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Investing in Private Equity Funds and Real Estate Funds: Giveback Formula & Distributions

Introduction

Limited partnership agreements for private equity funds frequently require the return of Carried Interest distributions1 that were previously made to the General Partner (the "GP") in the event certain financial targets are not attained. This is known as the "Giveback" or "Clawback." This Alert discusses Giveback-related issues that investors should understand.

Tax Netting—Including Netting of Tax Benefits

The Giveback obligation by the GP and its principals is generally limited to the after-tax amount available to such persons, rather than the full pre-tax carried interest distributions that such persons received. Most Givebacks assume the highest individual tax rates; other Giveback provision use the actual tax rate for the individual. *Investors should check to see how the after-tax amount is calculated; actual tax rates are more favorable to investors*.

LPs frequently request that the Giveback amount be increased by the amount of any tax benefit to the principals arising from payment of the Giveback amount. Tax benefits could arise from being able to offset carried interest and management fees previously received from the fund or from predecessor / successor / affiliate funds ("Related Funds"). If the same fund family has Related Funds from which these persons are also receiving carried interest, it becomes more likely that a tax benefit will be available, to offset the after-tax calculation. *Investors should confirm that the tax benefit is taken into account, and should request that the offset include benefits arising with respect to Related Funds*.

Guarantee of Giveback

Most funds that contain a Giveback also contain a guarantee of the Giveback by the recipients of the distributions. The guarantee is generally unconditional, and not subject to cancellation for any reason. Generally, the guarantee is issued by the individuals who ultimately receive the carried interest, but in some funds the guarantee is by an intermediate entity. *Investors should confirm that guarantees*

POSTED:

Aug 15, 2007

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https://www.reinhartlaw.com/people/jussi-snellman *exist, and that guarantees survive even if principals leave the employ of the GP. In addition, Investors should trace the giveback to the individual recipients of carried interest (or to a corporate entity that clearly has the financial ability to honor the guarantee)*.

The guarantee of Giveback is generally (but not universally) structured as a several, and not joint obligation (meaning each individual is only responsible for their share). Some more established funds have a joint and several guarantee obligation (making each individual liable for the entire amount due); this reflects a heightened sense of team spirit by the principals. It can also be a marketing term used by the fund, to inform limited partners ("LPs") that the principals' interests are aligned with one another. *Investors may want to request that the guarantee of Giveback be a joint and several obligation*.

Finally, as a practical matter, it is not unusual for the guarantees to be not ready—but rather "in the process of being finalized"—at the time the closing for the fund is scheduled. *Investors should insist that they be provided copies of any previously promised guarantees as a condition to their subscription*. (Their leverage to make this demand will never be as great post-subscription as it is pre-subscription.)

Escrow of Giveback

A minority of funds will agree to escrow a limited portion of the Giveback, to make it easier to collect on the guarantee. It is to the LPs' benefit to have an escrow, as this greatly facilitates collection of the Giveback amounts (to the extent needed). *Investors should consider whether an escrow is important to the investment, and request an escrow if appropriate*.

Giveback of Carried Interest: Whole-Fund Basis vs. Investment-by-Investment Basis

Carried interest is generally paid to the GP using one of two alternate structures:

- **On a Whole-Fund Basis**: First all capital contributions and preferred return must be returned to LP's, and only then is carried interest paid to the GP. This is more favorable to LP's; it is more common in funds that have a real estate focus.
- **On a Investment-by-Investment Basis**: If profit exceeds preferred return on a

particular investment (net of previous write-downs), carried interest is paid at the time of sale. The carried interest is not returned even if subsequent investments under-perform—except upon liquidation of the fund, and then only if there is a giveback provision in the fund's partnership agreement. Frequently, carried interest is even paid if the investment is sold in part, and the Fund continues to hold the remainder. This is a commonly used structure in private equity funds, and favors the GP.

Some private equity investors assume that when a fund pays carry to the GP on a whole-fund basis, the Giveback becomes a non-issue - to the point that the Giveback formula frequently is omitted from the partnership agreement for these funds. However, even these funds can encounter situations where a Giveback is desirable. For example, a Giveback would be of value to investors if the fund calls in additional capital after carried interest has been paid; such capital calls could be (by way of example) for any of the following purposes:

- Indemnification payments
- Payment of fees and expenses
- New investments (recycle) which have a low Internal Rate of Return ("IRR")
- Follow-on investments which have a low IRR

Examples of two situations involving whole-fund carry calculations where a Giveback would be desirable are below (examples assume an 8% preferred return and 80-20 catch-up to the GP thereafter, until the GP has received 20% of profits).

Example 1:

January 1:	Fund calls in $1,000,000
December 31:	Fund Returns $1,090,000 – which entitles GP to $8,000 of carried interest. LP's receive $82,000 (which represents 8% preferred return and 20% of remaining distributions)
January 1 of following year:	Fund calls in $10,000 for expenses/indemnification

Result:	– LP's received $72,000 and GP received $8,000 of the profit. – But, LP's should have received $80,000 (preferred return amount) and GP should have received $0!

Example 2:

January 1:	Fund calls in $1,000,000
December 31:	Fund Returns $1,090,000 – which entitles GP to $8,000 of carried interest. LP's receive $82,000 (which represents 8% preferred return and 20% of remaining distributions)
January 1 of following year:	Fund calls in $1,000,000 for new investment.
December 31 of following year:	New investment is disposed, for $1,020,000. This amount is paid entirely to LP's, as 8% preferred return has not been exceed.
Result:	– LP's received $102,000 and GP received $8,000 of the profit – But, LP's should have received all $110,000 of the profit, and GP $0, as LP's preferred return of $160,000 (i.e., $80,000 per year for two years) has not yet been attained!

There are several protections available to the investor, for situations described in the above examples:

- First, if the partnership agreement includes a satisfactory Giveback provision, investors will be protected.
- Otherwise, the partnership agreement could expressly provide that, after any carried interest has been paid to the GP, the Fund may not call in money (whether characterized as return of distributions or capital contributions) for any purpose - whether for fees, follow-on investments, new (or recycled) investments, or indemnification. We periodically advise our investor clients in their investments in funds that contain these protections.

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Investors should consider carefully what protections they have in funds where carried interest is distributed on a whole-fund basis.

Emerging Issue: Does Giveback Track Distribution Formula?

In most limited partnerships, the Giveback formula does not track the distribution formula during the "catchup" period. Rather, the Giveback only operates if the LP's have earned less than the Preferred Return, or if the GP has earned more than the 20% carry - but it does not provide a Giveback with respect to the LPs' "catchup" amount. *The more aggressive investor may wish to request that the giveback formula track the distribution formula*. This is a complex issue that will be the subject of a future Investor Alert.

To discuss this Alert further, please contact Jussi Snellman at 608-229-2243 or jsnellman@reinhartlaw.com or Keith Johnson at 608-229-2231 or kjohnson@reinhartlaw.com.

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[1]Carried interest is the profit interest that general partners are entitled to receive from private equity funds and real estate funds; generally this amount is 20% of all
profit, so long as a "hurdle rate" or "preferred return" has been received by the limited partners.