Private Equity Carried Interest Arrangements: A Business Perspective

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For stakeholders of private equity sponsors, the most lucrative potential payouts continue to be carried interest. Not surprisingly, with each successive fund raise, sponsors find themselves confronting the question of how to equitably share carried interest. Whether an employee is an investment professional or an operations professional, market practice is for carried interest to comprise part of the compensation package. Regardless of initial splits, exceptional performers expect their share of carried interest to go up with successive fund launches, and sponsors likewise may want to reallocate carried interest to these individuals. The ultimate goal is to create a flexible system, preferably early in the business cycle, so that the sharing of carried interest among owners and key personnel adjusts smoothly, predictably and equitably as the business matures.

This article provides an overview of various business considerations that come into play when sharing carried interest—in particular, allocation approaches, classes of recipients, structuring carried interest rights, changes to carry splits and vesting.[2] This article also touches on how carried interest arrangements are affected when a sponsor sells a minority stake of its business to a third party.

OVERVIEW

Approaches to Carry Splits

Historically, as part of the "2 and 20" model, general partners received 20% of distributed net profits (carried interest or carry) generated by a private investment fund after return of the initial investment and a preferred return (of 8%, for example) to the limited partners. A private equity sponsor's approach to sharing carried interest is often informed by how its business was created. For instance, founders may be influenced by their experiences at predecessor firms, which inevitably shape the way they view carry allocations. In other cases, a meaningful amount of carried interest may be shared with a third party, such as a seed investor who was integral to launching the business, or a minority investor who was integral to expanding the business. As sponsors mature, other factors, such as new hires, promotions and new business lines, take on greater importance in determining how to split carried interest.

Most sponsors ultimately arrive at an allocation approach that makes full use of carried interest as a powerful performance incentive and retention tool. Making performance and retention primary considerations in allocating carry can create an effective alignment of interests. Even if not fully memorialized, an implicit understanding has developed in the market that these considerations should be determinative of one's share of the carry pool.

[1] This publication is for informational purposes only and should not be relied on as a source of legal advice. Ms. Persaud would like to thank GangQiao (John) Wang, for his invaluable contribution.

[2] This article does not address tax aspects of carried interest.

Recipient Classes

At the top are founders, many of whom have extensive deal networks, are responsible for investor relationships and serve as chairpersons or CEOs of the sponsor. Founders tend to take a sizeable portion of carried interest relative to others, and in the case of sponsors with multiple founders who are actively involved in the business, this can sometimes amount to over 50% of total carried interest.

Senior investment professionals of a sponsor actively source, manage and sit on the boards of portfolio companies. These individuals take the next largest share of the carried interest pool. Other investment professionals, such as vice presidents and associates, who assist in analyzing and managing deals, generally receive smaller shares of carried interest.

Today, many sponsors also set aside carried interest for senior operations professionals, such as the general counsel, chief operating officer and chief financial officer. As sponsors fundraise and operate in a more regulated environment, it is not uncommon for the head of investor relations and the chief compliance officer to also receive a share of carried interest.

STRUCTURING THE RIGHT TO CARRIED INTEREST

Many sponsors will often establish special entities to effectively manage how carried interest is shared among employees who are not founders or other key owners. Those carry recipients own passive interests in these vehicles which invest as limited partners (or members) in the general partner. These vehicles allow for uniform terms to apply to relatively small stakes, avoid the administrative burden of having dozens of individuals directly invested in the general partner and facilitate more efficient admissions and removals of carry recipients. While most carry recipients generally have limited rights, founders and other key owners typically have robust rights ranging from anti-dilution protections to management and control rights.

Careful drafting of the general partner's governing agreement is crucial to providing a sponsor with maximum flexibility in allocating carried interest over the course of its business cycle. Failure to provide flexibility at the outset can result in unexpected complications, particularly when a carry recipient departs or when other events necessitate altering allocations. For example, if rights to carried interest upon a termination event are inadequately addressed in governing agreements, the unintended consequence could be a terminated person remaining an owner of carry entities on terms unfavorable to the sponsor but favorable to the terminated person.

At a number of sponsors, an employee's share of carried interest is documented in a side agreement admitting the employee as an owner of the general partner. Such agreements are particularly helpful when structuring one-off arrangements with key new hires or existing investment professionals. While these agreements allow for discrete confidential negotiations, the general partner's governing agreement continues to memorialize salient governance, removal and funding terms. Despite the use of confidential admission agreements, many sponsors recognize the importance of fostering a collaborative culture, which in practice often results in similarly ranked individuals or those who meet certain performance metrics receiving the same percentage of carried interest and being subject to the same dilution and vesting terms.

REASSESSING CARRIED INTEREST SPLITS

Sponsors typically allocate carried interest for a particular private equity fund upfront before investments are made. Besides tax advantages, settling carry splits early helps to temper contentiousness and prevents distractions from the real work of investing. The downside is that, given the long lifespan of a typical fund, an upfront allocation that works initially may become outdated as some employees excel, others falter, and a fund's ultimate success is revealed. This downside can be mitigated somewhat through adjustments to compensation (e.g., tracking interests, grants or a higher annual bonus), which serves as a reminder that carried interest is but one part of overall compensation.

The reassessment process varies among private equity sponsors. Smaller sponsors may prefer less formality, particularly if there are frequent open channels for ongoing dialogue with senior personnel. Larger sponsors with more personnel likely prefer formal reassessments in order to bring objectivity and fairness into the review process. Periodic reviews during the life of a fund provide opportunities to differentiate among investment professionals based on objective metrics determined well in advance by the sponsor. That being said, interim adjustments based on periodic reviews run the risk of increased gamesmanship or detrimental short-term thinking.

No matter the pros and cons of periodic reviews, sponsors are better off providing clear procedures for changing carried interest splits during the life of a fund and, indeed, during the life of a sponsor. Such changes may become inevitable as new hires are made and others get promoted or leave. Moreover, sponsors who are further along in their business cycles may be faced with reassessing the founders' share of carried interest in yet-to-be-formed successive funds as expectations by key personnel for increases in future carried interest are brought to the fore. In such cases, forging a path for consensus in advance of fundraises is essential for long-term success.

Awarding carry points to existing personnel or new hires means a dilution of other recipients' carried interest. A common approach to addressing such changes is for founders and senior investment professionals to participate pro rata in increases or dilutions due to promotions, departures or new hires. A variation on this approach is for founders and senior investment professionals to participate in increase or dilution up to a ceiling, and once the ceiling is reached, all carry recipients participate pro rata. Another approach is solely for founders to participate in increases or dilutions, however, unless founders receive a substantial share of carried interest, this approach has its limits. A less common approach is for all carry recipients, no matter how small their stakes, to participate in increases or dilutions. For employees with very small stakes, however, the general approach is to leave their percentages fixed, as founders and senior investment professionals are typically better positioned to bear adjustments. Usually, dilutions will be subject to a floor, below which consent is required, whether by founders or by founders and other key investment professionals.

RETENTION INCENTIVES: VESTING, FORFEITURE AND CLAWBACK

Vesting is a valuable tool for ensuring continued alignment of interests between a sponsor, its personnel and a fund's limited partners. Sponsors generally seek longer vesting periods in order to ensure continuity of management, promote retention and preserve institutional knowledge. Similarly, a fund's limited partners prefer longer vesting periods to ensure that personnel are properly incentivized to achieve long-term success. As a result, the most common approach is deal-by-deal vesting. In such cases, the vesting clock will start on the date a particular investment is made, and will vest in fixed installments over time (for example, 20% a year for four years, with the final 20% vesting upon a fund's exit from a particular investment). The same schedule is typically applied to all carry recipients, regardless of rank. Other approaches include fixed vesting over a period of years based on a fund's closing date and tranche-by-tranche vesting each time capital is contributed to a deal. Many sponsors use a hybrid of deal-by-deal, and fund-based vesting that permits all unvested carry with respect to a realized deal to vest immediately upon realization.

Fund-based vesting as opposed to deal-by-deal vesting is more typical where carry is shared primarily among founders and other key owners of the sponsor. This approach has the potential to create entrenchment when applied to other personnel and, if not structured properly, could result in departing individuals retaining substantial carried interest even though they are no longer working for the sponsor. One way to mitigate the entrenchment effect is to include a mandatory buy-back mechanism that permits a sponsor to buy back carry from departing recipients, with a buy-back price adjustment as needed.

When a carry recipient voluntarily leaves a sponsor (or is terminated without cause), unvested carried interest is typically forfeited, and thus returned to the remaining carry recipients who participate in the pool. This provides an obvious retention incentive, as substantial portions of potential wealth may be locked up in unvested carried interest at any given time. If a carry recipient dies or becomes disabled, all unvested carry may vest immediately, or the unvested portion may be forfeited, or a middle approach may be used—for example, a sponsor may award an additional period of vesting, with the (unvested) remainder being forfeited. At a number of sponsors, if a carry recipient voluntarily leaves a sponsor for "good reasons," which is often narrowly defined, or if a carry recipient is terminated without cause, the carry recipient might, upon departure, receive an additional period of vesting, with the unvested remainder being forfeited.

If a carry recipient is terminated for cause, by contrast, all vested and unvested carried interest is typically forfeited. The threat of losing all carried interest via cause removal serves as a strong deterrent against misbehavior, but also means that the definition of "cause" in the recipient's contract and/or the general partner's governing agreement requires careful drafting. Typical cause events include fraud, willful misconduct, securities law violations, gross negligence and behaviors that cause reputational harm to the sponsor. Certain post-employment covenants are also typically incorporated into the cause definition such that a breach of a post-employment non-compete or non-solicit of the sponsor's investors will also trigger a forfeiture of carried interest. In this way, a sponsor can customize protective arrangements that put greater portions of recipients' carried interest at risk, over longer periods, with respect to those actions that are most concerning to the sponsor.

Finally, there is the issue of "clawbacks" of carried interest. Unless a fund's limited partnership agreement requires some portion of carried interest to be escrowed, many sponsors immediately distribute all carried interest upon receipt. If a fund is initially successful, this may mean that recipients get substantial carried interest payments early in a fund's life. If a fund's later investments are not as successful, or a fund bears extraordinary liabilities, the limited partners of the fund may be entitled to claw back carried interest previously received by the general partner.

To ensure that all carry recipients bear their share of the clawback obligation, irrespective of whether they are still employed by the sponsor, robust powers and remedies in the general partner's governing agreement and employment agreements are essential to retrieve distributed amounts. These protections would be in addition to the typical guaranty that every carry recipient would be required by fund investors to sign.

MINORITY INVESTORS IN PRIVATE EQUITY FIRMS

As a private equity sponsor's business matures, outside capital can become increasingly attractive, leading sponsors to revisit their internal carry arrangements in preparation for partnering with minority investors. For some sponsors, outside minority investors help accelerate growth of the business through sizable capital infusion, and for others, minority investors are crucial to solving intergenerational transitions. Whatever the case may be, minority investors expect a share of revenue streams and robust contractual protections, which at a minimum translate into a meaningful portion of carried interest, safe from dilutions and forfeitures.

Outside minority investors are also focused on strong alignment between founders and senior investment professionals, and well-structured carry arrangements are a key indicator of successful alignment. In revisiting carry arrangements in advance of a minority investment, sponsors often seek to lock up key investment professionals for the long-term by improving governance transparency, enhancing protections to carried interest and instituting uniform restrictive covenants. Where carried interest is concerned, a sponsor may prescribe preemptive dilution rules to address how carry recipients are diluted as a result of taking a minority investment. For instance, in those cases where a portion of cash infusion from the minority investor is distributed to owners, carry recipients may receive commensurate portions of such distributions in exchange for dilutions. Some sponsors may have greater discretion to cabin the minority investment without having to seek buy-in from a broader group of carry recipients. In such cases, a sponsor may offer a new class of carried interest with different rights unavailable to existing carry recipients (e.g., a minority stake will generally not be subject to dilution and vesting and generally has tag/drag protections). Given the complexities introduced to carry arrangements by minority investors, it behooves founders and key investment professionals, in particular, to address the trade offs and benefits to all carry recipients in a manner that achieves a cohesive culture, which ultimately is the linchpin of a successful firm.

CONCLUSION

When structured thoughtfully, carried interest can be shared in a manner that creates a unique alignment among founders, senior investment professionals and other key personnel. This is because carried interest serves as a powerful retention and incentive mechanism, especially when vesting and termination triggers are properly incorporated. In addition, well-structured carry arrangements make sponsors well positioned to attract minority investors. While the "right" sharing of carried interest will remain fluid over the life of a sponsor, a considered approach at the outset will pay dividends in the long run. Thoughtful drafting of employment and governing agreements enables a sponsor to minimize disruptions throughout its business cycle while positioning the business to bring in outside minority investors when the opportunity arises to grow the business and manage generational transitions.