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STRUCTURING WATERFALL PROVISIONS

Waterfall provisions in partnership and limited liability company agreements specify the priority of distribution of cash and other assets to the equity holders. This article explores the issues involved when structuring waterfall provisions in private equity funds and investment-holding companies created for buyouts.

STEPHANIE R. BRESLOW
PARTNER
SCHULTE ROTH & ZABEL LLP

Stephanie is a Partner in the firm's New York office, co-head of the Investment Management Group and a member of the firm's Executive Committee. Her practice includes investment management, partnerships and securities, with a focus on the formation of liquid-securities funds, private equity funds and providing regulatory advice to investment managers and broker-dealers.

PHYLLIS A. SCHWARTZ
PARTNER
SCHULTE ROTH & ZABEL LLP

Phyllis is a Partner in the firm's New York office, where she focuses her practice on the structuring, formation and operation of private equity funds, including buyout funds, venture capital funds, mezzanine funds, distressed funds, real estate funds and small business investment companies. She represents both fund sponsors and investors.

Waterfall provisions (known also as distribution provisions) are included in partnership and limited liability company (LLC) agreements to specify how a business entity distributes cash and other assets to its partners or members. They create different priorities of payments among partners or members.

Absent contractual provisions, state partnership laws govern how distributions are made to partners. Partnerships and LLCs are very flexible business entities because state partnership and LLC statutes typically defer distribution obligations to the specific terms of the partnership or LLC agreement. This allows partners to use waterfall provisions to structure a wide variety of economic arrangements.

Waterfall provisions also allow private equity funds and buyout vehicles to reward their general partners, managers or other executives with special profits distributions (referred to in this article as carried interests or profits interests, depending on the context) for generating financial success for the business. Typically, a private equity fund pays a carried interest to the general partner if the underlying investments made by the fund are profitable (with the private equity professionals managing the general partner being allocated portions of the carried interest). Similarly, the management team (often executive employees) of

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the target company in a private equity buyout often receives profits interests distributions if the portfolio company is successful.

This article examines the issues involved when structuring waterfall provisions in private equity funds and investment-holding companies created for buyouts. It also provides waterfall provision examples and highlights key negotiating points.

>> This article is based on a Practice Note available on practicallaw.com. For this continuously maintained resource, which provides more detailed information on fund waterfall provisions, search Structuring Waterfall Provisions on our website.

TAX CONSIDERATIONS

In this article, "partnership" refers to any business entity that is treated as a partnership for US federal income tax purposes, and "partner" refers to any owner of that entity. LLCs discussed in this article are assumed to be taxed as partnerships for federal income tax purposes.

TAXATION OF PARTNERSHIPS

A business entity taxed as a partnership is a pass-through entity for income tax purposes, which means that it does not generally pay an entity level income tax. Instead, the partnership's profits and losses are allocated and passed-through annually to the partners. These partners include their respective share of those items on their income tax returns, whether or not actually distributed to the partners pursuant to the waterfall provisions. Generally, the character of any income earned by the partnership also passes through to the partners.

Because a partner must include annually its share of the partnership's tax items in the calculation of its income, ownership of an illiquid partnership interest may result in negative short-term tax implications. In particular, a partner must include and pay taxes on its share of the partnership's profit even if the partnership does not distribute sufficient cash for a partner to pay its tax liability (known as phantom income).

Therefore, a partner must be able to pay the tax liability on phantom income from other sources or ensure the partnership agreement includes a provision separate from the waterfall distribution provisions mandating tax distributions in years in which taxable income is generated. Many partnership and LLC agreements include a specific tax distribution provision providing that sufficient income will be distributed each year to cover the partners' expected US federal and state income tax obligations attributable to partnership operations.

A partner must be able to pay the tax liability on phantom income from other sources or ensure the partnership agreement includes a provision separate from the waterfall distribution provisions mandating tax distributions in years in which taxable income is generated.

Tax Distributions for Private Equity Funds

Most private equity funds provide for tax distributions to the general partner, and occasionally to all partners. General partners, who are entitled to receive their carried interest only after total capital contributions are returned to investors (see below *Carried Interest Distributions*), particularly benefit from tax distributions to cover the phantom income generated by these arrangements. The owners of the general partner may have phantom income because the general partner is allocated taxable income and loss of the fund with respect to its carried interest even when a distribution of the carried interest is not made to the general partner. To correct this mismatch, a special tax distribution is generally made to the general partner to cover its owners' resulting tax liability.

Tax distributions made to the general partner in this manner are treated as an advance against future carried interest distributions under the waterfall provisions and reduce those future distributions. Additionally, when the fund is liquidated, previously made tax distributions factor into any clawback payment due from the general partner (see below *Clawbacks*).

Tax Distributions for Private Equity Buyout Vehicles

Most LLC agreements used for buyout vehicles provide for tax distributions from the company's available cash to all members unless restricted by applicable law or contractual arrangements (such as restrictions under bank loan documents). As with private equity funds, the LLC agreement usually clarifies that tax distributions are treated as an advance against future distributions under the waterfall provisions and reduce those future distributions.

>> For more information about the taxation of partnerships, search Taxation of Pass-through Entities on our website.

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TAXATION OF CARRIED INTERESTS AND PROFITS INTERESTS

Partnership interests can be divided into:

- Capital interests.
- Profits interests.

A capital interest gives the owner the right to a share of the proceeds if the partnership assets were sold at their fair market value and the proceeds distributed in a complete liquidation of the partnership. Contributions of capital by a partner, including cash or other property or assets, are structured generally as capital interests.

A profits interest is a partnership interest that gives the owner the right to receive a percentage of future profits of the partnership (but not existing capital or accumulated profits). Carried interests and other management equity incentives granted by a partnership to its officers, employees and other individuals are generally structured as profits interests.

Unlike the owner of a capital interest, the owner of a profits interest has no current capital at risk in the venture and, usually, has no obligation to contribute funds in the future. Therefore, all the owner can lose are profits earned after the grant date of the profits interest. If structured properly, the contribution of services to a partnership in exchange for a profits interest is tax free to the partner and to the partnership at the time of grant and as it vests.

The owner of a carried interest typically invests a small percentage of capital in the investment, and receives a share of profits disproportionate to its capital investment. This excess profits interest (or "carry") is generally structured to qualify as a profits interest. Often the management team or executive employees in a buyout context receive "pure" profits interests where no capital investment is made.

A partner who could have received cash compensation but instead receives a profits interest may get the dual tax benefit of:

- Deferring income until income or gain is realized by the partnership.
- Converting compensation income (taxed as ordinary income which can be at US federal income tax rates as high as 35%) into preferentially taxed, long-term capital gain (currently taxed at a maximum federal rate of 15% for noncorporate taxpayers). To qualify as long-term capital gain, the gains realized by the partnership must relate to capital assets that were held for more than one year.

>> For more information about the nature and taxation of profits interests, search Profits Interests on our website.

RELATIONSHIP OF PARTNERSHIP ALLOCATIONS TO DISTRIBUTION WATERFALL

The waterfall provisions specify the priority of cash and other asset distributions to partners. The waterfall provisions, however, do not specify how the partnership allocates for book and tax purposes profits and losses of the partnership to its partners. Partnership agreements typically include a separate allocation provision detailing how these profits and losses are shared among the partners. This is necessary as the partners must include their respective shares of the allocated profits and losses on their income tax returns (see above *Taxation of Partnerships*). In addition, the partnership agreement requires the partnership to track these allocations through book entry capital accounts created for all partners. Capital accounts reflect, for each partner:

- Capital contributions made by the partner.
- Profits or losses allocated to the partner under the allocation provisions.
- Distributions to the partner from contributed capital and earnings according to the waterfall provisions or otherwise.

To the extent possible, the allocation provisions of a partnership agreement should allocate profits and losses to its partners in a manner that is consistent with the economic arrangement reflected by the distribution waterfall provisions in the partnership agreement. This way, the allocation of taxable income to the partners reflects the economics of the partnership.

>> For more information on allocation provisions in partnership and LLC agreements, search Structuring Waterfall Provisions and Understanding Partnership Target Capital Accounts on our website.

WATERFALLS IN PRIVATE EQUITY FUNDS

Private equity funds are commonly formed as limited partnerships. Private equity fund waterfalls determine the priority and manner in which the investors (limited partners) and the sponsor or manager of the fund (general partner) share proceeds from investments. Fund partnership agreements typically deal with waterfall provisions by addressing the:

- Terms of the carried interest for the general partner.

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- Return of all capital contributions made by the limited partners and the preferred return, if any.
- Catch-up distributions to the general partner.
- Obligation of the general partner to return excess distributions (known as a clawback).

CARRIED INTEREST DISTRIBUTIONS

The carried interest in a private equity fund waterfall provision refers to the general partner's right to receive a share of the profits attributable to the capital invested by limited partners in the fund. Typically, the general partner's carried interest is 20% of the profits that would have been paid to the limited partners (following return to the limited partners of their capital invested plus a preferred return (see below *Priority Return of Capital Contributions and Preferred Return*)). Some private equity funds, particularly real estate funds, may offer initially a lower carried interest percentage (for example, 15%), but allow for greater carried interest percentages (20% or occasionally more) if the performance of the fund meets certain targeted returns.

For example, if the general partner invests 3% of the capital of a private equity fund, the general partner receives all of the profits on that 3% investment plus 20% of the profits derived from the remaining 97% of capital invested in the fund by outside investors. For a more detailed waterfall provision, see *Box, Waterfall Example for Private Equity Fund*.

There are various types of carried interests paid under fund waterfall provisions, including:

- Deal-by-deal carry without loss carryforward.
- Deal-by-deal carry with loss carryforward.
- Back-ended carry.

Deal-by-deal Carry without Loss Carryforward

Deal-by-deal carried interests without loss carryforwards were used in early private equity funds. These allow the general partner to receive its carry on profitable deals without regard to losses from other deals within the fund.

This structure is uncommon today. It is viewed as an overly manager-favorable term that does not align the interests of the manager and investors. Investors fear that the general partner will be encouraged to make risky investment decisions knowing that potential gains on successful deals will not be affected by losses on others. However, the concept of deal-by-deal carry might still be found in a club or pledge fund where investors are permitted to decide whether they will participate in a particular deal.

Deal-by-deal Carry with Loss Carryforward

The more common version of deal-by-deal carried interest in waterfall provisions takes into consideration previously realized losses on deals that have been disposed of and write-downs (or permanent impairments of value) attributable to investments not yet sold. In addition, to the extent that there are losses on later deals after the carry has been distributed on earlier deals, the general partner must return the excess through a clawback payment (see below *Clawbacks*).

Back-ended Carry

A back-ended carry waterfall (known also as a total return waterfall) requires that investors receive distributions of their full invested capital plus their full preferred return (see below *Priority Return of Capital Contributions and Preferred Return*) before the general partner receives any carried interest distribution.

A back-ended carry formulation substantially delays the receipt of carry by the general partner. Because private equity funds make multiple investments and hold most or all of them for years, the general partner may not receive any carried interest until the tail end of the life of the fund.

The back-ended carry arrangement is more favorable to investors. Back-ended carry structures reduce the possibility that the general partner will:

- Receive excessive carry that must later be recouped through a clawback payment.
- Delay recognition of unrealized losses by waiting to dispose of losing investments and eliminate any need to value assets or to determine write-downs.

As a result, a back-ended carry is seen most commonly in first time funds or funds where capital raising is difficult. It is also generally more common in venture capital funds (where investments are seen as more risky) and investor-favorable marketing environments, such as the period following the financial crisis that began during the summer of 2007.

Back-ended carry arrangements can also offer advantages to general partners. For example, investors may be willing to forego the clawback entirely or protections to collect a clawback payment, such as escrow arrangements or personal clawback guaranties (see below *Clawbacks*). The back-ended carry structure also simplifies fund accounting, which can be particularly helpful in funds that make many investments.

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However, back-ended carry arrangements can result in phantom income for the general partner (meaning, recognition of taxable income by the general partner without corresponding fund distributions to pay the tax). As a result, the right of the general partner to receive tax distributions is a particularly important feature of private equity funds with back-ended carry structures (see above *Tax Distributions for Private Equity Funds*).

PRIORITY RETURN OF CAPITAL CONTRIBUTIONS AND PREFERRED RETURN

Private equity fund waterfall provisions generally provide for a priority return of all capital contributions made by the limited partners (as well as any capital contributions of the general partner). In addition, most private equity fund waterfalls offer investors a preferred return (known as a hurdle), which is less common in venture capital funds. The preferred return provides investors with a stated return on their capital contribution, along with a return of their capital, before the general partner receives any carried interest distribution.

The preferred return rate is generally 8% annually compounded. Real estate funds often provide for slightly higher rates and debt-focused funds may provide for lower rates (particularly during economic periods when interest rates are low). The preferred return typically accrues on all capital contributions to the fund from the date when these contributions are made until the date when these contributions are returned. Some funds offer a preferred return on invested capital only (excluding a return on contributed capital used for fund expenses). General partners do not heavily negotiate preferred return rates. This is because it is preferable to convey a message to investors that their fund is expected to generate returns well in excess of the preferred return rate.

CATCH-UP

After investors receive their invested capital and a preferred return, the waterfall provision generally provides for a "catch-up" distribution to the general partner (usually 100% of the cash to be distributed). This catch-up distribution continues until the amount of the preferred return distributions to the limited partners, together with the general partner catch-up distributions, results in a ratio of distributions of profits to the parties that is equal to the carried interest split (see above *Carried Interest Distributions*). Without a catch-up distribution, the general partner

WATERFALL EXAMPLE FOR PRIVATE EQUITY FUND

The following is an example of a simple private equity fund waterfall based on a deal-by-deal carry with loss carryforward:

> Net available cash flow from the disposition of any investment will first be divided among the limited partners and the general partner in proportion to capital contributions with respect to such investment. The share of such net available cash flow apportioned to the general partner will then be distributed to the general partner. Each limited partner's share of such net available cash flow will then be further divided and distributed as between each limited partner and the general partner as follows:
>
> (a) First, to the limited partner until such limited partner has received a return of its invested capital in the investment to which such distribution relates plus its unreturned invested capital in any prior investments that have been the subject of dispositions, plus any write-downs on other investments not yet the subject of dispositions, plus the allocable share of such limited partner's unrecouped expenses relating to all such investments;
>
> (b) Second, to the limited partner until such limited partner has received cumulative returns of 8% per annum (compounded annually) under this clause (b) and clause (d) below on the amounts distributed to such limited partner under clause (a) above;
>
> (c) Third, 100% to the general partner until the amount distributed to the general partner pursuant to this clause (c) equals 20% of the amounts distributed to such limited partner and the general partner pursuant to clause (b) above and this clause (c); and
>
> (d) Thereafter, 20% to the general partner and 80% to the limited partner.

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will never receive its full carried interest percentage of profits.

CLAWBACKS

Under certain circumstances, typical private equity fund waterfalls can result in the general partner receiving distributions of profits in excess of its stated carried interest percentage for those profits (or distributions that do not result in investors receiving their full preferred return). These circumstances include:

- An early sale of profitable investments followed by losses generated by unprofitable investments.
- Greater expenses in the fund's later years.
- Unexpected liabilities.
- A slowdown in the profitability of the fund in later years so that even if losses are not incurred, the preferred return owed to investors increases and the ultimate level of return achieved by the fund is insufficient to entitle the general partner to receive its full carry.

To address this possibility, partnership agreements often provide an obligation of the general partner to return excess distributions. This obligation is known as a clawback.

Clawback obligations are common in funds with a deal-by-deal carry waterfall (see above *Deal-by-deal Carry with Loss Carryforward*). By contrast, clawback obligations are less common in funds with a back-ended carry waterfall given the timing of the carry distribution (see above *Back-ended Carry*). Notably, the general partner can receive excess carry even in back-ended carry funds. That possibility exists when the fund returns committed capital previously drawn into the fund, distributes a carry to the general partner (with any necessary hurdle to the limited partners), subsequently draws in the balance of committed capital, but then suffers losses on investment made with those later capital contributions.

>> For more information on clawbacks, including calculating clawbacks, the methods for taking into account tax liabilities on clawback obligations and the timing of, and liability for, clawback payments, search Structuring Waterfall Provisions on our website.

MATERIAL NEGOTIATED ISSUES

There are many issues embedded in fund waterfall provisions that are heavily negotiated and that can have significant economic implications for the parties (see *Box, Waterfall Example for Private Equity Fund*). Key negotiated issues relate to the:

- Priority return of capital contributions.
- Nature of the preferred return.
- Terms of the carried interest payments.

Return of Capital Contributions

- Will all capital contributions be returned first, or will distributions be distributed on a deal-by-deal basis?
- If deal-by-deal distributions are made, how will expenses be allocated across investments for waterfall purposes? Some fund waterfalls require that investors recoup their share of all fund expenses, which are paid out of contributed capital, incurred through the date of the distribution. Often, however, expenses are instead allocated across the fund's investments.
- How will write-downs be treated? Typically, assets that the general partner determines to have suffered a permanent impairment of value are treated as if they have been disposed of for purposes of the waterfall provisions and carry calculation. In addition, the capital associated with this investment must be returned before the general partner receives any carried interest. Otherwise, a general partner could avoid recognizing a loss until a clawback payment is due upon dissolution of the funds.

Preferred Return

- Will the preferred return be compounded? If so, how frequently?
- Will the preferred return be payable on all amounts expended by the investors or only on amounts invested in investments?
- How is general partner catch-up structured? After the preferred return is paid, the general partner usually receives a catch-up distribution of profits so that the general partner actually receives 20% of the total profits distributed (see above *Priority Return of Capital Contributions and Preferred Return*). The catch-up varies from 100% of available profits to a 50% sharing with investors until the catch-up is achieved.
- What time period is used to determine how long capital has been outstanding for purposes of calculating the preferred return? Some private equity funds accrue preferred return on all capital that has not yet been returned to investors. Others calculate the preferred return on amounts

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truly at risk in those funds, in which case preferred return does not accrue on capital that has been drawn down until it has actually been invested or expended.

Carried Interest Payments

- Will there be separate waterfalls that provide for distributions of current income as opposed to disposition proceeds from investments? In the case of private equity funds that generate significant amounts of current income (such as a real estate fund with mature operating properties or mezzanine funds), significant interest payments or current income payments can be generated. Some fund documents permit the general partner to take a carry on these current income amounts without first applying the amounts toward repayments of the cost basis of the investment to which they relate or on the recouped cost basis of other deals, or both.
- Will there be carry charged on short-term investment proceeds? Private equity funds can expect to earn some level of return on capital held in bank accounts or other short-term investments pending use for portfolio investments and expenses. Sometimes earnings on short-term investments do not bear the carry, while in other cases they are run through the same waterfall as disposition proceeds.
- What coverage ratios are required? In deal-by-deal carry waterfalls, investors may insist that the general partner reduce or delay receipt of the carry during the life of the fund to the extent that valuation calculations made on the portfolio remaining to be sold do not provide adequate assurance to investors that a clawback will not be required. The amounts foregone by the general partner may be either placed into an escrow to secure the clawback or paid as accelerated distributions to the investors.

WATERFALLS IN PRIVATE EQUITY BUYOUTS

Generally, in buyout transactions, an investor (or sponsor) and members of management form, and become equity owners of, a new investment-holding company structured as a pass-through vehicle for tax purposes. By contrast to private equity funds that are typically structured as limited partnerships, these investment-holding companies are more commonly formed as LLCs.

>> For a discussion of the structure and financing of a buyout, search Buyouts: Overview on our website.

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MULTI-MEMBER FORM LLC AGREEMENT

In many complex investment transactions, including private equity buyouts, investors choose to use a limited liability company (LLC) as the holding company investment vehicle. Because these transactions typically involve multiple investors and classes of equity interests, including profits interests for management, the LLC agreement is integral to defining the relationship among the parties. The LLC agreement sets out the economic deal and governs the operation and management of the LLC and the members' contractual rights and obligations.

PLC Corporate & Securities recently published a Standard Document for a long-form US LLC agreement aimed at investment transactions with multiple members and a board of managers controlled by a private equity sponsor. This Standard Document includes integrated notes with important explanations and drafting and negotiating tips.

For a copy of this Standard Document, search LLC Agreement: Multi-member, Manager-managed on our website.

The waterfall provisions in LLC agreements for buyout-holding companies serve the same purpose as the distribution waterfall provisions in private equity funds by determining the order in which the members' LLC units are entitled to receive any proceeds from the investment. The specific layering of buyout waterfall provisions among the members is a matter of negotiation and has a wide variety of options, though certain approaches prevail. The main negotiated issues relate to:

- The priority return of invested capital and any preferred return.
- Whether the securities are participating or nonparticipating.
- The terms of management profits interests.

PRIORITY RETURN OF INVESTED CAPITAL AND PREFERRED RETURN

Buyout waterfall provisions in LLC agreements generally replicate the preferred and common stock structures that are common in buyouts with C-corporation investment vehicles (for more information, search Buyouts: Overview on our website). With an LLC-structured buyout, the sponsor acquires both preferred and common units (or a single class of preferred units with characteristics of both). In addition, as with stock options or restricted stock in a corporation-structured buyout, management is awarded common equity incentives in the LLC in the

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form of profits interests (see below *Profits Interests for Management*).

As with preferred stock, buyout waterfall provisions entitle the preferred units to receive a liquidation preference before any payments being made to common unitholders. The liquidation preference includes the amount of capital invested by the preferred unitholders in the company and, commonly (but not always), a preferred yield (or hurdle) that accumulates on the units (similar to a cumulative preferred stock dividend).

The liquidation preference ensures the sponsor receives at least the bulk (if not all in a single-class preferred equity structure) of its invested capital back, plus any preferred yield, before any remaining value from the investment is shared with management. This protects the sponsor by subjecting it to the least risk of nonpayment.

>> For an overview of preferred stock used for a corporation, search Preferred Stock: Overview on our website.

PARTICIPATING VERSUS NONPARTICIPATING

With buyout waterfall provisions, whether the sponsor holds both preferred and common units or just a single class of preferred units, the sponsor typically receives a pro rata share (along with management profits interests) in distributions of the remaining residual value of the company following the return of its liquidation preference. One of the main issues commonly negotiated is whether, following the payment of the liquidation preference, the waterfall provision is participating or nonparticipating.

A participating waterfall provision is more favorable to a sponsor. This is because of the "double-dip" nature of the feature, which entitles the sponsor not only to its liquidation preference (including the preferred yield), but a pro rata share of the remaining equity value as well. As a result, the sponsor receives both the preferred return and its share of any upside value in the company with no discount due to the prior receipt of the preferred yield. By contrast, with a nonparticipating waterfall provision, following receipt of its invested capital, a common structure would allow the sponsor to receive the greater of its preferred return and its pro rata share of the remaining residual value of the company, but not both.

The participation versus nonparticipation distinction in a waterfall provision depends on whether the waterfall provides for a management "catch-up." A nonparticipating waterfall provision includes a management catch-up, while a participating waterfall provision does not.

With a management catch-up, following satisfaction of the sponsor's liquidation preference (including the preferred yield), the waterfall provides for priority distributions to the profits interests held by management. These catch-up distributions are made until the aggregate distributions to management relative to all distributions made to the sponsor and management (including all catch-up distributions) equals the agreed ownership split between the sponsor and management. The balance of any distributions following the catch-up is then typically split pro rata between the sponsor and management based on the same ownership split.

The liquidation preference ensures the sponsor receives at least the bulk (if not all in a single-class preferred equity structure) of its invested capital back, plus any preferred yield, before any remaining value from the investment is shared with management.

PROFITS INTERESTS FOR MANAGEMENT

As with common stock-based equity incentives (such as stock options or restricted stock) issued to management in corporation-structured buyouts, equity incentives in the form of profits interests typically are issued to management in an LLC-structured buyout. A profits interest gives the owner the right to receive a percentage of the partnership's future profits, but not existing capital or accumulated profits (see above *Taxation of Carried Interests and Profits Interests*). In a buyout waterfall provision, profits interests share (with any other common units) only in any remaining value in the company following the liquidation preference distributed to the preferred units (see above *Priority Return of Invested Capital and Preferred Return*).

>> For an overview of profits interests, search Profits Interests on our website.

Unlike the fixed 20% carried interest in private equity funds (see above *Carried Interest Distributions*), there is not necessarily a market standard for the size of the profits interest pool established for management in buyouts. Rather, like a stock option pool, private equity sponsors and management negotiate the size of the profits

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WATERFALL EXAMPLE FOR PRIVATE EQUITY BUYOUT VEHICLE

The following is an example of a basic buyout waterfall provision based on two classes of sponsor units with a preferred return and participating preferred economics for the sponsor and profits interests for management:

All Distributions determined to be made by the Board pursuant to Section [__] shall be made to the Members as follows:

(a) First, to the Members pro rata in proportion to their holdings of Preferred Units then outstanding, until the aggregate Distributions under this clause (a) equals a cumulative return of [__]%, compounded [semi-]annually on the aggregate invested capital of the Members in the Preferred Units as of the time of such Distribution;

(b) Second, to the Members pro rata in proportion to their holdings of Preferred Units then outstanding, until the aggregate Distributions under this clause (b) equals the aggregate invested capital of the Members in the Preferred Units; and

(c) Third, any remaining amounts to the Members pro rata in proportion to their aggregate holdings of Common Units and Incentive Units then outstanding, with the Common Units and Incentive Units treated as one class of Units for this purpose.

To revise the waterfall provision for nonparticipating preferred economics for the sponsor with a management catch-up, add a distribution tier for the catch-up between the second and third tiers as follows:

(c) Third, to the Members pro rata in proportion to their holdings of Incentive Units then outstanding, until the ratio of (i) the aggregate Distributions to the Members under this clause (c) to (ii) the aggregate Distributions to the Members holding Units under clauses (a), (b) and this clause (c) equals the ratio of (i) aggregate Incentive Units then outstanding to (ii) the aggregate Incentive Units and Common Units then outstanding treated as one class of Units for this purpose; and

interest pool, which typically ranges from 5% to 15% of the fully diluted equity ownership. This percentage is usually set at the time of the buyout, but may increase over time, diluting the sponsor's share of the profits.

On the other hand, because of vesting arrangements, the total percentage of profits interests granted to executives in a buyout can also diminish if profits interests are later forfeited (see below *Vesting Requirements*). Because profits interests used for buyouts apply to the performance of a single investment and do not normally receive distributions before the end of an investment when there is a liquidity event, they are rarely subject to a clawback obligation as with a private equity fund (see above *Clawbacks*).

Strike Price Requirement

To provide that a profits interest represents a stake in the future growth of the company, the award agreement for each grant of profits interests includes a "strike price." The LLC agreement typically requires the board to set the strike price, which is based generally on the fair market value of the common equity of the LLC on the date of grant. The strike price ensures that any profits interest has no immediate liquidation value to qualify as a profits interest (see above *Taxation of Carried Interests and Profits Interests*). This is reflected in the buyout waterfall provision, which limits distributions to the profits interests until distributions under the waterfall to other units (including other profits interests that have satisfied their strike price) equal the particular strike price.

Vesting Requirements

It is common for profits interests issued to management to be subject to vesting. With vesting, the economic rights (including the right to distributions in the waterfall provisions) to the award do not pass to the recipient of the award until after certain preconditions are met. If those preconditions are not met, the award is forfeited. This is reflected in the buyout waterfall provision, which limits distributions to the profits interests until they are vested.

For a complete overview of vesting for management equity incentives, search Management Equity Incentives in Buyouts on our website.

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Management Equity Incentives in Buyouts or 2-500-2291

Profits Interests or 3-422-4189

Taxation of Pass-through Entities or 2-503-9591

MATERIAL NEGOTIATED ISSUES

There are many issues embedded in buyout waterfall provisions that are heavily negotiated and can have significant economic implications for the parties (see *Box, Waterfall Example for Private Equity Buyout Vehicle*). Key negotiated issues relate to:

- The preferred return on the preferred units.
- Whether the waterfall provision is participating or nonparticipating.
- The terms of the profits interests payments.

Preferred Return

- Will there be a preferred return on the preferred units? If so, what will the terms be? A sponsor often insists on a preferred return to ensure at least some minimum return before management shares in any proceeds of the investment. However, unlike the standard 8% rate in private equity funds (see above *Priority Return of Capital Contributions and Preferred Return*), the terms of the preferred return are negotiated on a case-by-case basis and are based on the underlying business of the company and the negotiation leverage of the parties involved. Generally, the yield on the preferred return ranges from 8% to 10% and is typically cumulative with compounding at least annually.

Participating versus Nonparticipating

- Will the waterfall provision reflect a participation or a nonparticipation feature? Whether the sponsor in a buyout receives a double-dip participation in a successful buyout is typically a heavily negotiated issue. With a nonparticipation feature, the management catch-up is typically a 100% catch-up rather than a lower percentage.

Profits Interests for Management

- Will management be granted profits interests to share in profits of the investment? Given the importance of the management team to the success or failure of a buyout, it is fairly rare for the management team in a buyout not to receive a management carry in the form of profits interests. The aggregate percentage reserved for the management profits interest pool varies among sponsors and specific deals, but commonly ranges from 5% to 15%. Individual allocations from the pool usually are based on the seniority of the manager, with the most senior or key managers (such as the chief executive officer) granted the largest portions of the profits interests.
- Will the profits interests awarded to management be subject to vesting requirements? If so, what type of vesting will apply and what will the terms be? It is common for profits interests awarded to management to be subject to vesting. Generally, vesting arrangements are heavily negotiated and often differ among members of management. Time vesting (whether prorated or cliff vesting at the end of a period) is more common than performance vesting. It is not unusual to have a combination of time vesting and performance vesting for different portions of the carry.

>> This article is based on a Practice Note available on practicallaw.com. For this continuously maintained resource, which also examines waterfall provisions in joint ventures, search Structuring Waterfall Provisions on our website.

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