

# Private Equity Carried Interest Clawbacks: Fund Agreement Mechanisms and Tax Considerations

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TUESDAY, JUNE 15, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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# **Part I: Background—American-Style and European-Style Waterfalls**

# Waterfall Options

- Typical “European-Style Waterfall”: Priority return to investors of all contributed capital and a preferred return on such amount before any carried interest distributions
- Typical “American-Style Waterfall”: Priority return to investors of all contributed capital on “realized” investments and a preferred return on such amount before any carried interest distributions

# American Style Variations

- What is a “realized” investment?
  - When are depreciated assets considered realized? Must the asset be worthless to be “realized”? How to define “worthless”?
- How to treat partial sales and distributions? Are regular distributions (e.g., tax distributions from an operating flow-through) treated the same as extraordinary distributions?
- How are fund expenses treated? Apportioned based on capital contributions of investments? Reducing carry on earlier investments?
- How are LP clawback obligations apportioned? Pro rata based on contributions? Based on distributions of associated deal? Based on total distributions to date?
- How frequent are GP clawbacks?

# American Style Variations (continued)

- How to calculate the preferred return?
  - Typical to have a pref on PE, RE funds but not for VC funds
  - Sometimes there can be multiple layers of pref and catch-ups
  - Typically based only on realized investments, related expenses and a share of “general expenses
  - Variations on compounding methodologies and whether this reflects a minimum IRR
- How to calculate the GP “catch-up”?
  - Most PE funds do include a GP catch-up (so that the “pref” is only a pref on timing, assuming sufficient distributions)
  - If no catch-up → “hurdle”
  - Often GP gets 100% of distributions until caught up but can vary (80/20 or 50/50). 50/50 can also be more common in funds with REIT subsidiaries

# Distribution Waterfall Examples

- Five investments made during investment period (aggregate cost \$90m)
- Sale of first investment (cost \$20m, with proceeds of \$50m) in Year 3
- Sale of second investment (cost \$25m, with proceeds of \$75m) in Year 4
- Cumulative fees/expenses as of Year 3 sale date = \$6m (\$3m allocable to first investment), and \$10m as of Year 4 sale date (\$3m allocable to second investment)

# Deal-by-deal waterfall, including carried interest distributions; no preferred return

- Yr 3 sale of first investment (cost \$20m, with proceeds of \$50m)
- Cumulative expenses as of sale date = \$6m (\$3m allocated to first investment)
- Portion of proceeds allocable to GP's capital interest typically deducted from the gross proceeds and does not run through the waterfall. For simplicity of hypothetical example, assume GP capital interest is \$0.

Yr 3 sale proceeds	\$50m	
Cost	\$20m	LPs
Expense recovery	\$3m	LPs
Profit	\$27m	(\$50m-\$20m-\$3m)
20% carried interest	\$5.4m	GP
Residual 80%	\$21.6m	LPs

# Full return of all contributed capital first; no preferred return

- Yr 3 sale of first investment; Yr 4 sale of second investment
- Aggregate capital contributions as of Yr 3 sale date (\$96m) and Yr 4 sale date (\$100m)
- Cumulative expenses as of Yr 3 sale date (\$6m); Yr 4 sale date (\$10m)
- Assume GP capital interest is \$0

Yr 3 Sale proceeds	\$50m	
<i>Cumulative capital contributions</i>	\$96m	
Yr 3 proceeds to return invested capital	\$50m	LPs
<i>Year 4 sale proceeds</i>	\$75m	
<i>Cumulative capital contributions</i>	\$100m	
Yr 4 proceeds to return invested capital	\$50m	LPs
<i>Remaining Yr 4 proceeds</i>	\$25m	
GP 20% carried interest	\$5m	GP
Residual 80%	\$20m	LPs

# Deal-by-deal carried interest distributions with preferred return

- Yr 3 sale of first investment (cost \$20m)
- Five investments made as of sale date (cost \$90m)
- Cumulative expenses as of sale date = \$6m (\$3m allocated to first investment)
- Cumulative preferred return as of sale date = \$12m (\$4m allocated to first investment)

<i>Yr 3 sales proceeds</i>	\$50m	
Return cost of first investment	\$20m	LPs
Expense recovery	\$3m	LPs
Preferred return	\$4m	LPs
<i>Remaining Profit</i>	\$23m	(\$50m-\$20m-\$3m-\$4m)
<b>“GP catch-up”</b> on preferred return	\$1m	GP (100% catch up)
<i>Remaining Profit</i>	\$22m	
20% carried interest	\$4.4m	GP
Residual 80%	\$17.6m	LPs

# Full return of all contributed capital, with preferred return

- Yr 3 sale of first investment; Yr 4 sale of second investment
- Investment cost as of Yr 3 and Yr 4 sale dates (\$90m)
- Cumulative expenses as of Yr 3 sale date (\$6m); Yr 4 sale date (\$10m)
- Cumulative preferred return as of Yr 4 sale date = \$12m

<i>Yr 3 Sale proceeds</i>	\$50m	
<i>Cumulative capital contributions</i>	\$96m	
Yr 3 proceeds to return invested capital	\$50m	LPs
<i>Year 4 sale proceeds</i>	\$75m	
<i>Cumulative capital contributions</i>	\$100m	
Yr 4 proceeds to return capital contributions	\$50m	LPs
Preferred return	\$12m	LPs
<i>Remaining Yr 4 proceeds</i>	\$13m	(\$125m-\$100m-\$12m)
GP catch-up on preferred return	\$3m	GP
<i>Remaining Profit</i>	\$10m	
20% carried interest	\$2m	GP
Residual 80%	\$8m	LPs

## **Part II: Clawback Mechanics**

# Carried Interest Clawbacks: Overview

- Purpose of Clawback:
  - Preserve the economic arrangement reflected in Fund Agreement waterfall, e.g., distribution of carried interest after return of capital and preferred return, net of tax carve-out
  - Ensure GP or carry vehicle does not receive more than agreed profit split (e.g., 20%) over life of Fund and, if waterfall contains a preferred return, that LPs receive their contributed capital plus preferred return
  - Tensions between interest of GP -- to receive carried interest earlier in life of Fund, and LPs -- to protect capital and do not want GP to get carried interest distributions ahead of their return of capital

# Carried Interest Clawbacks: Overview

- Typical Clawback: Capital contribution by GP or carry vehicle at end of life of fund
- Clawback may be required regardless of whether waterfall is American or European style
  - “Fair Value Capital Account” limitation on distributions
  - GP may receive carried interest distributions prior to full return of capital if LPs’ fair value capital accounts, plus cumulative distributions to LPs, are greater than or equal to a specified percentage, e.g., 120%, of LP capital contributions

# Typical Carried Interest Clawback Mechanics

- Clawback Concept: At time of final distribution of Fund assets in connection with the winding up of the Fund, if the GP (or carry vehicle) has received aggregate carried interest distributions that exceed either (a) its carried interest percentage (e.g., 20%) of cumulative net profits over the life of the Fund, or (b) the LPs do not receive a full return of their capital plus the accrued preferred return, the GP must make a capital contribution to the Fund equal to such over-distributed carried interest, subject to a cap equal to the aggregate after-tax carried interest it received
- Mechanics of Clawback:
  - Timing of Clawback
    - End of Life of Fund: Typically at end of life of Fund so can look back on aggregate contributions and distributions.

# Typical Carried Interest Clawback Mechanics

- Interim Clawbacks: Investors may insist on interim clawbacks (in addition to end of life clawback) that occur at designated periods during the life of the Fund (e.g, end of Investment Period, 8<sup>th</sup> year), based on a hypothetical liquidation of Fund at FMV as of end of each interim period
  - Interim clawbacks take pressure off end of life clawback
  - They may result in GP returning capital before it is necessary since based on hypothetical liquidation of Fund assets and not actual liquidation of Fund assets
- **Satisfying Clawback**: The clawback is satisfied by a capital contribution by the GP to the Fund in the amount of the over-distributed carried interest. (See collateral support for clawback below)
- **Cap on Clawback Obligations**: There are different methodologies for calculating the tax allocable to carried interest distributions. Tax impact is commonly assessed based on an assumed tax rate, all in for federal, state and local. Investors may insist on reducing tax impact by tax benefits of return of capital, but this is difficult to measure

# Typical Carried Interest Clawback Mechanics

- Collateral Support for Clawback:
  - Personal Guaranty: Several and not joint liability; issues with enforcing obligation
  - Escrow or Holdback by Fund: May be preferable to personal guaranties and interim clawbacks

# Example – Scenario 1

Fund has American-style waterfall with no preferred return

- LP commitment is \$100
- GP commitment is \$0
- Fund makes Investments 1 and 2 in Year 1 at cost of \$20 each.
- In Year 3, Investment 1 is sold for \$74. Cumulative contributions for expenses are \$8 (50% are allocable to Investment 1)

	LP	GP
Year 3 Cash Flow (74)		
Return of Investment 1 Invested Capital (20)	20	0
Return of expenses allocable to Investment 1 (4)	4	0
Allocation of Profit (20%)	40	10
<b>Totals</b>	<b>64</b>	<b>10</b>

## **Example (continued)**

In Year 6, Fund sells Investment 2 for \$10 and liquidates. Cumulative expense contributions as of Year 6 are \$14

Step 1: Calculate total GP carry distributions (\$10)

Step 2: Calculate hypothetical GP carry distributions (\$6), which is 20% of \$84 (total proceeds) minus \$54 (total contributions)

Step 3: Determine excess \$4 (before determining after-tax clawback cap)

## Example – Scenario 2

Fund has European waterfall with no preferred return

- LP commitment is \$100
- GP commitment is \$0
- Fund makes C corp Investments 1 and 2 in Year 1 at cost of \$20 each
- In Year 3, Investment 1 is sold for \$60. Cumulative expense contributions as of Year 3 are \$10

	LP	GP
Year 3 Cash Flow (60)		
Return of Invested Capital (40)	40	0
Return of expense contributions	10	0
Allocation of Profit (20%)	8	2
<b>Totals</b>	<b>58</b>	<b>2</b>

## Example – Scenario 2 (continued)

- In Year 4, Fund makes C corp Investments 3 and 4 at cost of \$20 each
- In Year 5, Fund sells Investment 2 for \$10
- In Year 6, Fund sells Investments 3 and 4 for \$15 each and liquidates. Cumulative expenses as of Year 6 = \$20, funded by LP contributions.

Step 1: Calculate total GP carry distributions (\$10)

Step 2: Calculate hypothetical GP carry distributions (\$0), which is 20% of \$100 (total proceeds) minus \$100 (total contributions)

Step 3: Determine excess, before determining after-tax clawback cap (\$10)

# Interim carried interest clawbacks

- Clawback obligation calculated prior to fund liquidation (e.g., 8<sup>th</sup> / 10<sup>th</sup> anniversary of fund commencement) based on hypothetical liquidation of fund at FMV
- Minimizes risk of over-distribution
- But creates possibility of unwarranted return of carried interest (i.e., before full potential of all investments is realized and before there is an arm's-length assessment of value)
- Alternatively some funds have carried interest escrows—these can be even less desirable because of limitations on accessing capital, but they also can avoid challenges of GP having to collect clawback from members
- Interim clawback amounts typically are distributed through waterfall

# Interim Clawback Example – Scenario 1

Fund has European waterfall with no preferred return

- LP commitment is \$100
- GP commitment is \$0
- Fund makes C corp Investments 1 and 2 in Year 1 at cost of \$20 each.
- In Year 3, Investment 1 is sold for \$60. Cumulative expense contributions as of Year 3 are \$10.

	LP	GP
Year 3 Cash Flow (60)		
Return of Invested Capital (40)	40	0
Return of expense contributions	10	0
Allocation of Profit (20%)	8	2
<b>Totals</b>	<b>58</b>	<b>2</b>

# Interim Clawback Example – Scenario 1 (continued)

- In Year 4, Fund makes C corp Investments 3 and 4 at cost of \$20 each.
- In Year 8, C corp Investments 2 and 3 each have a value of \$10 and Investment 4 is still valued at \$20. Cumulative expense contributions as of Year 8 = \$20, funded by LP contributions.

Step 1: Calculate hypothetical carry based on prior distributions and current value (\$0), based on total distributions and remaining value equaling capital contributions.

Step 2: Determine excess of actual carry receives over hypothetical carry, before after-tax cap (\$2)

## **Part III: Tax Considerations**

# Waterfalls and GP Tax Liabilities

- The GP's clawback obligation typically cannot exceed the GP's "after-tax carry amount." It is thus key to understand when the GP has a tax liability from its right to carry.
- Where the GP's assumed tax liabilities arising from its carry rights exceed its right to distributions under the waterfall, the GP often will be entitled to "tax advances" from fund earnings that divert cash flow to the GP that effectively is not subject to the clawback.

# Waterfalls and GP Tax Liabilities

- Why is the GP allocated income before it can receive cash? A fund often is required to “allocate” taxable income to a GP before the GP is entitled to cash flow under the waterfall:
  - Tax rules contemplate that a partnership allocate taxable income based on a “hypothetical liquidation” of the partnership’s assets—assets are deemed sold at their “Tax Code Section 704(b) value”, which frequently ignores unrealized losses
  - It is common for a GP of a fund with a European-style waterfall to be allocated income (and thus need tax advances) before it is entitled to carry distributions under the waterfall.
  - This is less common to arise for the GP of a fund with an American-style waterfall but can result (e.g., if there is a “writedown” of an investment that impacts the waterfall but the writedown has not created a realized loss).
- Calculation (and drafting) complexities when the GP owns both a capital interest and a carried interest in the fund—generally should treat as if held by separate partners for purposes of TD, waterfall and clawback calculations.

# Waterfall and GP Tax Liabilities Examples

## Example 1:

- Fund has European-style waterfall (with no preferred return) with an LP that has a \$200 capital commitment. The GP is entitled to 20% of profits and is subject to taxes at a 23.8% rate.
- Fund makes two \$100 C corp Investments (Investment A and Investment B). Fund sells Investment A for \$150. But for taxes, the LP would receive \$150 of the proceeds. However, a “hypothetical liquidation” allocation is expected to cause the Fund to allocate to the GP \$10 of gain (\$150 of sales proceeds plus the \$100 “704(b)” book value of Investment B minus the \$200 return-of-capital waterfall step, multiplied by 20%). The GP thus receives a tax advance of \$2.38, and LP receives the remaining \$147.62.
- If Investment B subsequently becomes worthless, the GP typically will not be required to return any portion of the tax advance.

# Waterfall and GP Tax Liabilities Examples

## Example 2:

- Same as Example 1, except Fund sells Investment A for \$300 instead of \$150.
- Upon the sale of Investment A, GP is allocated \$40 of gain (\$300 of sales proceeds plus the \$100 “704(b)” book value of Investment B minus the \$200 return-of-capital waterfall step, multiplied by 20%). GP receives \$20 of distributions. GP does not receive a separate tax advance because it is receiving sufficient carried interest proceeds to satisfy its tax liabilities ( $23.8\%$  of \$40 = \$9.52).
- If Investment B becomes worthless, the GP’s clawback obligation typically will be \$10.48 ( $\$20 - 23.8\%$  of \$40).

# Waterfall and GP Tax Liabilities Examples

## Example 3:

- Same as Example 1, except Fund has an American-style waterfall
- Typically same allocation outcome as Example 1, based on the hypothetical liquidation methodology. But GP is entitled to \$10 of cash pursuant to the waterfall and does not receive tax advance of \$2.38.
- If Investment B becomes worthless, the GP's clawback obligation typically would be \$7.62.

## Example 4:

- Same as Example 2, except Fund has an American-style waterfall
- Typically same allocation outcome as Example 2. But GP is entitled to \$40 of cash pursuant to the waterfall and does not receive a tax advance of \$9.52.
- If Investment B becomes worthless, the GP's clawback obligation typically would be \$30.48.

# After-Tax Carry Calculation Wrinkles

In-kind distributions can significantly complicate “after-tax” clawback caps. Often, clawback formulas will provide that the GP will calculate its clawback obligation as if the GP sold any distributed property with respect to its carry rights immediately after receipt.

## Example:

LP contributes \$90 to Fund, and GP contributes \$10 to Fund. Fund invests \$100 in Investment A (the Fund’s sole asset). At a time when investment A is worth \$140, Fund distributes Investment A equity—GP is distributed carry of \$7.20 of Investment A stock and distributed \$14 of Investment A stock in respect of its capital investment. GP’s tax basis is spread across \$21.20 of shares, so a sale of the “carry portion” would yield gain of \$3.77 and a deemed tax liability of \$0.90. Should these calculations assume the GP has no basis in the shares distributed to it in respect of the carry?

## **After-Tax Carry Calculation Wrinkles (continued)**

International investments also can create technical questions. Clawback formulas often look to the income “allocated” to the GP; however, the GP may have “income inclusions” under the “Subpart F” and “GILTI” international tax rules that are no longer “allocated” to the GP based on a recent change in law. Such included amounts generally should be deemed allocated to the GP.

# Tax Benefits Increasing the Clawback Cap

- The GP may be allocated capital losses as a result of having a clawback obligation. Do these tax attributes impact the clawback cash obligation?
- In certain cases, the GP might not be “allocated” capital losses when it makes a clawback payment, but the GP might recognize such a loss as a result of making that payment—do these tax attributes impact the clawback cash obligation?
- Typically an “actual realization” threshold
- Typically significant time limits on assessing use of tax attributes
- Documentation obligations of GP?