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Investment Funds Update

Getting flexible: new strategies for whole-of-fund carried interest

by Piers Warburton

For a fund manager, whole-of-fund carried interest can be a blunt instrument. However, it has become and is likely to remain the standard carried interest arrangement for European investment funds because of the protection it provides for investors against early payments of carried interest being made despite disappointing overall fund returns.

What is more, for UK tax-paying carried interest holders, whole-of-fund carried interest maximises the benefit of the "base cost shift" which can deliver a low effective rate of taxation for the carried interest.

Types of carried interest

With a whole-of-fund carried interest, no payments are made to the carried interest until investors have received amounts equal to their aggregate drawn-down commitments plus a preferred return.

With a pure deal-by-deal carried interest, payments are made to the carried interest out of the returns of a particular investment once investors have received the commitments drawn down for that investment (and that investment alone) plus a preferred return on that amount.

Pure deal-by-deal carried interest has increasingly been replaced by the hybrid "take-as-you-go" arrangement, under which payments are made to the carried interest out of the returns of a particular investment once investors have received the commitments drawn down for that investment **plus** any outstanding amounts drawn down for previously realised investments plus a preferred return on that aggregate amount.

Whatever carried interest system is adopted, additional protection may be provided for investors through an escrow or "claw-back" arrangement which can ensure that early over-payments are returned to investors in the event of subsequent poor fund performance.

Whole-of-fund concerns

One of the concerns for a fund manager with whole-of-fund carried interest is that it may not always be the right motivational tool for the fund's executives.

For example, simply allocating shares of a whole-of-fund carried interest among an investment team does not recognise that individual contributions vary from transaction to transaction. While there may of course be merit in providing some rewards that reflect the success of the team as a whole, this does not by itself provide the best incentive for executives to excel on their own transactions.

Furthermore, while a whole-of-fund carried interest may be appropriate for more senior executives, the long delay before a fund's first whole-of-fund carried interest distribution does not meet the needs of ambitious young executives looking, for example, to purchase properties.

Solutions

While some of the problems with whole-of-fund carried interest could, in principle, be resolved with a deal-by-deal carried interest together with a suitable escrow arrangement to protect investors' interests, for many investors used to typical European fund terms that might well be a step too far. And of course, the tax advantages of whole-of-fund carried interest would be lost. It is also worth noting that one of the most high profile European funds to adopt the deal-by-deal approach has only a 10 per cent carried interest.

However, Ashurst has experience of implementing variations on a straightforward whole-of-fund carried interest which can address motivational issues while at the same time meeting the expectations of investors.

Flexible allocation

One approach is to use a whole-of-fund carried interest, but to allocate distributions on a flexible basis - for example, by way of an annual or deal-by-deal allocation. Ashurst has developed models to implement such arrangements in a way that mimics, as closely as possible, the individual returns that would result from a deal-by-deal carried interest. This arrangement may represent a better individual incentive to executives while retaining the tax advantages of a whole-of-fund carried interest.

Ashurst has recently acted for the managers of a major international venture capital fund in implementing such an arrangement.

Partial deal-by-deal

A second approach is to retain the whole-of-fund model, but to build into it a small element of deal-by-deal carried interest. This is clearly a compromise - but one that may be more readily accepted by investors than an unfamiliar deal-by-deal model as it retains much of the protection offered by the traditional whole-of-fund approach.

The distribution "waterfall" under this arrangement is the same as for a normal whole-of-fund carried interest, except that the repayment of drawn-down loans and the payment of the preferred return to investors are subject to an "interim carried interest". The interim carried interest delivers a small carried interest calculated on the basis of the investment that is being realised (for a true deal-by-deal carried interest) or on all realised investments (for a take-as-you-go carried interest). The whole-of-fund carried interest distributions are then reduced by the amount of all interim distributions that have been made so that the overall carried interest remains the same.

Ashurst has recently implemented such a carried interest arrangement for a major buy-out fund.

Ashurst's funds group

Ashurst's investment funds group has helped raise over €24bn since 1998 and has wide experience of acting for fund managers, fund investors and investment executives on fund formation, carried interest and co-investment arrangements.

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