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Investment Funds Group Update: Emerging Issues for GPs and LPs Relating to Carry

In these more sobering times, with many private equity funds experiencing more losers than winners on the realization of their portfolio investments, two issues have emerged. The first issue is of concern to investors – the ability of general partners to satisfy any clawback obligations if a fund pays out carry distributions but thereafter suffers a series of loss-making deals. The second issue affects carry recipients – the perceived unfairness of aggregating results from the disposition of portfolio investments for carry recipients who have little or no interest in loss-making deals and substantial interests in profitable deals, both in terms of the carry distributions they may receive and any clawback obligation that they may have.

The first part of this memorandum reviews the recent trend of incorporating interim clawbacks in investment funds and the problems with crafting appropriate language so that the general partner is not inadvertently disadvantaged to the benefit of investors. The second part of this memorandum discusses a method of mitigating the effects of aggregation in funds – commonly referred to as “tracing” – where carry recipients have different interests in different deals.

I. Interim Clawbacks.

As a consequence of the boom-bust cycle of the late 1990s and early 2000s, some investors are demanding that investment funds provide for interim clawbacks and not just clawbacks upon the termination of a fund. A clawback (or general partner giveback) is a mechanism to ensure that the general partner does not receive more than its agreed portion of the fund’s overall profits – usually a 20% profit share or carry. Typically, the clawback obligation is calculated only once, at the end of the life of the fund, after all of the fund’s portfolio investments have been disposed of or realized. Thus, investors in a fund that has been able, at first, to realize a series of winners and that has distributed carry to the general partner on an on-going basis, but then suffers a series of losers that wipes out all or some of the gain from the earlier investments, may become concerned that the general partner or the ultimate carry recipients who have received carry distributions during the early years of the fund do not have the means to satisfy their clawback obligation upon the liquidation of the fund. Interim clawbacks are being requested by some investors as a solution to this problem. Rather than wait until the end of the fund, a general partner, and the ultimate carry recipients, will be required to give back at interim intervals excess carry that they received during the life of the fund.

The timing of interim clawbacks can vary. An interim clawback may be calculated on a periodic basis, *e.g.*, every two years (or even on an annual basis), on a one-time basis, such as at the expiration of the commitment or investment period, or following the disposition of each investment.

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If a general partner is required to fund an interim clawback, the interim clawback and distribution provisions need to be drafted carefully so that they achieve their intended purpose and do not inadvertently disadvantage the general partner and provide a windfall to the investors. As an example, if an interim clawback is treated in the distribution waterfall only as a return of capital in the first step in a customary waterfall, without any additional changes to the typical waterfall (*i.e.*, first, return of capital, second, preferred return, third, general partner catch-up and, finally, the split of profit between the investors and the general partner), it may have the effect of drastically reducing the carry profit that should be distributed to the general partner.

The following example illustrates the problem. For simplicity's sake, we have not factored in a preferred return or general partner catch-up.

	Invested Capital	Disposition Proceeds	Profit/Loss
Deal A	\$200	\$300	\$100
Deal B	\$100	\$0	(\$100)
Deal C	\$200	\$350	\$150

Assume that the general partner receives a 20% carry and that it pays tax on its carry distributions at a rate of 15%. The interim clawback is done on an annual basis, and the obligation is limited to after-tax carry.

The general partner's carry distribution after Deal A is \$20 (*i.e.*, 20% x \$100). The next year, Deal B is realized. The loss in Deal B offsets the gain in Deal A. As a result of aggregating the results of Deal A and Deal B, the general partner is not entitled to any carry distribution. The interim clawback requires the general partner to refund to the investors the carry it received, net of taxes (*i.e.*, \$17).

The following year, Deal C is realized. The total capital to be returned to the investors is \$283 (*i.e.*, the unreturned capital on Deal B and Deal C of \$300, less the clawback payment of \$17). After distributing \$283 to the investors as return of capital, the balance of the proceeds from the sale of Deal C, *i.e.*, \$67 (\$350 less \$283), is split 80/20 between the investors and the general partner. The general partner will receive a carry of \$13.40 (*i.e.*, 20% x \$67). Added together with the \$3 of carry paid in taxes by the general partner, the general partner has received \$16.40 in total as its carry on all three deals.

However, when calculating the carry that the general partner should be entitled to when aggregating the results of Deal A, Deal B and Deal C, the amount the general partner should have received is \$30 (*i.e.*, 20% x \$150), and not \$16.40! The reason for the shortfall is that the general partner paid 100 cents on the dollar for the clawback, but only shares in 20 cents on the dollar in regular residual profits.

In providing for an interim clawback, there is no intention that the investors should receive a windfall at the expense of the general partner. Thus, the waterfall provisions need to be carefully reviewed (and revised, if necessary) to ensure that interim clawbacks do not lead to this result.

One solution is to provide for an additional step, an excess clawback catch-up, following the return of capital and a preferred return to investors so that the general partner is given a distribution from the remaining proceeds prior to any general partner catch-up and profits split in an amount equal to the excess of the clawback amounts that it has refunded to investors in an interim clawback, over the clawback amount that would be owed on the date of such distribution based on all distributions that have been made. Taking the example above, if we apply the excess clawback catch-up solution, after \$283 of capital is returned to the investors, \$17 of the balance of the proceeds (*i.e.*, \$67) is first distributed to the general partner (*i.e.*, \$17 (the clawback paid by the general partner) less the clawback that would be owed on the date of the distribution based on all distributions that have been made, *i.e.*, 0), and then the balance of \$50 is split 80/20 between the investors (\$40) and the general partner (\$10). Thus, the general partner will receive a total carry of \$30 (\$20 plus \$10).

Another approach is to provide that the ultimate profit split is done on a cumulative basis (net of any amounts returned by the general partner for interim clawbacks). Note that in each case, the general partners will have taxable gain corresponding to the makeup of the clawback, an amount on which they have already paid taxes. However, it should generally be the case that the tax loss that gave rise to the clawback should be available as a carryforward to negate any tax unpaid on the restoration.

II. Tracing.

The Basic Issue

A carry recipient's carry interest that differs from investment-to-investment affects the manner in which carry proceeds are allocated and clawback obligations are shared.

Differing carry interests in different deals arise in a number of situations. Investment professionals may have a greater role in some deals and therefore their contribution is reflected in the grant of a larger interest in the carry relating to those deals, compared to other deals in which their contribution is not as great. In other situations, an existing fund that wishes to engage a sought after investment professional may need to offer to protect such professional from earlier loss-making investments as an inducement to such professional's joining the fund's management team, whether by granting such person carry points only in deals made after he joins the fund, or little or no carry interests in existing investments that are probable losers. In addition, in many funds, it is not uncommon for carry percentages to be reduced upon a recipient's termination of employment, whether due to death, disability, termination for cause or without cause, or voluntary resignation (such forfeiture of carry is typically done through a vesting mechanism), and for a carry recipient to have no participation in any deals done after his termination.

If one takes the view that carry recipients with different carry percentages in different deals should be protected from losses on deals in which they have little or no carry interest if those losses offset carry distributions to the general partner (or causes clawbacks) from deals in which they have a high carry interest, then a tracing mechanism is required to track relative interests in loss deals

and profitable deals. However, tracing only mitigates, it does not eliminate, the impact of aggregation for carry recipients.

The Problem with Aggregation

As a preliminary observation, many funds do *not* attempt to trace the varying interests in different deals when they distribute carry or compute a clawback obligation. With respect to the distribution of carry, many funds will distribute carry based on the percentage interest of each person in that deal, without regard to their respective (and possibly differing) interest in prior loss deals. Similarly, many funds will compute each person's liability for a clawback by multiplying the amount of the clawback by a fraction, the numerator of which is the aggregate distributions made to such person and the denominator of which is the aggregate distributions made to all carry recipients. The result of this formula is that each carry recipient is liable for his share of a clawback regardless of whether he participated in the investment causing the clawback. The rationale for this traditional approach is that each carry recipient shares in the benefit of being in an overall enterprise with continuing funding for investment opportunities and accordingly bears the risk of the overall enterprise, which aggregates all losses against all gains.

However, this traditional approach may lead to arguably inequitable results. Take for example a situation in which a fund sells a deal at a loss (Deal A), then sells a deal for a gain (Deal B), and finally disposes of a third investment at a gain (Deal C). The gain in Deal B will be first used to offset the losses on Deal A. Consequently, the carry amount derived from Deal B is reduced, and in the worst case, reduced to zero. If X has a 1% interest in the carry in each of Deal A and Deal C and a 10% interest in the carry on Deal B, should X be obligated to bear the burden of the losses on Deal A and only be entitled to 10% of the carry proceeds in Deal B *as reduced by* the losses in the deal in which he only had a 1% interest? And should X only be entitled to 1% of the carry from Deal C, which was increased because Deal B offset a prior loss? Or should the loss from Deal A fall more heavily on those participants who had a larger interest in Deal A? If one believes that the latter approach is more equitable, then a "tracing" mechanism is necessary to enable the fund to achieve this result.

Tracing Mechanism

Tracing can be implemented by the creation of separate bookkeeping "carry accounts" for each carry recipient. Upon the realization of an investment, "carry profit," *i.e.*, the carry recipient's notional share of positive carry or profit from the investment, determined without regard to set-off for prior losses or write-downs on other investments, is credited to his carry account. If there has been a loss, the carry recipient's notional share of negative carry or loss from the investment is to be debited to his carry account. Assuming a 20% carry, then the carry loss would be 20% of the loss generated by the disposition of the investment.

Distributions of carry proceeds are made to carry recipients with positive carry account balances *pro rata* in accordance with their respective positive balances. Any such distributions reduce the amount of, and are debited against, the carry account of such carry recipients. If there is insufficient cash to satisfy a carry recipient's entire positive carry account balance (which could arise where a prior

loss in a deal in which he had little or no interest wipes out any carry in a subsequent deal in which he had an interest), then such recipient simply waits for a subsequent profitable deal to satisfy any shortfall in the payment of his carry account balance.

Clawback obligations are based on each carry recipient's carry account. If a clawback is required to be paid to the investors in a fund, then such obligation is to be satisfied first by carry recipients who had received prior distributions of carry proceeds and who at the time have a negative carry account balance (the "First Round"). Such carry recipients are liable for the clawback on a *pro rata* basis based on the ratio of their respective negative carry account balance (which reflects such person's interest in the losses that caused the clawback) to the aggregate negative balances of all carry recipients who received prior carry distributions but have a negative balance in their carry accounts. However, the liability of the carry recipients in the First Round to fund a clawback would be limited to the lesser of (i) the carry actually distributed to such carry recipient, and (ii) the absolute value of the negative balance of such recipient's carry account.

A carry recipient who has never received any carry distributions and who has a negative carry account balance will not be required to fund any portion of the clawback. It is not intended that any carry recipient will be required to contribute any money out of his own pocket to satisfy his share of any clawback obligation.

If, following the First Round, the clawback obligation has not been satisfied completely, then all carry recipients (regardless of their carry account balances) who have received carry distributions must return carry proceeds on a *pro rata* basis, based on the ratio of the amount of carry actually distributed to each such carry recipient (net of the amount of any clawback funded by him in the First Round) to the aggregate amount of the carry distributions made to all carry recipients (net of the aggregate amount of the clawback funded by all of the carry recipients in the First Round), subject possibly to equitable adjustments by the general partner or managing entity of the fund. In this event, however, no carry recipient will be liable to pay more than the amount of all carry distributions received by him (less taxes if investors have so agreed) and any amounts refunded in the First Round.

Through this two-tier clawback mechanism, a carry recipient may have his carry wiped out in total or be forced to return his carry by reason of a loss deal in which he had little or no interest, *but only after* other carry recipients with a greater interest in that loss deal return their after-tax carry in whole. In effect, this results in a form of "return protection" for the carry recipient who has little or no interest in a loss deal because his return is protected by being the last money clawed back.

To Trace or Not to Trace?

In deciding whether to adopt tracing, one needs to analyze the benefits and disadvantages of applying tracing to different scenarios, particularly in situations when a carry recipient may leave a fund as a result of different triggering events such as termination without cause, for cause, death, disability or voluntary resignation. Tracing can benefit a person who leaves a fund, and be detrimental to the carry recipients who remain with the fund. A person who leaves a fund after it has

realized a series of winners, will not participate or will have a small interest in future deals that may generate losses.

To mitigate this problem, a general partner could decide that the “return protection” of first satisfying any clawback obligation from carry recipients with negative carry account balances be applied on a selective basis only, *e.g.*, to carry recipients who are terminated for reasons such as death or disability, but not for persons who voluntarily resign or who are terminated for cause (though, in most cases, typically, when a person is terminated for cause he forfeits all his carry). Alternatively, the general partner might wish to provide for the allocation to a person of carry loss, but not carry profit, from deals realized after such person’s termination as a result, for example, of voluntary resignation.

On the other hand, tracing may be appropriate when a fund wishes to induce a new investment professional to join the team. Such a person may want to be insulated from any deals made prior to his admission to the management team and only to share in the carry on the deals that he works on or that are made after his admission.

Finally, the practical issue of the administration of a tracing mechanism may affect a fund’s decision to adopt tracing. Tracing will require careful maintenance of books and records. The relative administrative complexity of keeping even relatively simple carry accounts may deter some general partners from adopting a tracing mechanism. The complexity of administering the arrangement may be compounded if the fund has reserve account or other provisions that require allocations of cashless income, with attendant requirements for tax distributions.

Tracing and Interim Clawbacks

If a fund provides for interim clawbacks and, at the upper-tier level, tracing of carry profit or loss, the computations of the carry accounts to allocate carry profit or loss based on the carry recipients’ respective interests in the carry would be made as described above, and would be the basis to determine which carry recipients fund the interim clawbacks and in what amounts.

Separate “interim clawback” accounts would also need to be kept to record the amounts paid by carry recipients to fund interim clawbacks and to determine which carry recipients receive “refunds,” and in what amounts, if a prior interim clawback proves to have been unnecessary, whether in full or in part, as a result of the realization of a subsequent deal that is a winner. If the disposition proceeds of a subsequent deal are insufficient to refund in full to the general partner (and the ultimate carry recipients that funded the interim clawback) any interim clawback that was unnecessary, then the available proceeds should be distributed to the relevant carry recipients on a *pro rata* basis, based on the amounts of the interim clawbacks that they have funded (net of any prior refunds).

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If you are interested in exploring interim clawbacks or tracing further, we would be happy to discuss these concepts with you and to provide you examples of how these concepts are applied.

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