating to all Realized Investments, and (B) the product of: (x) such Limited Partner's Capital Contributions which were applied to the payment of all Offering Expenses, Organizational Expenses and Partnership Expenses (including Management Fees) and (y) a fraction, the numerator of which is such Limited Partner's Capital Contributions relating to all Realized Investments and the denominator of which is such Limited Partner's Capital Contributions relating to all Portfolio Investments;

  (ii) Preferred Return. Second, 100% to such Limited Partner until the excess of: (A) the cumulative distributions to such Limited Partner attributable to all Realized Investments over (B) the amount described in (i) above with respect to such Limited Partner, equals eight percent (8%) per annum cumulative return, compounded annually, on the amount so described in (i) above;

  (iii) General Partner Catch-Up. Third, 100% to the General Partner to the extent, if any, necessary so that the cumulative distributions to the General Partner relating to such Limited Partner equal 20% of the sum of the cumulative distributions to such Limited Partner attributable to all Realized Investments (other than such distributions described in (i) above plus the cumulative distributions to the General Partner relating to such Limited Partner; and

  (iv) 80/20 Share. Thereafter, 80% to such Limited Partner and 20% to the General Partner.

- Distributions of Distributable Cash Not Attributable to Portfolio Investments. Distributable Cash not attributable to Portfolio Investments shall be distributed to all Partners (including the General Partner) in proportion to their respective proportionate interests in the Partnership property or funds that produced such Distributable Cash, as reasonably determined by the General Partner.

* Note: First, this example includes the following concepts: (i) an aggregate distribution approach whereby distributions are done based upon all investments rather than on a deal-by deal basis except that the return of capital is based only on realized investments; (ii) a return of capital contributions used to fund management fees and organizational expenses; (iii) a preferred return that includes an accrual for management fees and organizational expenses as well as a general partner catch-up provision; and (iv) a provision that short-term investments are not included in the carried interest calculation. Second, defined terms used herein are explicitly defined in the limited partnership agreement.

Reminder Example – Distribution Waterfall – UK Based PE Fund[1]

- **Distributions of Income and Capital:** All amounts allocated to the General Partner, the Limited Partners and the Carried Interest Partner shall, after payment of or making appropriate provision (if any) for costs, liabilities, Tax, expenses and working capital requirements of the Partnership and taking into account where appropriate payments (if any) required to be made to Defaulting Limited Partners, be distributed in the following order:-
  - (i) General Partner Management Fee: firstly to the General Partner in respect of the amounts payable to the General Partner in relation to the Priority Profit Share (i.e. management fee) which have not been paid;
  - (ii) Return of Limited Partner Loans[2]: secondly to the Limited Partners (pro rata to their respective Capital Contributions) until they have received back their aggregate drawn down Commitments;
  - (iii) Preferred Return: thirdly to the Limited Partners (pro rata to their respective Capital Contributions) until aggregate distributions under this paragraph (c) are equal to the Preferred Return (8%);
  - (iv) Catch-up: fourthly 80% to the Carried Interest Partner and 20% to the Limited Partners (pro rata to their respective Capital Contributions) until the Carried Interest Partner has received amounts equal to 20% of the total amounts distributed to Limited Partners under paragraph (iii) above and to the Limited Partners and the Carried Interest Partner under this paragraph (iv); and
  - (v) 80/20 Share; thereafter 80% to the Limited Partners (pro rata to their respective Capital Contributions) and 20% to the Carried Interest Partner,

  provided always that each of the above sub-clauses shall be reapplied de novo in respect of each new distribution and in all cases after payment of or making appropriate provision (if any) for costs and expenses and working capital requirements of the Partnership and taking into account where appropriate payments (if any) required to be made to Defaulting Limited Partners.

[1] Note: First, this example includes the following concepts: (i) payment in accordance with the distribution waterfall is made after payment of or provision for costs, liabilities, taxes, expenses and working capital requirements of the Partnership (ii) a “whole fund model” approach whereby the limited partners must be repaid all of their drawn-down loans and preferred return before the carry begins to operate; (iii) a priority distribution to the General Partner, made for VAT purposes (to be discussed in another presentation). Second, defined terms used herein are explicitly defined in the limited partnership agreement.

[2] Note: UK LPs are funded by each investor making a capital contribution of a nominal amount only and the rest of its investment by way of a loan to the limited partnership. The reason for this is that the capital contribution represents the amount of the liability of each limited partner to thirdparties and that liability remains, even if the capital is returned to the limited partners.

Key Concepts for Clawbacks/Givebacks

- What are the timing issues that funds face?
- How are tax considerations relevant?
- What is a clawback / giveback?
- How can the repayment of a clawback / giveback be secured?

General Timing Issues

- Funds generally invest in several portfolio companies over a three to five year period, however, the investment periods can vary dramatically (3-7 year holding periods are common).
- Aggregation, the practice of netting gains and losses from different investments, has become all but universal but the issue with identifying the point or points at which the profitability of a fund should be calculated remains controversial.
- The interests of the sponsor and investors are not aligned here. For an investor, they do not know that their investment has been profitable until their capital commitment has been returned with the exact amount of profit unclear until the fund is liquidated.
- The best outcome for investors is to restrict distributions of carry until the investors have recovered their capital contributions. This is considered best practice in the ILPA Principles. This approach is common in Europe but rarely followed in the US.
- Instead, most US funds operate on the implicit assumption that unrealized investments will generate proceeds at least equal to their carrying value.
- Three key factors are largely responsible here are:
  - the calculation of carry on a deal-by-deal (rather than fund as a whole) basis;
  - the resistance of sponsors to returning all capital commitments in priority to carry as this would defer carry distributions until late in the life cycle of a fund; and
  - tax considerations (considered further in the next slide).
- Factor 1 has been discussed in the slides dealing with carry; factor 2 goes to the question of management incentives and factor 3 is considered in the next slide.

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Tax Considerations

- As we know, the flow through character of carry results in lower tax rates than would be the case with an incentive bonus taxed as ordinary income.
- However, if carry is to be taxed at favorable capital gains rates, capital gains of the fund need to be allocated to the GP in a manner which would be respected by the tax authorities.
- Generally, allocations of income and loss are respected for tax purposes if they are determined by reference to the capital accounts of the partners in the fund.
- The key problem is that taxes are required to be paid with the tax return filed for the year in which the income is allocated, whether distributions have been made by the fund or not.
- Given the obvious preference for this favourable tax treatment – even though it may create a unfunded tax liability for the GP and sponsor – where funds do defer carry until repayment of committed capital to investors they provide for a partial distribution of cash to the GP to cover taxes on the carry allocation.

Clawbacks

- A contractual provision that adjusts for distortions of the intended economic bargain attributable to the timing of gains and losses (discussed on the previous slides).
- Clawback provisions:
  - are generally triggered when the fund is being liquidated and wound up (see below for triggers)
  - depending on interim distributions may oblige the GP to return all or a portion of carry already distributed
  - returned amounts are then distributed to investors
- Tax is often a key factor in clawback negotiations – why?
  - Some portion of distributed carry is used to pay taxes. Sponsors argue that they can't return what they no longer have and seek to limit clawbacks to the after-tax portion of interim carry distributions. Additionally, determining the actual taxes paid on each dollar of carry – distributed, potentially, to several partners of the GP – is fraught with difficulty.
  - Most investors accept the argument that that the use of a hypothetical tax rate represents a reasonable and cost effective method of determining the reduction in the clawback amount. Importantly though, the IPLA Principles state that clawbacks should be grossed up for taxes.
- Timing of the triggering event depends on the type of fund?
  - Either if the GP receives more than 20% of profits (however defined), which is common; or
  - If the investor has not received their full preferred return over the life of the fund.

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Recovering Carry – Security/Escrow

- If a fund has a clawback, investors will be concerned about the sources of payment if the obligation is ultimately triggered.
- Distributions received by the GP (including of carry) are ordinarily immediately redistributed to the sponsors and other persons with equity interests in the GP. This means that a GP cannot often be relied upon to have the resources to satisfy a clawback.
- The options for investors:
  - Sponsors and other persons with equity interests in the GP can guarantee the clawback obligation;
    - ➢ Guarantees are often limited to the portion of the carry received by a particular equity holder. Joint and several guarantees are generally not considered useful given the limited ability of one equity holder to collect amounts owed by others.
  - Reserving a portion of the carry in escrow in order to satisfy any future clawback obligations.
    - ➢ Sponsors resist reserving the entire after-tax portion of carry distributions as it differs the carry until late in the life of the fund.
    - ➢ Reserve accounts representing half of the after tax carry are more common.

Summary – Negotiating Points

- Basic Concepts:
  - Clawbacks / Givebacks: Manager is contractually obliged to pay back any overpayment of carry received throughout the term of the fund when the fund is ultimately liquidated.
  - Security / Escrow: Either guarantees are given by equity holders in the GP; or, distributions in respect of carry are retained in an escrow account to be set against any overpayment.
  - Clawback / Giveback / Escrow mechanisms are required because LPs want protection from overpayment of carry to the manager as the manager will often receive carry before the final liquidation of the fund and, therefore, before the aggregate net gains of the fund can be calculated.
- Negotiation issues for LPs:
  - A manager should not receive more than its entitlement. This is not contentious. There is tension between rewarding early performance by the management team and the continuing risk that poor performance later in the term of the fund will result in the manager having received more than its entitlement to profits.
- Compromise - in a world where investors want more protection:
  - Total subordination of the managers right to proceeds – until there is no risk of overpayment of carry – is not the norm in the US, Europe or elsewhere.
  - For a deal-by-deal distribution waterfall, which has a greater risk of an overpayment of carried interest attached, an escrow is considered to offer greater protection. A compromise can be reached on the use of an escrow by agreeing that only a portion of the carry is held back. Distributions need to at least cover the managers tax liability.
  - For a fund-as-a-whole distribution waterfall, it is often argued that a clawback was sufficient.

Clawback – UK Example in the LPA (read together with the Escrow provisions on the next page)

- Upon the liquidation of the Partnership, if the Carried Interest Partner (i.e., the Manager) has received, over the life of the Partnership, more by way of Carried Interest than it would have been entitled to had the Carried Interest calculations been made on an aggregate basis at the time of the final distribution, the Carried Interest Partner shall contribute an amount equal to the excess to the Partnership for distribution to the Limited Partners. The Carried Interest Partner shall use reasonable efforts to make any such contributions within two years of the date of recognition of such liability.
- For the avoidance of doubt, the amounts so payable by the Carried Interest Partner under this clause shall not exceed the aggregate amount of distributions received by the Carried Interest Partner as Carried Interest calculated in accordance with the provisions of this Deed, less the amount of any irrecoverable Tax in respect of the Carried Interest suffered by the Carried Interest Partner or assessed on or assessable on the Carried Interest Partner or any person entitled to any interest in the Carried Interest or any part thereof through such Carried Interest Partner, after taking into account any Tax benefits received by any such person as a result of a repayment being made pursuant to this Clause by the Carried Interest Partner as certified by the Auditors.

Escrow – UK Example in the LPA (read together with Clawback provisions on the previous page)

- The Carried Interest Partner shall deposit 20% of the Carried Interest it receives into the Escrow Account. Sums deposited in the Escrow Account may not be withdrawn other than: (i) pursuant to this Deed; (ii) in order to meet any payment obligation under this Deed; (iii) to the extent that the amounts held in the Escrow Account are more than sufficient to meet any obligations of the Carried Interest Partner (on the assumption that all unrealized Investments are realized for zero consideration, that all remaining undrawn Commitments are drawn down and invested and the Investments so acquired are realized for zero consideration, and that the Partnership has no assets available for distribution), in which case any amounts in excess of any payment that could be required to be made shall be released to the Carried Interest Partner; or (iv) upon the termination of the Partnership or, if earlier, the date on which all Investments have been realized and the proceeds therefrom distributed pursuant to the terms of this Deed. All assets held from time to time in the Escrow Account shall be held in the name of the Carried Interest Partner, shall not be treated as Partnership Assets and for all purposes of this Agreement shall be treated as having been distributed by the Partnership to the Carried Interest Partner.
- An advance payment on account of any irrecoverable Tax against any partner of the Carried Interest Partner (or other person having an indirect economic interest through such partner) by any relevant tax authority in respect of its share of an allocation of Carried Interest made to the Carried Interest Partner may be distributed to the Carried Interest Partner from the sums standing to the credit of the Escrow Account. Interest or other equivalent payments accrued on the Escrow Account may be distributed to the Carried Interest Partner as soon as practicable after the end of the calendar quarter in which it was received and at such other times as the Carried Interest Partner may determine. Any distribution made pursuant to this clause shall not be repayable by the General Partner, without prejudice to its obligations above.

Clawback – US example

- Clawback Attributable to Return of Capital Contributions Plus Preferred Return: If, following the dissolution, winding up and termination of the Partnership and the distribution of all or substantially all of the Partnership's assets, (i) the aggregate amount received by any Limited Partner does not equal or exceed (ii) an amount equal to (A) such Limited Partner's Capital Contributions applied to the purchase of Portfolio Investments, plus (B) amounts paid by such Limited Partner in respect of Partnership Expenses (including Management Fees) plus (C) an amount sufficient to provide a [___]% per annum return, compounded annually, on the amount set forth in clause (A) and (B) above, the General Partner shall immediately contribute to the Partnership for payment to such Limited Partner an amount equal to the excess of the amount set forth in clause (ii) above over the amount set forth in clause (i) above, provided, however, that the amount which must be repaid by the General Partner to the Partnership in respect of any Limited Partner shall not exceed the amount distributed to the General Partner pursuant to (or by reference to) its Carried Interest in respect of such Limited Partner after deducting from such amount the aggregate income tax liability of each Person whose tax liability is determined by reference to the income of the General Partner determined by using the Assumed Income Tax Rate.
- Clawback Attributable to Excess Carried Interest Generally: In addition, if, following the dissolution, winding up and termination of the Partnership and the distribution of all or substantially all of the Partnership's assets: (i) the aggregate amount distributed to the General Partner with respect to any Limited Partner exceeds (ii) twenty percent (20%) of the excess of (A) the sum of the aggregate distributions received by such Limited Partner, plus the aggregate amount distributed to the General Partner with respect to such Limited Partner over (B) an amount equal to such Limited Partner's Capital Contributions to the Partnership applied to the purchase of Portfolio Investments and amounts paid by such Limited Partner in respect of Partnership Expenses relating to Portfolio Investments, then the General Partner shall immediately contribute to the Partnership for payment to such Limited Partner an amount equal to the lesser of (1) the excess of the amount set forth in clause (i) above over the amount set forth in clause (ii) above and (2) the aggregate amount distributed to the General Partner with respect to such Limited Partner (less any portion of such distributions paid to such Limited Partner pursuant to the immediately preceding sentence), reduced by the aggregate income tax liability of each Person whose tax liability is determined by reference to the income of the General Partner determined by using the Assumed Income Tax Rate. Each such payment to a Limited Partner shall constitute a guaranteed payment (within the meaning of Section 707(c) of the Code) to such Limited Partner, and the related deduction shall be allocated solely to the General Partner.
- Notes: The above language: (i) assumes that the Fund is a limited partnership; (ii) includes defined terms that would be precisely defined in the Limited Partnership Agreement for the Fund, and (ii) assumes that the clawback obligations of the GP are net of all income taxes attributable to their receipt of excess Carried Interest.

Further information

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