Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

Carried Interest: Vesting

The raison d'être of every fund manager is the "carried interest," that is, the typically 20% share of the profits earned by a fund manager by investing other people's money. Just as carried interest is the chief means of aligning the interests of general partners and limited partners, vesting of carried interest is the means of aligning the interests of individual investment professionals and the general partner, ensuring that they have an incentive to remain active throughout the long life of a fund. Reflecting this critical role, the vesting schedule is among the few items disclosed to limited partners regarding the internal arrangements of the general partner. Despite, or perhaps as a result of, this critical role, there is no clear market standard in how carried interest vests, and we urge general partners to pay particular attention to the details involved in structuring a vesting program so that it is appropriate for the type of firm, accomplishes the goals sought, is understood by all parties, and can be appropriately administered.

Vesting Schedules

The vesting period and the pace of vesting vary widely among fund managers. In the majority of cases, vesting is tied loosely to the investment period of the fund from which the carried interest is derived. Note that carried interest is allocated and vested with respect to each separate fund managed by a fund manager. The time period in which limited partners are obligated to make capital contributions to fund new portfolio investments varies among funds, but the typical investment period is anywhere from four to six years. The simplest vesting schedules will match the investment period on a straight-line method (see Table 1, Example 1), vesting either monthly or yearly in equal shares. Variations on this schedule include immediate grants upon the closing of the fund in order to compensate and recognize individuals for having made significant contributions to the fundraising process (see Table 1, Example 2) and may also include the withholding of 10% to 20% for the final dissolution of the fund in order to induce professionals to remain throughout the life of the fund, up to 10 to 13 years (see Table 1, Example 3). Another method employed is a simple straight line across the full term of the fund (see Table 1, Example 4). Vesting schedules may also be varied depending on seniority, with founders sometimes being fully vested.

Table 1 – Sample Vesting Schedules

	Incremental Amount of Carried Interest Vesting in:										
	Closing	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10 or Liquidation
Example 1	-	20%	20%	20%	20%	20%	-	-	-	-	-
Example 2	20%	-	20%	20%	20%	20%	-	-	-	-	-
Example 3	20%	-	15%	15%	15%	15%	-	-	-	-	20%
Example 4	-	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%

Typical Adjustments to Vesting Schedules

Vesting schedules are often subject to adjustment depending on the circumstances giving rise to the departure of the individual subject to vesting.

Cause: In many funds, when an investment professional is removed for cause (typically defined as bad acts, but not as poor performance), all past and future entitlement to carried interest allocations and distributions are subject to forfeit and any amounts previously received may be subject to return or "clawback." It is also common for the fund manager to retain discretion as to the exact penalty to impose under the circumstances.

Death or Disability: In cases of the death or disability of a private equity professional, some accommodation is often made to accelerate vesting as an additional benefit. Such acceleration may be achieved by assuming that the triggering event occurred one year later, thus adding an additional year of vesting.

Noncompetition: In some instances, incentives against leaving a private equity firm are enhanced by reducing vested interests if the departing professional competes with the fund manager during a previously agreed-upon time period after his or her departure. In states such as California where a traditional noncompetition agreement is unenforceable as a restraint of trade contrary to public policy, such economic incentives have been employed to try to achieve the same result. However, it is unclear and untested whether such provisions would be enforceable in these states.

Vesting Mechanics in a Tax Pass-Through Vehicle

Under current law (subject, however, to significant debate in Congress), carried interest is taxed as capital gain income instead of ordinary income so long as the income is received by the professional holding an interest in a tax pass-through vehicle (i.e., a partnership or limited liability company). This is a major reason why most general partners are structured as limited liability companies or partnerships. Vesting in a tax pass-through entity should take into account adjustments to past and future allocations of income and loss and how vesting affects both past and future distributions of proceeds.

For example, suppose a private equity professional leaves the employ of a fund manager after four years and is entitled to 80% of his portion of the carried interest. Going forward, it is easy to allocate to such person only 80% of what such person would have received had he or she not left the firm (so long as they share in 100% of losses that reduce gains previously allocated at 100%). The occasionally neglected issue is determining what the professional should have received for the first four years if his or her carried interest allocation during that period had been only 80% of his or her nominal interest for the same period, calculating what the income allocations and distributions would have been during those four years at the now reduced carried interest percentage. This retrospective aspect is not necessary, but should be carefully considered. Because a tax pass-through entity must allocate 100% of its income to its interest holders each year, all prior allocations of income to the departing professional were required to have been made as if the professional had been 100% vested.

Consequently, upon a triggering event, it is advisable to go back and recalculate the individual's capital account to reflect prior allocations on the basis of the reduced vested percentage. The resulting reduction of the capital account requires reallocation of the unvested income to the remaining partners. If such reduction results in the departed professional having a negative capital account balance, then the departed professional may be required to return distributions previously received to the extent of such negative balance. The clawback of distributions previously made, however, is handled in various ways among fund managers. Some agreements require the immediate clawback of excess distributions, others require payback over a defined period, while others provide for a potential clawback only at the end of the life of the fund if additional allocations of vested income to the departed professional do not make up the deficit balance. Some agreements, particularly in buyout funds that have deal-by-deal accounting, will not require any clawback (other than any clawback obligation due to the underlying investment partnership), treating all prior distributions as "vested."

Vesting in What Portion of the Carried Interest?

When structuring vesting arrangements, there is a fundamental split in approaches that roughly follows the lines between private equity funds and venture capital funds.

Vesting "in the Fund": Venture capital funds, which make numerous relatively small and risky investments, tend to provide that a professional will vest in the carried interest derived from an underlying fund regardless of when portfolio investments are made by such underlying fund. This is called vesting "in the fund" because it means that the investment professionals will all have a share in the entire carried interest derived from the profits generated by all investments in a particular fund. This has the benefit of simplicity in understanding and administration and fosters teamwork.

Vesting "Deal by Deal": Leveraged buyout funds, where investments tend to be much larger and fewer in number than for venture capital funds, generally tend to favor vesting in carried interest on a deal-by-deal basis (mirroring their typical deal-by-deal distribution waterfalls in their fund agreements). As such, a departing professional would vest only in the carried interest generated by investments made on or prior to the date such professional departed.

Deal-by-deal vesting by an individual professional is complicated by two factors: (1) deal-by-deal distributions of carried interest are typically subject to reduction due to the required prior repayment of invested capital associated with prior losses and expenses in a particular fund; and (2) the carried interest to which the fund manager is ultimately entitled and has available to distribute is still calculated by taking into account all deals (i.e., reduced by losses from other deals) and is subject to the fund-level clawback. All of such complications can be described generally as the mismatch between (a) the terms governing the fund manager's rights to receive carried interest allocations and distributions from an underlying fund and (b) the terms governing an investment professional's right to receive a piece of the carried interest from the fund manager. For instance, depending on the timing of payments, distributions, and realizations with respect to particular deals, a professional's entitlement to carried interest in a particular deal may be adversely affected by other deals entered into by the fund.

These considerations are amplified when a private equity firm hires additional personnel during the life of a fund and grants them carried interest in deals in which they participate. While many firms ignore the potential inequities that may arise in the deal-by-deal scheme due to the complications of trying to even them out, some have adopted formulas in which each professional is viewed as having his or her own portfolio of investments, a theoretical share of the aggregate carried interest generated by that portfolio based on the professional's carried interest sharing percentage in each portfolio company and an entitlement to the available pool of carried interest proceeds based on his or her notional aggregate share compared to each other professional's notional aggregate share. Some firms apply this concept once at the end of a fund and "true up" at that point (either through clawback or withholding of distributions), while others apply the aggregate percentage concept with each distribution in order to minimize any true-up at the end.

Vesting Hybrids: Some firms, desiring to strike a balance between the teamwork fostered by vesting "in the fund" and the individual incentives generated by "deal by deal" vesting, have developed vesting programs that incorporate both methods. In that instance, a professional's vested percentage in a deal-by-deal scenario will be modified to include a certain percentage in every portfolio investment and an additional vested percentage in each portfolio investment completed during that professional's employment.

Conclusion

As you can see from this brief discussion, the issues involved in allocation and vesting of carried interest are numerous and complex and should be approached with great care.

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For more information on the issues discussed here, please contact your Morgan Lewis Private Investment Funds Practice attorney.

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