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Energy Private Equity And The Specter Of Clawbacks

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Law360, New York (November 14, 2016, 4:21 PM EST) -- In recent months, managers of private equity funds in the energy sector have been facing a scenario they likely never imagined: having to return millions of dollars of their "carried interest" earnings back to investors.

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The investment period for a fund can be several years long, typically between three and five years, but occasionally up to a decade. For this reason, many fund managers structure their funds' agreements to allow for a "deal-by-deal" (or "American") distribution waterfall, which allows the fund's manager to earn its carried interest as each investment is liquidated (or generates revenue), rather than waiting until the end of the fund's term or until investors have received their invested capital back.

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In a deal-by-deal waterfall, any earnings from a particular investment generally will be paid first to investors until their entire initial investment with respect to such deal is returned and they earn a fixed "preferred" rate of return on such amount. Then, a certain percentage of the remaining returns ("carried interest" or "carry") generated by such investment is paid to the manager.

Most funds provide for a manager "clawback" mechanism, whereby, if the manager has earned more than the agreed-to percentage of cumulative distributions over the life of the fund, then the manager must return any excess to investors (after-tax). Problems can arise in situations where that money has already been distributed to the principals or other employees and presumably spent, rather than held in escrow.

The situation is made even more precarious when principals or employees who received carried interest distributions along the way have left the management firm. In those cases, the remaining principals of the manager will have to ask for the money back or cover the cost themselves.

Several energy-related funds that were formed in nascent stages of the boom now have terms ending during collapse-protracted downturns. Managers may feel as though they could recoup some losses if they could delay liquidating assets until oil recovers further.

Many fund agreements provide for a one or two year extension of the fund's investment period at the manager's discretion; however, to the extent that this option has already been exhausted, some managers are now going back to investors to seek additional time and, potentially, additional capital.

To placate investors in such cases, a manager may need to reduce or eliminate management fees charged to a fund for the duration of any extension period. Unfortunately, apart from extending a fund's investment or harvest period, managers have little recourse after a fund's inception.

The best way a manager can avoid the predicament of having to return a large sum to investors in respect of a clawback is to build preventative measures into the organizational documents of the fund or the vehicle earning the carry at the outset (i.e., escrows at the carry level or the contractual ability to get any distributions back from employees).

The most conservative and investor-friendly approach is to structure the fund using a "European" waterfall, in which carried interest is calculated at only the fund level. Under this arrangement, the manager is not paid its carry until the fund investors are made whole and have received any preferred return on their entire investment. In this case, a clawback is not needed at all, except in rare circumstances where limited partners may be asked to return distributions to the fund to pay unforeseen liabilities.

For some managers, though, this option may not be realistic. The economics of certain private equity management firms, especially new firms with few (if any) other funds earning carry, may not be able to support a three to 10 year fund term without carry coming in to incentivize team members, whose reward for work on a particularly successful investment early in a fund's life could be delayed for several years.

An alternative is for the manager to withhold the carry in an escrow account until a specified amount is returned to investors. Although this practice can neutralize the benefit of a deal-by-deal waterfall if all carry is held in escrow, holding a specified percentage (e.g., 30 percent) may be a viable option.

Managers who employ this strategy should also arrange for the fund to make tax distributions to the manager, since the manager will be liable for tax on carried interest income in each year it is earned, even though it will not have received all of the cash.

Other potential solutions include the use of interim clawbacks, as well as a "modified" deal-by-deal waterfall structure. Interim clawbacks are triggered at defined stages during the life of the fund, or upon the occurrence of certain events, so that the manager is forced to reckon with any shortcomings as they occur, rather than all at once at the end of the fund's life.

The "modified" deal-by-deal waterfall approach requires realized losses or, in some cases, write-downs, on a deal to be made up before distributions in respect of future deals can be paid.

Further, although Section 956 of the Dodd-Frank Act relating to executive compensation could impose a mandatory return-of-incentive compensation scheme on certain financial institutions, it is unlikely that the proposed rules, in their current formulation, would apply to carried interest distributions, but they are subject to further clarification.

In conclusion, although private equity managers who currently face an imminent clawback have few remedies apart from extending the life of the fund to avoid liquidating positions at a loss, with foresight and planning, there are several measures that managers can put in place when structuring new funds to prevent this scenario in the future.

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