

## GENERAL PARTNER CARRY ECONOMICS – AN OVERVIEW

*Carried interest economics need to take into account the dynamics of the group, the investment strategy and the incentives the private equity firm wishes to create, explain David Tegeler and Jamiel Poindexter of Proskauer Rose.*

Because each private equity firm has its own personality, it is often a challenge to develop an economic framework for general partners that reflects the culture and dynamics of a particular firm. The following is a brief discussion of the key decisions that a private equity group must make when establishing the economic terms of the agreement among the general partners to split the carried interest distributed by a private equity fund.

### SPLITTING THE CARRIED INTEREST

It is most common for each carry-recipient to be entitled to a fixed percentage of all carry distributions made by the fund during the term of such carry-recipient's employment with the firm, without regard to the identity of the investment that generated such distribution. However, some groups prefer to split carry from each investment in a particular fund among the persons responsible for such investment. Sometimes, these "deal-by-deal" carry arrangements are established only for venture partners or other non-employee specialists enlisted to work on one or more specific deals, rather than the entire portfolio.

Deal-by-deal carry arrangements can be problematic because the carry received from a fund is typically calculated on an aggregate basis, not on a deal-by-deal basis. That is, the carried interest is normally a percentage of the fund's cumulative net profits, and not a percentage of profits from any particular investment. To illustrate the complexities and potential issues that this creates, assume that the carry from Investment A is split among the members of Team A, and the carry from Investment B is split among the members of Team B. If Investment A is sold for a \$100 million gain, generating \$20 million of carry, Team A theoretically should receive \$20 million. However, if Investment B was previously sold at a loss, a portion of the \$100 million gain from Investment A would have to be used to restore the loss to the investors in the fund, resulting in less than \$20 million of carry in the aggregate, which would not be enough to provide Team A with the \$20 million that they expect.

Furthermore, if the carry distributed by the fund is calculated net of fund expenses (as is often the case) a portion of the \$100 million gain would have to be used to offset such expenses. Even if there is a gain on both Investment A and Investment B, it would be necessary to apportion fund expenses between the investments for purposes of calculating the carry to be received by Team A and Team B.

These carry-sharing issues can become clawback issues if carry distributions are made with respect to one investment (Investment A) and there are subsequent losses on other investments or if significant expenses are subsequently incurred. This would result in a clawback obligation to the fund, which presumably would be paid by Team A, since 100 percent of

the carry distributions were paid to Team A. Even if there is not a clawback obligation to the fund, there may be a need to have an internal clawback among the various teams. For instance, assume that there is a \$100 million gain on Investment A, followed by a \$50 million loss on Investment B, followed by a \$50 million gain on a third investment (Investment C). Theoretically, Team A should be entitled to \$20 million of carry and Team C should be entitled to \$10 million of carry; however, there is only \$20 million of carry to distribute (i.e., 20 percent of the \$100 million of cumulative net gain). Unless the carry distributions from Investment A were escrowed at the GP level (which is one way to address this situation), fairness would dictate that Team A return some of its carry distributions for the benefit of Team C.

Another method to tie compensation to performance is to periodically shift carry percentages among partners, or to “warehouse” carry with one partner or with “the house”, and later apportion it out as appropriate. This strategy may result in unacceptable tax consequences for carry-recipients that are taxable in the United States, and possibly certain other jurisdictions, as these periodic shifts of value may be taxable as compensation income.



*David Tegeler*



*Jamiel Poindexter*

For many firms, deal-by-deal arrangements may seem to be the best way to create the proper incentives, given the internal dynamics of the group and the way its deals are staffed. However, the complexities discussed above normally make it worthwhile to consider other structures. The tax implications in the relevant jurisdictions also may limit the available alternatives. Because of these limitations, most firms split the carry

based on a fixed percentage that applies to all deals. This methodology may be the most logical in the first instance if, because of the staffing structure, it makes sense to compensate each GP based on the performance of the entire the team.

#### **VESTING SCHEDULES**

A GP's share of the carry is often subject to some type of vesting arrangement. Typically, a specified percentage of the GP's interest will vest at timed intervals, and the GP will forfeit the portion that is unvested (if any) when the GP leaves the firm. Several factors must be considered when choosing the appropriate vesting schedule for your GP group.

When establishing vesting schedules for the individual GPs, the following objectives must be kept in mind:

*A successful vesting scheme should correspond to the fund's investment strategy and align the interests of the GPs and the LPs.*

(i) creating an incentive for the GP to continue with the firm until all of the work on the fund's portfolio is complete, (ii) ensuring that a departed GP is not unduly compensated for work done by others after his departure, and (iii) ensuring that there is sufficient carry to properly incentivise the remaining team (including any replacement for the departed GP) to successfully continue the operations of the fund. For these reasons, a successful vesting scheme should correspond to the fund's investment strategy and align the interests of the GPs and the LPs.

If the fund's strategy requires significant labour in the later years of the fund (as might be the case in an early-stage venture fund that will need to nurture a portfolio company for many years before finding an exit) it may be more appropriate to use a back-loaded vesting scheme, where most of the carry vests in the later years of the fund. If the fund's strategy depends largely on sourcing and executing investments during

the investment period, and not so much on nurturing investments for long periods of time (as might be the case with a mezzanine fund, a co-investment fund, a fund-of-funds and certain buyout funds) it might be appropriate to adopt a front-loaded vesting scheme, where most of the carry vests during the fund's investment period. For other groups, including many venture funds, straight-line vesting over a period of years is appropriate.

The vesting arrangement chosen will also depend on how the carry is split. For instance, if the carry is split on a deal-by-deal basis, vesting may likewise be applied on a deal-by-deal basis, on a schedule that takes into account the likely amount of time and work that each investment will require.

#### **ECONOMICS OF FORFEITURE**

When a GP departs, the unvested portion of the GP's carry is typically forfeited. This forfeiture may be prospective or retroactive. For instance, if the GP is entitled to 10 percent of the carry received from the fund, and, pursuant to his vesting schedule, he forfeits 20 percent of his 10 percent interest, the GP will receive eight percent of the carry after his departure. However, earlier distributions may have been made based on his 10 percent interest. It is not uncommon for the GP to retain those earlier distributions, in which case the forfeiture would just be applied on a prospective basis (i.e., he will receive eight percent of each future carry distribution).

The alternative is to require the GP to restore those prior distributions by making a payment upon departure and/or taking a reduction in subsequent distributions so that, overall, the GP has only received eight percent of

cumulative carry distributions since inception of the fund.

A third option is for the firm to simply escrow carry distributions attributable to unvested interests until such interests vest. It is generally undesirable from an economic perspective to retain idle funds in an escrow, however. In any case, it is equitable and standard for the GP to receive at least enough cash to cover his tax liability (if any) on the escrowed amount.

#### **PENALTY FORFEITURE FOR BAD ACTS**

The forfeiture provisions are often used to penalise GPs for certain activities that are detrimental to the organisation. For instance, a GP may be required to forfeit some or all of his vested carry if he is removed for failure to perform his assigned duties, if he breaches his fiduciary duties to the fund or any other entity within the organisation, if he misappropriates a corporate opportunity of the fund or the firm, if he breaches the terms of any agreement governing his employment relationship with the firm, or if he commits fraud or any other dishonest act against the firm.

In addition, the risk of forfeiture often extends beyond the date of departure to restrict the GP's activities in the outside world. Common examples are penalty forfeitures for competing with the firm, soliciting employees of the firm, disclosing confidential information, or disparaging the firm or its employees. Non-competition and confidentiality provisions are often designed to put the firm in an advantageous position to negotiate the terms of departure for a GP that is taking another position within the industry.

*The forfeiture provisions are often used to penalise GPs for certain activities that are detrimental to the organisation.*

These provisions should be largely irrelevant for a GP that is leaving the private equity business; however, a GP that has taken a job with another firm, or who plans to start his own firm, would need to be released from the prohibition on competing. In particular, the departing GP would need to be able to disclose his “track record” in connection with marketing of another fund at another firm. The confidentiality and non-competition requirements, together with the risk of forfeiting more carry, give the firm an advantage in negotiating the extent to which the GP may compete with the firm and take credit for investments managed by the firm.

#### **CLAWBACK**

If the fund agreement requires the return of excess carry distributions in the event that the carry is overpaid, the agreement among the GPs should specify how this obligation will be shared. If the GPs have

*If the fund's strategy requires significant labour in the later years of the fund, it may be more appropriate to use a back-loaded vesting scheme. If the fund's strategy depends largely on sourcing and executing investments during the investment period, it might be appropriate to adopt a front-loaded vesting scheme.*

joint and several liability for this obligation, each GP should be particularly concerned that his fellow GPs are obligated to fund their respective portions.

If the carry-sharing percentages remain the same for the same GPs throughout the life of the fund, it stands to reason that the clawback obligation should be funded by the GPs in proportion to their carry distributions. However, if any GP departs from the firm, or if sharing percentages are shifted for other reasons, the appropriate sharing ratios for the GP clawback will not be as obvious. In addition, if the carry is shared on a deal-by-deal basis (as discussed above) it will not always be clear who should be responsible for a clawback obligation.

#### CONCLUSION

Carry-sharing arrangements – including vesting and other forfeiture provisions – impact the future of the firm and even the performance of the fund. For this reason, each firm (and each prospective investor, in the

course of due diligence) should think carefully about the structure that fits best, taking into account the dynamics of the particular group, the investment strategy, and the incentives that the firm wishes to create. ■

#### CONTACTS:

##### **David W. Tegeler**

Tel: +1 617 526 9795

Email: [dtegeler@proskauer.com](mailto:dtegeler@proskauer.com)

##### **Jamie E. Poindexter**

Tel: +1 617 526 9773

Email: [jpoindexter@proskauer.com](mailto:jpoindexter@proskauer.com)

Proskauer Rose LLP  
One International Place  
Boston, MA 02110  
United States of America  
Tel: +1 617 526 9600  
Fax: +1 617 526 9899