Important Fund Formation Developments — Or Five Things Every Private Equity Fund Sponsor Must Know.

KIRKLAND & ELLIS

By Jack S. Levin, Bruce I. Ettelson, and Donald E. Rocap[1]

The number (and dollar amount) of private equity ("*PE*") funds being formed has skyrocketed in recent years, including LBO funds, later stage growth equity funds, consolidation funds, early stage funds, mezzanine funds, turnaround funds, special situation funds, funds of funds, healthcare funds, telecommunications funds, etc. As the number and size of fund formations have escalated, the interrelated tax, SEC, economic, and negotiating issues encountered in structuring a PE fund have both changed and multiplied. This article reviews five important recent developments in structuring a PE fund.

- One development is an outgrowth of 1996 amendments to the Investment Company Act of 1940 (the "*ICA*") substantially easing the 100-investor limit for most funds.
- Another development results from the universal adoption of LLC statutes in the U.S.
- Two additional developments involve tax structuring techniques that can substantially enhance the after-tax return to fund sponsors by (1) minimizing the nondeductibility of private placement agent fees and (2) enabling PE funds to invest in operating portfolio companies formed as tax flow-through entities while accommodating most tax-exempt limited partners' unrelated business taxable income concerns.
- The final set of developments deals with a number of important complexities in calculating the general partner's 20% carried interest, including a limited partner (an "*LP*") preferred return hurdle and an all-partner giveback obligation.

Jack S. Levin, Bruce I. Ettelson, and Donald E. Rocap are partners at the law firm of Kirkland & Ellis, where they concentrate in private equity fund formations, LBOs, private equity investing, mergers and acquisitions, and other complex transactions.

MR. LEVIN graduated suma cum laude from Harvard Law School first in his class, won the gold medal on the CPA exam, teaches part time at Harvard Law School and the University of Chicago Law School, is author of a book *"Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions"* (updated and republished annually), and is co-author of a three-volume set *"Mergers, Acquisitions, & Buyouts"* (updated and republished semi-annually).

MR. ETTELSON graduated cum laude from the University of Chicago Law School with a John M. Olin Fellowship in Law and Economics, received his B.S.E. (Finance) magna cum laude from the Wharton School of Business at the University of Pennsylvania, and is author of several articles on fund formations trends.

MR. ROCAP graduated from the University of Virginia Law School, teaches part time at the University of Chicago Law School, is a special editor of Mr. Levin's book *"Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions,"* and is a volume co-author of Mr. Levin's book *"Mergers, Acquisitions, and Buyouts."* Prior to joining Kirkland & Ellis, Mr. Rocap was Deputy Tax Legislative Council (Regulatory Affairs) at the U.S. Treasury Department's Office of Tax Policy.

1. Late 1996 Investment Company Act Amendments Allowing More Than 100 Fund Investors.

Because a PE fund is "engaged primarily ... in the business of investing ... in securities," it is required to register as an "investment company" under the ICA absent an applicable exemption. The ICA imposes onerous and impenetrable regulatory burdens on a registered investment company which can significantly impede a PE fund's activities. Hence, most PE funds have traditionally structured themselves to comply with ICA §3(c)(1)'s long-standing exemption (the "*rule of 100*") for a PE fund which (1) has no more than 100 beneficial owners of its securities and (2) has not made (and does not plan to make) a public offering of its securities.

In order to satisfy the rule of 100 many PE funds have excluded desirable investors and settled for a smaller fund size than desired. Happily, October 1996 legislation (which became effective April 9, 1997) greatly liberalized the rule of 100 so that in the future it will generally not be necessary for a PE fund to exclude desirable investors.

Qualified Purchaser Fund. The legislation creates a new §3(c)(7) exemption for a qualified purchaser ("*QP*") fund, i.e., a fund (1) all the outstanding securities of which are owned exclusively by persons who are QPs and (2) which has not made (and does not plan to make) a public offering of its securities. For purposes of this exemption, QP generally means (1) a human being owning at least $5 million of "investments" or (2) an entity with at least $25 million of "investments." There are several important sub-rules in determining whether a person is a QP:

- Where a married human being owns an investment asset jointly with his or her spouse, both spouses can count such asset for the $5 million test, and where a married couple invests jointly in PE fund, both spouses can count all of the couple's investments, whether or not jointly owned, for the $5 million test.

- A trust qualifies as a QP where (1) it was not formed for the specific purpose of acquiring PE fund's securities and (2) the trustee (or other person authorized to make decisions), as well as each person who contributed assets to the trust, is a QP.

- For an entity (such as a partnership, LLC, or corporation) owned by a single family to qualify as a QP, it must meet only the $5 million (not the $25 million) test. For this purpose, family means (1) natural persons related as siblings, spouse (including former spouse), or direct lineal descendants by birth or adoption, (2) such persons' spouses and estates, and (3) foundations, charitable organizations, and trusts established by or for the benefit of such persons.

- An entity or a human being can qualify as a QP where it (1) acts for its own account or for the accounts of other QPs and (2) in the aggregate owns and invests on a discretionary basis at least $25 million of investments.

The SEC's approach in defining investments adopted the philosophy that an investment for this purpose should include more than merely securities, but that not every asset should be regarded as an investment. Rather, to count as an investment, an asset must be held for investment purposes and the nature of the asset must suggest that the holder has such investment experience and sophistication as to be able to evaluate the risks of investing. Thus, for example, personal residences and many family-owned businesses are not investments. More specifically, SEC by regulation has determined that a person's "investments" (1) *include* (a) securities and (b) if held for investment purposes, real estate, commodities, cash, and cash equivalents, but (2) *exclude* securities in a company controlled by the person where the company both has less than $50 million of shareholders' equity and is not filing reports as a public company under the Securities Exchange Act of 1934 (the "*1934 Act*"). The regulation requires a person's investments to be reduced by the amount of outstanding indebtedness incurred for the purpose of acquiring investments.

A QP fund can now have an unlimited number of QP investors, although in order to avoid registration with SEC as a public company under the 1934 Act, the QP fund should have no more than 499 holders of any class of its equity securities.

While new §3(c)(7)'s QP exemption provides welcome relief to old §3(c)(1)'s strict rule of 100, Congress has granted this relief in a particularly rigid fashion. Specifically, where a PE fund seeks to meet the new §3(c)(7) QP exemption, all investors in the fund must be QPs and inclusion of a single non-QP investor makes the exemption unavailable. And where a PE fund seeks to meet the old §3(c)(1) rule of 100, all investors in the fund — even QPs — must be counted. This creates a dilemma for a fund sponsor seeking to admit both QPs and non-QPs.

Nonintegration of Tandem Funds. Relief from this dilemma — albeit at the cost of additional complexity — is provided by new ICA §3(c)(7)(E), permitting a fund sponsor to form two tandem funds: one fund with 100 or fewer non-QPs qualifying for ICA exemption under old §3(c)(1)'s rule of 100 and the second fund with an unlimited number of QPs qualifying for ICA exemption as a new §3(c)(7) QP fund.

Absent new §3(c)(7)(E), two such funds organized and operated in tandem would be integrated and treated as a single fund for ICA purposes, and such integrated fund would not qualify for exemption under either §3(c)(1) or §3(c)(7) because it would have more than 100 security holders and would not have exclusively QP investors. Under §3(c)(7)(E), two such companion funds, although investing in tandem, are not integrated for purposes of determining whether they qualify for the ICA §3(c)(1) and §3(c)(7) exemptions.

Consequently, beginning in April 1997, a fund sponsor can accept significantly more than 100 investors by using a bifurcated fund approach, i.e., by forming two side-by-side funds, which have in the aggregate (1) an unlimited number of QP investors, (2) up to 100 non-QP investors, and (3) an unlimited number of knowledgeable employees (as discussed below).[2]

Exception for Knowledgeable Employees. Another significant ICA liberalization is SEC's April 1997 rule ignoring securities (e.g., an interest in a PE fund) beneficially owned by a "knowledgeable employee" in determining whether (1) a §3(c)(1) fund meets the rule of 100 and (2) a §3(c)(7) fund's outstanding securities are owned exclusively by QPs.[3] "Knowledgeable employee" generally means a human being who regularly participates in the investment activities (other than performing solely clerical, secretarial or administrative functions) of PE fund or any other investment fund managed by its general partner ("*GP*"), so long as such person has for at least 12 months so participated in investment activities on behalf of any investment fund (whether or not affiliated with the GP).[4]

Where PE fund's GP is a special purpose entity formed for the purpose of investing in and serving as PE fund's GP, the GP entity is generally looked through for ICA purposes and the GP entity's beneficial owners treated as beneficial owners of PE fund. Hence, where the GP entity is wholly owned (either directly or indirectly through other special purpose entities) by investment professionals with at least 12 months experience, the GP and its owners are all disre-

2 In order to avoid SEC registration as a public company, neither fund should have more than 499 holders of any class of its equity securities.

If the fund sponsor forms two §3(c)(1) funds to invest in tandem — perhaps one for regular non-QP investors and a second with different terms for the GP's "friends and family" (such as portfolio company executives) — it continues to be likely that both §3(c)(1) funds will be integrated for purposes of applying the rule of 100.

3 SEC Reg. §270.3c-5.

4 Two further technical refinements on the "knowledgeable employee" definition as stated in text above: First, a person who is an executive officer, director, trustee, GP, advisory board member, or person serving in a similar capacity at PE fund or its GP need not satisfy the 12-months test. Second, for a person to qualify as a knowledgeable employee, he or she must be either (1) an employee of PE fund or its GP or (2) an executive officer, director, or other person described in the immediately preceeding sentence, i.e., a non-employee consultant does not qualify.

Interests in a PE fund owned by the following persons are also ignored: (1) the estate of a knowledgeable employee, (2) a person (a "donee") who acquires securities from a knowledgeable employee as a gift, bequest, or pursuant to a legal separation or divorce agreement, or (3) a company established by a knowledgeable employee exclusively for the benefit of (or owned exclusively by) the knowledgeable employee, his or her estate, and donees.

garded in determining whether PE fund qualifies for ICA exemption under §3(c)(1) or §3(c)(7).[5]

Publicly Traded Partnership Tax Rules. This recent relaxation of the traditional ICA rule of 100 has not been matched by corresponding changes in the Internal Revenue Code's publicly traded partnership (*"PTP"*) rules. Under Code §7704, a PTP is generally taxed as a corporation, a highly undesirable result for a PE fund. Because a PTP is defined to include not only a partnership (or LLC) whose interests are actually traded on a securities exchange, but also any partnership (or LLC) with respect to which there is a vaguely defined "substantial equivalent of a secondary market," a PE fund generally seeks to fit into one of several regulatory safe harbors to be certain of avoiding PTP status.

A recent IRS regulation (the "*100 partner IRS safe harbor*") specifically exempts from PTP treatment a partnership (or LLC) (1) none of whose ownership interests were issued in an SEC-registered offering and (2) which at no time has more than 100 partners.[6] Although the mechanics for counting to 100 for ICA purposes and for tax purposes have always differed somewhat, a PE fund relying on the ICA's rule of 100 was in the past generally able also to qualify for the 100 partner IRS safe harbor, because it did not have more than 100 partners. However, a §3(c)(7) QP fund with more than 100 owners (consisting of an unlimited number of QPs and knowledgeable employees) or a §3(c)(1) fund with more than 100 owners (consisting of up to 100 investors and an unlimited number of knowledgeable employees) can no longer qualify for the 100 partner IRS safe harbor. Moreover, while tandem QP and non-QP funds are not integrated for ICA purposes, there is some risk IRS may seek to integrate them for the 100 partner IRS safe harbor, particularly if the partnerships' (or LLCs') governance provisions are integrated, e.g., limited partner (or member) votes are calculated based on the aggregate votes of both entities' owners. Accordingly, the 100 partner IRS safe harbor may not be available.

A PE fund which cannot rely on the 100 partner IRS safe harbor has three alternative methods for avoiding taxation as a corporation. First, under Code §7704(c), a PTP is not taxed as a corporation if at least 90% of its gross income is derived from interest, dividends, capital gains from the disposition of stocks and securities, and certain other specified sources. A PE fund which invests only in debt instruments and corporate stock should be able to meet this 90% passive-income test. However, a PE fund that invests in tax flow-through operating entities and hence is treated for tax purposes as having operating income (as discussed in section 4 below) may fail this test.

Second, under a recent IRS regulation, a partnership (or LLC) is not treated as a PTP if the percentage of the entity's capital and profits interests transferred in any taxable year does not exceed 2% of the entity's capital or profits interests, and for purposes of this 2% test the entity can ignore certain exempted transfers, including each "block" transfer of a greater-than-2% interest and certain types of transfers among related persons.[7] A PE fund seeking to rely on this safe harbor should make certain its partnership (or LLC) agreement empowers the GP (or managing member) to prevent transfers that would result in a violation of the 2% per year calculation (including assignments of economic interest that do not result in the transferee becoming a substitute owner).

Third, a PE fund which fails all of the above safe harbors can always take the position that there is not sufficient trading in its ownership interests to meet IRS's vague regulatory definition of "substantial equivalent of a secondary market." [8]

5 Where a person who is not a knowledgeable employee is a part owner of the GP entity, it is arguable (but not clear) that such person can be disregarded for ICA purposes on the ground that the GP (which owns only a general partner interest in PE fund) does not own an interest in PE fund which constitutes a security.

6 Treas. Reg. §1.7704-1(h).

7 Treas. Reg. §1.7704-1(j) and (e).

8 Treas. Reg. §1.7704-1(c).

2. Emergence of LLCs.

Traditionally, PE funds, as well as their GP entities, have been formed as limited partnerships. Now many, if not most, newly formed GP entities are being formed as LLCs. This trend is primarily attributable to two recent developments — the universal adoption of LLC statutes in the U.S. and the new check-the-box IRS regulations.

As of April 1, 1997, each of the 50 states and the District of Columbia has adopted an LLC statute, thereby eliminating the possibility that a state without an LLC statute might treat (1) an LLC operating in that state as a general partnership and (2) the LLC's members as general partners with unlimited liability for the LLC's debts and obligations.

Under a typical LLC statute, where an LLC is unable to pay all of its liabilities, the LLC's equity owners (the members) are not personally liable for the LLC's unpaid liabilities — even if they participate in the LLC's management — absent invocation of piercing-the-veil, co-participant, or a statutory liability doctrine, all of which doctrines would be equally applicable if the LLC had been formed as a corporation. LLC statutes impose no personal liability on a member similar to the unlimited liability for a partnership's GP, nor does an LLC member risk being treated as a GP as a result of assuming too large a management role, as does a partnership's LP, at least in Louisiana, the only state which has not adopted some version of the Revised Uniform Limited Partnership Act ("*RULPA*").[9] Thus, the liability protection of LLC members corresponds to that of shareholders in a C or S corporation.

The second significant development for LLCs was a change, effective January 1, 1997, in IRS regulations governing the classification of entities as corporations or partnerships for federal income tax purposes. Prior to 1997, an LLC had to satisfy the complex "Kintner" regulations in order to be treated as a partnership (i.e., as a flow-through entity for tax purposes). IRS's new check-the-box regulations generally treat all LLCs as partnerships for federal income tax purposes unless the LLC affirmatively elects to be taxed as a corporation, and hence make it significantly easier to achieve flow-through tax status.[10]

For the two reasons discussed above, it is now more common to form a PE fund's GP entity as an LLC. In the future a PE fund itself is also more likely to be formed as an LLC. However, because most LLC statutes are recent and there is thus little or no judicial guidance as to their interpretation, it may be some time before all institutional investors become comfortable with LLCs as a fund entity.

Moreover, there are still a few lingering tax issues when either a PE fund or its GP entity is formed as an LLC. Some states (e.g., Texas and Florida) impose an entity level tax on an LLC but not on a limited partnership. Hence, the tax law of each state and local jurisdiction where a particular LLC will do business must be checked to determine whether an LLC is a flow-through entity for state and local tax purposes or whether it must pay full or partial entity-level state or local income tax. Also if an LLC has non-U.S. owners, the tax law of some foreign jurisdictions (e.g., Canada) imposes tax on LLC income allocated to a foreign national of such country, a position which is less favorable than with respect to a limited partnership. Finally, federal tax law as currently in effect may enable a GP entity formed as a limited partnership, rather than as an LLC, to reduce its equity owners' 2.9% medicare tax liability.

3. Nondeductibility of Placement Agent Fees.

In the past three years there has been a dramatic increase in the number of PE funds using private placement agents to assist in fund raising. The recent ICA statutory amendments allowing a fund to have more than 100 investors — i.e., permitting a fund to raise money from an unlimited number of QPs plus up to 100 non-QPs — means that PE funds will more often seek to tap wealthy individuals who may in the past have been denied access to these funds under the traditional rule of 100. This will likely spur increased use of private placement agents.

9 In the other 49 states which have adopted some version of RULPA, there are statutorily permissible methods for LPs to participate in the partnership's management without being treated as a GP.

10 Treas. Reg. §1.7701 -2 and -3. A publicly traded LLC continues, however, to be treated as a corporation under Code §7704's PTP rules (as discussed in section 1 above).

Generally a PE fund's GP must bear the cost of the private placement agent's fees and expenses (the "*PPA costs*"), because the fund's LPs are generally not willing to bear such costs. A PE fund's PPA costs can reach 2% of the fund's aggregate commitments. This is approximately equal to a full year's management fee payable by a PE fund to its GP.[11] Where the GP pays the fund's PPA costs out of management fees received by the GP from the fund, the GP faces an unexpected tax problem.

Under IRS Code §709(a), syndication expenses, such as PPA costs, are neither deductible nor amortizable for federal income tax purposes. Assuming the combined federal, state, and local income tax rate on the GP's management fee income is 50%, the GP must use two full years of after-tax management fees to pay the nondeductible PPA costs.[12] There are, however, two methods by which the GP can reduce its after-tax cost.

The first method is for the PE fund, rather than the GP, to contract for and directly pay the PPA costs. Typically, however, LPs of a PE fund are willing to bear the GP's annual management fees but are not willing to bear the additional burden of the PPA costs. To avoid having the LPs bear any additional burden as a result of PE fund paying the PPA costs, the management fee paid by PE fund to the GP can be reduced dollar-for-dollar by the PPA costs paid by PE fund. This approach causes the nondeductibility of the PPA costs to be shared by all of PE fund's partners (both LPs and GP), thereby significantly reducing the GP's tax burden. Indeed, the nondeductibility of such costs has little or no adverse effect on PE fund's tax-exempt LPs, who generally supply the majority of PE fund capital.[13]

Secondly, the parties may be able to reduce their after-tax burden from the PPA costs by retaining the placement agent to perform two tasks, first to raise the fund's LP capital (the fee for which is non-deductible) and second to provide ongoing financial and advisory services and advice (the reasonable fee for which is deductible). This method for reducing the after-tax burden of the PPA costs at best allows a deduction only for the amount reasonably allocable to the placement agent's ongoing financial and advisory services and at worst the allocation may be susceptible to IRS challenge.

4. Unrelated Business Taxable Income

In the past three years there has also been a dramatic rise in the number of PE funds permitted by their partnership agreements to incur some unrelated business taxable income ("*UBTI*"). Tax-exempt organizations ("*TEOs*") are generally not taxed on their income, except for income treated as UBTI under the Code.[14] The principal manner in which a PE fund is likely to incur UBTI is by investing in an operating business through a tax flow-through entity, such as a limited partnership or LLC, rather than through a corporate entity. Structuring a portfolio operating company as a flow-through entity rather than as a corporation offers two advantages: a single level of tax on the portfolio company's operating income and, upon exit, the ability to deliver a stepped up asset tax basis to the buyer of the portfolio company without incurring two levels of tax, thereby increasing the purchase price the buyer should be willing to pay. Over time, these tax advantages of flow-through status should raise a PE fund's IRR.

Traditionally, PE fund partnership agreements have prohibited the incurrence of any UBTI, because LPs which are TEOs have insisted on a UBTI prohibition. TEOs are required to file a tax return reporting, and paying tax on, UBTI. From an economic perspective, a TEO should generally be indifferent to whether (1) the TEO pays TEO - level income tax (generally at corporate rates) on UBTI allocated to it from a flow-through portfolio operating company or (2) the TEO bears indirectly the corporate-level income tax

11 The typical PE fund management fee payable to the GP during the fund's investment period is approximately 2% of capital commitments per year, payable in semi-annual or quarterly installments.

12 Obviously from a cash flow viewpoint, it is a desirable and common practice to spread payment of the PPA costs over a number of years.

13 Even where GP directly pays the PPA costs, GP and PE fund may well be able to take the position that GP paid the costs on behalf of PE fund so that the PPA costs should be allocated among all of PE fund's partners for tax purposes, with a portion of GP's management fee being treated as a reimbursement to GP of its expenses (the PPA costs) incurred on behalf of the fund. See, e.g., *Egolf v. Commissioner*, 87 T.C. 34 (1986).

14 Code §§511-514 generally treat a TEO's income as UBTI if it is either (1) operating income generated by business or (2) debt-financed passive income and capital gain.

on income earned by a portfolio company formed as a C corporation.[15] TEO reluctance to receive UBTI has in some cases stemmed from fear that filing a UBTI tax return would lead to IRS audit. Over time, many TEOs have become more comfortable that IRS does not focus on UBTI tax returns as an audit trail. Hence, the filing of a UBTI tax return is now generally viewed merely as an inconvenience; one with which most TEOs are already burdened from other investments. Nonetheless, TEOs frequently request, sometimes ardently, that a PE fund be prohibited from incurring UBTI.

There are several methods for accommodating both the GP's and the TEO LPs' interests. First, the partnership agreement can (and increasingly in recent years has) allowed a limited portion of aggregate fund commitments (typically 20% to 40%) to be invested in portfolio operating companies formed as flow-through entities.

Second, a group trust can be interposed between pension plan investors and PE fund.[16] A group trust can be used only for pension plans, not for such TEOs as university endowments or charitable trusts. While a group trust does not avoid payment of UBTI tax, it does shift the reporting and payment burden from the pension plan to the intermediary group trust. Non-UBTI income remains tax exempt at both the group trust and TEO levels.

Third, a "blocker corporation" may be inserted between the TEOs and PE fund. Under this structure, a UBTI-adverse TEO may elect to fund through the blocker corporation the portion of its commitment being invested by PE fund in UBTI-generating portfolio companies, with the remainder of the TEO's commitments contributed directly to PE fund. Unlike the group trust, this complicated approach results in a corporate-level tax on an electing TEO's share of all income (including capital gain) from a UBTI-generating portfolio company funded through the blocker corporation, and not merely the income that would be treated as UBTI had the TEO invested directly in PE fund.

Both the group trust and blocker corporation can be used in the same PE fund. In addition, several other UBTI blocking approaches can be used alone or in combination with the two methods described above.

5. Calculating the GP's 20% Carried Interest.

There has never been a single method for calculating a GP's 20% carried interest.[17] However, changes in recent years in the methods typically used to calculate the GP's carried interest have had a substantial (and complicating) impact on the amount the GP actually receives.

Deal-by-Deal Calculation. In the early and mid 1980s a few prominent PE funds were structured so that (a) each fund investment was made through a separate partnership and (b) the management fee was paid directly by the LPs to the GP. Consequently, (1) the GP's carried interest in a profitable investment was not offset by losses on unprofitable investments, i.e., losses were borne 100% by all partners according to their contributed capital, while the GP received a full 20% carried interest in profits, and (2) the GP's carried interest was not burdened by the management fees paid to the GP. In the late 1980s and the 1990s, fewer firms were able (or even attempted) to raise capital under such GP-favorable terms. PE funds are now generally structured so that the GP receives a carried interest only on the net profit from all fund investments calculated as whole, net of management fees and other fund expenses.

15 Two other factors may, however, cause the TEO not to be indifferent: First, where the flow-through portfolio company incurs significant debt, a portion of the gain on sale of the portfolio company may constitute debt-financed UBTI, taxable to the TEO, although gains on sale of a portfolio company formed as a C corporation would not have been UBTI.

Second, the GP's carried interest in PE fund's net profits is based on PE fund's distributions, so that (a) when a portfolio operating company is a C corporation, its entity-level income tax is subtracted before calculating the GP's carried interest, but (b) when a portfolio operating company is a tax flow-through entity, the LP-level tax (regular income tax on a taxable LP and UBTI tax on a TEO LP) is not subtracted before calculating the GP's carried interest. Therefore, LPs may be burdened by a somewhat larger GP carried interest where the portfolio company is a flow-through entity.

16 See IRS Rev. Rul. 81-100, 1981-1 C.B. 326.

17 While some funds have a carried interest which is higher or lower than 20%, we use 20% throughout this article because it is the most common carried interest percentage.

Preferred Returns. In the traditional PE fund, the GP's carried interest was 20% of the fund's net profit, regardless of how large or small the amount of net profit. However, escalating competition for capital among an increasing population of PE professionals has led to a proliferation of LP preferred return provisions, especially among first generation funds that were not the beneficiary of earlier fund agreements without a preferred return. There are, however, at least three radically different types of LP preferred return provisions:

With a *permanent hurdle approach,* (1) 100% of net profits are first allocated to all partners pro rata according to their capital contributions until all partners have been allocated a specified IRR on their investment (8% for purposes of illustration) and (2) remaining net profits are allocated 20% to the GP as a carried interest and 80% to all partners in proportion to their capital contributions. Such a permanent hurdle gives the LPs (and the GP to the extent of its capital contribution) a true, permanent preferred return, so that the GP never receives a 20% carried interest in the portion of PE fund's net profits used to satisfy the hurdle and thus the GP's carried interest never quite reaches 20% of net profits no matter how spectacular the fund's performance.

With a *quickly disappearing hurdle approach,* (1) 100% of net profits are first allocated to all partners pro rata according to their capital contributions until all partners have been allocated a specified IRR on their investment (8% for purposes of illustration), (2) 100% of further net profits are allocated to the GP as a carried interest until the GP has been allocated 20% of cumulative net profits (i.e., the GP has caught up), and (3) remaining net profits are allocated 20% to the GP as a carried interest and 80% to all partners according to their capital contributions. Such a quickly disappearing hurdle gives the GP a full 20% carried interest in all of the fund's net profits if the fund's overall IRR sufficiently exceeds the specified hurdle rate.

A *gradually disappearing hurdle approach* is the same as a quickly disappearing hurdle, except that the GP's catch up is gradual, i.e., after the first tranche allocation of the specified IRR to all the partners according to their capital contributions, the second tranche allocation of further net profits goes only 50% (not 100%) to the GP as a carried interest (and the remaining 50% goes to all partners according to their capital contributions) until the GP has caught up and received 20% of cumulative net profits as a carried interest.[18]

We illustrate in the chart on the following page, the radically different economic results to the GP from these alternative approaches of calculating its carried interest, using for illustration a PE fund (1) which raised $100 million of capital commitments, (2) which ultimately returned to its partners (the GP and the LPs) either $150 million (the "*low case*"), $175 million (the "*mid case*"), or $200 million (the "*high case*"), and (3) where an 8% preferred return over the life of the fund amounted to $50 million.

18 If the parties desire the hurdle to disappear a bit more quickly, the second tranche can be allocated (e.g.) 80% (rather than 50%) to the GP as a carried interest and the remaining 20% to all partners according to their capital contributions.

		GP CARRIED INTEREST		
FUND TERMS	DESCRIPTION	LOW CASE $50M NET PROFITS	MID CASE $75M NET PROFITS	HIGH CASE $100M NET PROFITS
No preferred return	20% of all net profits	$10m	$15m	$20m
8% permanent hurdle	20% of net profits in excess of $50m	0m	5m	10m
8% quickly disappearing hurdle	100% of net profits between $50m and $62.5m plus 20% of net profits in excess of $62.5m	0m	15m	20m
8% slowly disappearing hurdle	50% of net profits up to $83m plus 20% of net profits over $83m	0m	12.5m	20m

Interim Distributions. As described in the chart above, a preferred return can significantly affect the GP's overall carried interest. In addition, even when a preferred return does not affect the ultimate amount of the GP's carried interest, it can significantly affect the amount of interim distributions with respect to the GP's carried interest. The extent to which a preferred return reduces the GP's interim carried interest distributions depends on (1) the specified hurdle rate (8% in the above illustration) and (2) whether the fund agreement calls for (a) a fully loaded hurdle or (b) a hurdle only on realized investments.

A fully loaded hurdle is calculated on all capital contributions by the partners from commencement of the fund until the calculation date. A hurdle only on realized investments is calculated only on (1) the fund's cost basis for investments which have been realized (e.g., sold) *plus* (2) the amount of any write-downs in the cost basis of faltering investments *plus* (3) all of the partnership's expenses (e.g., management fees), or in some cases only the portion thereof allocable to realized investments. Obviously a fully loaded hurdle is larger and hence more likely to reduce substantially the GP's interim carried interest distributions.[19]

All-Partner Giveback. Another emerging issue at the heart of the 80/20 GP/LP split is the all-partner giveback.[20] An all-partner giveback requires all the partners to return to the fund a portion of their distributions if the fund incurs a loss in excess of its assets (after calling unfunded commitments) that would otherwise be borne 100% by the GP, which is generally liable for all of the fund's obligations.

Such a situation might arise late in a fund's life after the fund has made substantial distributions, where the fund is held liable (or settles a contested claim) for an amount exceeding the fund's remaining assets. Such a claim could arise (e.g.) from (1) an environmental clean up obligation of an insolvent portfolio company which was controlled by PE fund when the portfolio company caused the pollution,[21] (2) a breach of a contractual representation or warranty made by the fund in selling a portfolio company, (3) an inaccurate prospectus issued in the fund's sale of a portfolio company's stock to the public in a registered public offering, or (4) a PBGC claim on account of an underfunded pension plan sponsored by a portfolio company 80% or more controlled by the fund.[22]

The need for an all-partner giveback is illustrated by the following example: PE fund, formed several years ago with

19 In the past many PE funds used a fair value ("*FV*") capital account test to determine whether the GP is entitled to interim distributions with respect to its carried interest. A typical FV capital account test does not allow the GP to receive any interim carried interest distributions (other than tax distributions) until the LPs' capital accounts (calculated by marking to FV all of the fund's investments) plus all prior distributions to the LPs equals a specified percentage of the LPs' aggregate capital contributions (typically 120% to 135%). As more funds have adopted preferred returns, use of the FV capital account test has declined, because (as explained above) the preferred return mechanics afford LPs similar protection by prohibiting interim carried interest distributions until the hurdle has been exceeded.

20 Even the phrase 80/20 split is an oversimplification. Generally the GP receives (1) a 20% carried interest plus (2) a share of the remaining 80% of profits proportionate to its capital contribution. Thus, if the GP contributes (e.g.) 1% of the fund's capital, the GP receives 20.8% of fund profits (20% carried interest plus 1% of the remaining 80%), subject to any preferred return arrangement.

21 Under certain circumstances, a polluter's controlling shareholder may be held liable for the polluter's unpaid CERCLA clean up costs. See Levin, *Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions,* §501.5.3.2 (Aspen Law & Business).

22 Under certain circumstances an 80% or greater parent may be liable for a pension plan underfunding. See Levin, *Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions* §501.5.3.1 (Aspen Law & Business).

$100 million of commitments ($99 million from the LPs and $1 million from the GP) is now nearing the end of its successful life, having earned $100 million of net profits, and has recently distributed $200 million cash ($100 million capital plus $100 million net profits) to its partners, as follows:

	RETURN OF CAPITAL	ALLOCATION OF PROFITS	TOTAL
LPs	$ 99m	$ 79.2m[23]	$178.2m
GP money interest	1m	.8m[24]	1.8m
GP 20% carried interest	—	20.0m[25]	20.0m
Total	$100m	$100.0m	$ 200.0m

Shortly after PE fund's $200 million cash distribution to partners, PE fund is successfully sued (or settles an ominous lawsuit) of the type described above for $21 million, an amount for which the GP will be responsible unless PE fund is able to obtain assets with which to pay the $21 million liability.[26]

If the fund agreement contains an all-partner giveback, the partners (the GP and the LPs) would return to PE fund $21 million of their previously-received distributions, with the GP and the LPs respectively paying this amount in the same proportion as they would have borne the cost if PE fund had never distributed the $21 million.

On the other hand, if the fund agreement contains no all-partner giveback, the GP would bear the entire $21 million cost, causing the following wholly anomalous results: (1) PE fund has an overall net profit of $79 million (i.e., $100 million net profit prior to the lawsuit less $21 million liability arising out of the lawsuit), (2) the LPs retain $79.2 million of profit, and (3) the GP returns to the fund all $20.8 million of net profit it previously received (i.e., $20 million of carried interest profit and $1.8 million of non-carried-interest profit) as well as $200,000 of its returned capital contributions. Despite the apparent equity of an all-partner giveback and the apparent inequity of omitting an all-partner giveback, many PE fund agreements do not contain such an all-partner giveback, because LPs have resisted such givebacks on the grounds that (1) once money is distributed, the LPs need to know it is theirs to keep and (2) it is the GP's responsibility to hold back adequate cash reserves for anticipated future fund liabilities.

Over the past decade, the likelihood of such unexpected back-end liabilities has magnified dramatically as society (including disappointed buyers) has become more litigious and government regulators have established more expansive enforcement remedies. In addition, LPs have frequently restricted a GP's ability to hold back all or a substantial portion of cash proceeds received by PE fund on disposition of portfolio companies.

Although some LPs still refuse to invest in a fund with an all-partner giveback, the prevalence of an all-partner giveback of some sort is growing. In order to accommodate both LP and GP concerns, a number of intermediate all-partner giveback provisions can be crafted so that, for example, the partners' obligation to return distributions is limited to (1) a specified percentage of partner commitments or distributions or net profit distributions and/or (2) a specified temporal period following a distribution.

In today's complex fund-formation environment, it clearly is not enough merely to say that the GP has a 20% carried interest. All of the important issues discussed in this section 5 can significantly impact calculation of the GP's carried interest, making it in reality anything between 0% and 20%.

23 $100m fund profits x 80% x 99%.

24 $100m fund profits x 80% x 1%.

25 $100m fund profits x 20% carried interest. PE Fund in this example either (1) had no LP preferred return or (2) had a disappearing LP preferred return which has been substantially exceeded and thus has disappeared. If PE fund had a permanent LP preferred return or a disappearing LP preferred return which had not been substantially exceeded, GP would have received less than a 20% carried interest in the fund's net profits.

26 This example assumes either that the GP entity has sufficient assets on hand to satisfy such liability or that any GP limited liability structure is pierced or otherwise circumvented.