COVID-19: Heightened Potential for General Partner Clawbacks (and Disputes)?

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We at The Capital Commitment blog have previously discussed several steps for fund managers and others to weather the storm brought by COVID-19. One of those steps is assessing the likelihood of a carried interest return obligation under a fund agreement's general partner clawback provision (and planning for how to mitigate those obligations, if necessary). A recent article from our colleagues in Proskauer's Private Funds group highlights the important role that general partner clawbacks play in ensuring the economic deal between a fund manager and the fund's limited partners is protected, regardless of how market disruptions, such as those brought on by COVID-19, impact a fund's portfolio.

As detailed in that article, a boom-bust cycle may result in a general partner receiving more than its agreed-upon share of a fund's cumulative profits if initial investments resulted in large profits, but later investments lose value or are written off entirely. If distributions of carried interest made early in the life of a fund result in a general partner receiving a total share of the fund's aggregate profits greater than what was agreed upon with the investors at the fund's outset, the excess must be returned to the fund for distribution to the limited partners. It is important to note that general partner clawbacks can and do happen, even for successful funds and for funds that return full contributions back to investors before making carried interest distributions, which is why it is important for all general partners to analyze and plan for a potential return obligation.

Returning carried interest under a clawback obligation can often be complex and painful, as general partners ordinarily distribute carried interest out to their individual members and other carry recipients on or shortly after receipt. Clawback provisions, on the other hand, are not typically applied until the end of a fund's life, meaning that several years may pass between distributions of carried interest and the final calculation determining whether excess profits have been received by the general partner. Asking individuals to return money they received several years prior, and likely have already spent, is very difficult and may increase the potential for disputes between the individual members of the general partner, particularly those who may have already departed the firm. Fund sponsors that are considering fundraising in the near future should recognize that limited partners will be very interested in whether a sponsor's prior funds are facing potential clawbacks and what plans the sponsor has to help mitigate and manage those obligations.

Effective communication between and among a general partner and its limited partners, as well as between the individual members of a fund sponsor, are of the utmost importance in managing carried interest clawback risk and avoiding potential disputes. For more, please check out our colleagues' recently published article, and watch here for future updates as we continue to monitor disputes and litigation arising from the impacts of COVID-19.

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