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On Waterfalls

Cesar Estrada of J.P. Morgan and Jonathan Karen of Simpson Thacher discuss best practices for the design and implementation of waterfall provisions within a fund agreement

In private equity jargon, the 'waterfall' refers to the prioritising of returns among the limited partners (LPs) and general partner (GP). Depending on a fund's performance, the GP may receive more than its pro rata share of proceeds based solely on its invested capital; these additional amounts potentially payable to the GP are referred to as 'carried interest.'

Carried interest waterfalls in private equity and real estate funds are commonly thought of by investors and sponsors as neatly falling into specific types, broadly termed 'European-style' and 'American-style' waterfalls.

The reality is not quite so neat. Waterfall provisions are often highly negotiated and bespoke arrangements, where nuances in words and implementation often produce significant differences in the calculation and/or timing of distributions.

COLLABORATIVE DRAFTING OF THE FUND PARTNERSHIP AGREEMENT

For sponsors, today's environment is characterised by both challenging fundraising and increased scrutiny from investors. Hence, it is critical for them to demonstrate an understanding of their own waterfalls and their capability to properly implement and administer them.

Investors, on the other hand, must now contend with greater oversight from and accountability to their ultimate constituents. For them, it is vital to ensure that they are entrusting their money to sponsors who possess this understanding and capability.

Seasoned finance and accounting professionals – including those at experienced private fund administrators – know from firsthand experience that no matter how precise the drafting, prose often fails to translate perfectly to mathematical implementation in a manner that is completely free of ambiguity – or that does not require the making of some unwritten assumptions.

Similarly, lawyers and investment professionals recognise that finance and accounting people are not often found on the front lines of the drafting and negotiating of waterfall provisions. As a result, they have limited opportunity when drafting these provisions to receive the real-world perspective of those who run these mathematical calculations.

If we add to all of this the effect of increasingly complex fund terms and structures, it is clear that the time is now past when we can hope to rely with any confidence on the ability of a lone back-office worker – often armed solely with an Excel spreadsheet – to correctly implement the provisions of this critical legal documentation.

Estrada: *collaboration is key*

Karen: *waterfalls often highly bespoke*

In order to ensure that there is broad internal consensus about and clear understanding of these complex and important provisions, sponsors would be well-advised to ensure that there is a collaborative dialogue from the inception of negotiations. Such a dialogue should include the lawyers who draft and negotiate the waterfall provision, the finance and/or accounting professionals who administer and implement the waterfall, and the investment professionals who manage relationships with investors.

EUROPEAN-STYLE WATERFALLS

First, let's look at the most simple and straightforward case: a typical European-style waterfall (also termed 'full return' or 'back-ended' carried interest waterfalls). In this formulation, the sponsor does not receive any carried interest until the investors have first received back cumulative distributions equal to the aggregate amount of their capital contributions, typically plus a preferred return on these contributions.

The applicable wording for the first two parts of such a waterfall may, for example, read as follows:

(i) First, 100% to such Limited Partner until such Limited Partner has received cumulative distributions pursuant to this clause (i) on or prior to such date in an amount equal to the aggregate amount of Capital Contributions made by such Limited Partner on or prior to such date;

(ii) Second, 100% to such Limited Partner until the cumulative distributions to such Limited Partner (other than distributions made pursuant to clause (i) above) represent an 8% per annum, compounded return on the amount distributed to such Limited Partner pursuant to clause (i) above.

Although these first two steps may seem quite straightforward, there are nevertheless a number of variations and variables that must be considered. For example, is the preferred return to be calculated from the date of contribution to the date of distribution, or from the day the capital is deployed by the fund to the date it is received back by the fund?

> *Nuances in words and implementation often produce significant differences in the calculation and/or timing of distributions*

Similarly, is the preferred return to be calculated as an interest factor on the aggregate amount of capital contributions (as illustrated above), or is it to be calculated as an internal rate of return? How do interim GP clawbacks and/or any returns of distributions by LPs affect subsequent calculations? How are in-kind distributions to be valued?

Each of these questions is likely to be specifically negotiated. In addition, the remaining steps of the waterfall (such as the GP 'catch-up', which itself often varies) are also likely to be closely negotiated by investors.

It is important to note that even where items are specifically negotiated and an agreement memorializes the arrangement or perhaps the use of a specific methodology, there still may be related rules that remain unwritten, as well as calculation methodologies that are unexpressed. For example, in the preferred return calculation noted above, while it is clear that the preferred return is to be calculated as an interest factor similar to compound interest, rather than as an internal rate of return, the compounding convention is not specified. Is the rate of return to be compounded daily? Or is it to be compounded on a different periodic basis (e.g., monthly, quarterly or annually)? In a several hundred million dollar fund with a term of over ten years, the resolution of this particular

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question can be literally become a million-dollar question and result in a meaningful difference in outcomes in the amount and timing of distributions.

AMERICAN-STYLE WATERFALLS

The more complex 'American-style' waterfall formulation (also termed 'realised-deal' and/or 'cumulative deal-by-deal' waterfalls) presents even more opportunities for variation and, therefore, ambiguity. In a typical instance of this methodology, the sponsor generally does not receive any carried interest from the sale of an investment until the investor has first received cumulative distributions in an amount referred to as its 'realised capital and costs', typically plus a preferred return thereon. The realised capital and costs is often calculated as the sum of: (x) the aggregate amount of capital contributions for such investment and all realised investments, plus (y) the amount of capital contributions related to unrealised losses on write-downs of unrealised investments, plus (z) the amount of its capital contributions for an allocable portion of fees and expenses.

The applicable wording for the first two parts of such a waterfall may, for example, read as follows:

(i) First, 100% to such Limited Partner until such Limited Partner has received cumulative distributions from such Investment and all Realised Investments in an amount equal to such Limited Partner's Realised Capital and Costs;
(ii) Second, 100% to such Limited Partner until the cumulative distributions to such Limited Partner (other than distributions made pursuant to clause (i) above) from such Investment and all Realised Investments represent an 8% per annum, compounded return on such Limited Partner's Realised Capital and Costs.

In addition to the issues and questions noted above in the European-style waterfall, there are further variables – in each case often the focus of negotiations with investors – that can distinguish some 'American-style' waterfalls from others within the same category. For example, are the unrealised losses that comprise part of the above-mentioned 'realised capital and costs' (which are required to be returned prior to carried interest) calculated as all write-downs on unrealised investments – irrespective of any write-ups on unrealised investments? Or, is the calculation based upon write-downs only in excess of write-ups on the entire pool of unrealised investments?

Similarly, there can be significant differences, often specifically negotiated, in the treatment of current income from unrealised investments. ('Current income' in this case is defined as distributions to investors consisting of interest, dividends or other current income from investments that have not been the subject of a disposition.)

There are two general approaches to the treatment of current income illustrated in the text above. In the first approach, the sponsor is able to receive carried interest from a distribution of current income from an unrealised investment without having to first return the full amount of such investment, just as if it were a realised investment. In the second approach the sponsor must return the full amount of an unrealised investment, just as if it were realised. Moreover, there are distinctions in the way current income

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can be distributed. First, the current income distinction is set forth in its own separate waterfall which often requires that current income first provide a specified current return on such unrealised investment and make-up for any existing realised losses. Second, which is more favorable to the sponsor, the current income distribution first requires a cumulative return of realised capital and costs with respect to other realised investments (in this latter case, the example language above would be modified by striking the words "from such Investment" in the operative text).

Just as both American-style and European-style waterfalls may have economic provisions that vary, it is also true that either style of agreement may include unwritten rules and/or calculation methodologies that are not expressed. In our example above, exactly what amounts and timing of inflows (FIFO? weighted average?) would be used to calculate the preferred return on a net amount calculated by determining the excess of write-downs over write-ups on unrealised investments? Similarly, for purposes of calculating the inflows implicit in a preferred return calculation, how would capital contributions for an allocable portion of fees and expenses be allocated to a pool of net write-downs?

The answers to these questions have the potential to significantly alter the timing of a sponsor's receipt of carried interest proceeds. Clearly, therefore, these are questions that warrant careful consideration.

RECOMMENDATIONS

These common examples and frequently asked questions illustrate just why it is so important for sponsors to devote sufficient time, attention and support to ensure broad, internal understanding of – and consensus about how to implement – private equity fund waterfall provisions.

In fact, the discussion above is familiar to the many fund administrators, accountants and attorneys who serve both sponsors and investors in the private equity fund community. As such, several recommendations follow on this discussion:

1. In order to demonstrate their proficiency to investors, private equity fund sponsors should be sure to include finance and/or accounting professionals and fund administrators in the drafting and negotiating of waterfall provisions. This should be done on a real-time basis, alongside attorneys and investment professionals.
2. Sponsors must also ensure that they have the institutional and administrative capabilities to actually implement the provisions of their carried interest waterfall. This capability can be either internal or one provided by a top fund administrator who has the ability to automate the process.
3. Those who serve sponsors and investors in private equity funds must help to ensure that their clients have the requisite understanding and capabilities. When necessary, they should direct their clients to the professionals who can assist them. ■

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