Venture Capital Fund Carried Interests

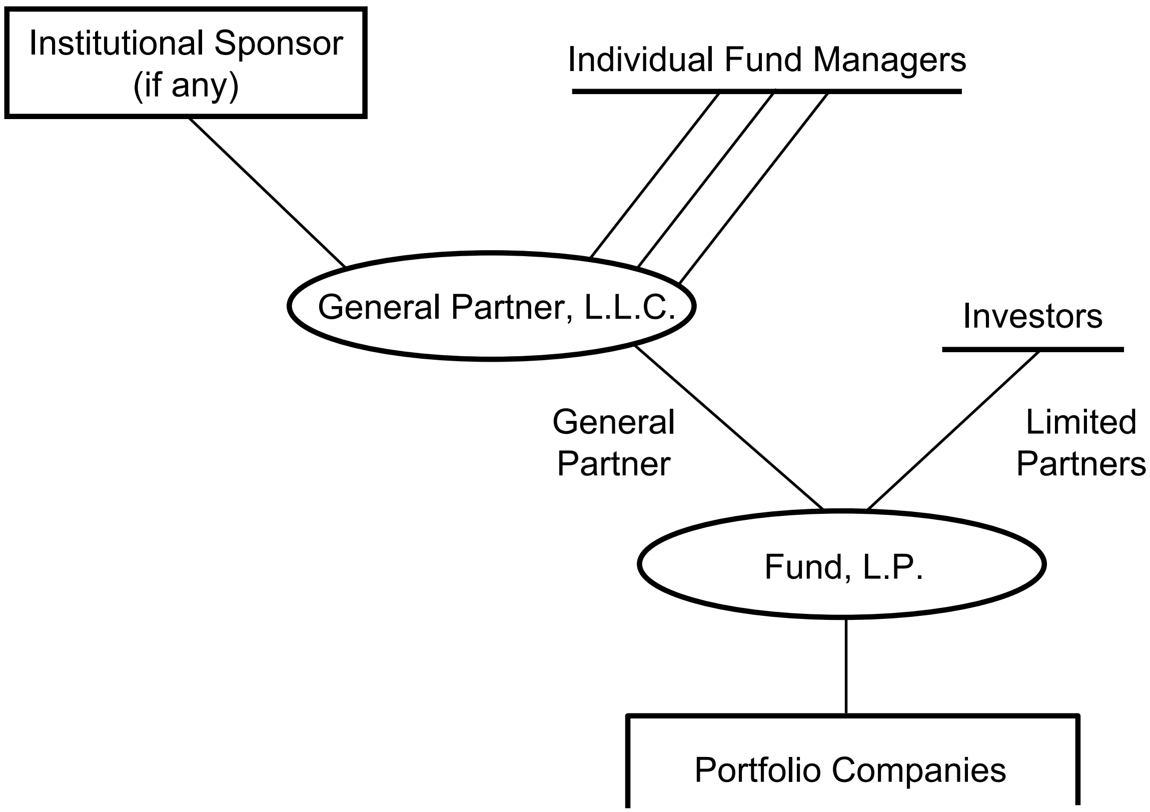
Background and Selected Issues

Wilson Sonsini Goodrich & Rosati
PROFESSIONAL CORPORATION

July 2001

1352819

Background: Typical Fund Structure



Definition of “Carried Interest”

The Carried Interest is a share of fund net profits allocated to the General Partner that is disproportionate to the General Partner’s capital commitment to the fund

Typical Fund Capitalization

Capital Committed by Investors:	99%
Capital Committed by General Partner:	1%

Typical Allocation of Fund Net Profits

- *Proportionate Allocation:*
  - 80% to *all Partners* (including the General Partner) in proportion to their respective capital commitments
- *Carried Interest Allocation:*
  - 20% to the General Partner

Range of Carried Interest Rates

- The vast majority of General Partners have a 20% carried interest
  - Very few have a carried interest of less than 20%
    - Different rule for in-house corporate venture funds, where carry often is less than 20%
  - A modest number of “top-tier” General Partners have a carried interest of 25-30%

Range of Carried Interest Rates

- Occasionally, the carried interest rate is contingent upon performance
  - Example: Carried interest rate is 20%, unless the IRR to Limited Partners exceeds 25%, in which case carried interest rate is 30%

Appearances Can Be Misleading

- Stated carried interest percentages are not the whole story
  - There are a number of key provisions that can modify the economic value of the stated carried interest percentage

Selected Modifications

- Hurdle Rate
- Floor
- Calculation of “Net Profits”

"Hurdle Rates"

Some fund agreements allocate carried interest profits to the General Partner only after the Limited Partners have achieved a specific IRR

Sample Hurdle Rate Allocation

- Net profits will be allocated:
  - First, to all the Partners until each Partner has been allocated net profits sufficient to represent an 8% cumulative IRR on such Partner's contributed (and unreturned) capital;
  - Next, 100% to the General Partner until total allocations have been made:
    - 80% to all the Partners in proportion to their respective capital commitments; and
    - 20% to the General Partner; and

Sample Hurdle Rate Allocation, cont'd.

- Next,
  - 80% to all the Partners in proportion to their respective capital commitments; and
  - 20% to the General Partner.

Observation About Hurdle Rates

Because of the 100% “catch-up” allocation to the General Partner, the hurdle will have no ultimate effect on the carried interest if the fund achieves its target IRR

Alternative to the Hurdle: The "Floor"

- Under this approach, the carried interest applies only to those net profits that exceed the hurdle rate
- There is no General Partner "catch-up"
- More frequently used in "Hedge Funds" than in Venture Capital Funds; strongly resisted by General Partners

Sample Floor Allocation

- Net profits will be allocated:
  - First, to all the Partners until each Partner has been allocated net profits sufficient to represent an 8% cumulative IRR on such Partner’s contributed (and unreturned) capital; and
  - Next,
    - 80% to all the Partners in proportion to their respective capital commitments; and
    - 20% to the General Partner.

Calculation of "Net Profits"

- Majority Rule
  - Net profits are calculated by taking into account all items of fund income, gain, loss and expense (including management fees paid to the General Partner)
- Pro-General Partner Rule
  - Net profits are calculated by taking into account only gains and losses on portfolio company investments (excluding items of fund expense such as management fees)

Sample Allocation Provision Using Pro-General Partner Rule

- Items of gain and loss realized upon the sale of portfolio securities shall be allocated:
  - 80% to all the Partners in proportion to their respective capital commitments; and
  - 20% to the General Partner.
- All other items of income, gain, loss and expense shall be allocated:
  - 100% to all the Partners in proportion to their respective capital commitments.

Example of Economic Impact

- Assume:
  - Limited Partner capital commitments: $99 million
  - General Partner capital commitment: $1 million
  - Annual management fee rate: 2.5% of committed capital
  - Fund term: 10 years
  - Total management fees: $25 million
  - Net investment gains: $25 million

Example of Economic Impact

- Allocations to the General Partner:
  - Under Majority Rule:
    - Investment gains: $ 250,000
    - Management fee expense: $ 250,000
  - Under Pro-General Partner Rule:
    - Investment gains: $5,200,000
    - Management fee expense: $ 250,000

Allocations vs. Distributions

- Carried interest allocations govern the underlying economic deal among the partners
- Distribution provisions govern the *timing* and *content* of payments in respect of the carried interest

Sample Distribution Approaches

- Pro-Limited Partner:
  - Distributions shall be made:
    - First, 100% to all partners in proportion to their respective capital commitments until the Limited Partners have received a complete return of contributed capital; and
    - Thereafter, 80% to all partners in proportion to their respective capital commitments and 20% to the General Partner.

Sample Distribution Approaches

- Pro-General Partner:
  - Distributions shall be made:
    - First, 80% to all partners in proportion to their respective capital commitments and 20% to the General Partner until all net profits have been distributed; and
    - Thereafter, 100% to all partners in proportion to their respective capital commitments.

Sample Distribution Approaches

- Middle of the road:
  - First, the cost basis of each portfolio security giving rise to a distribution shall be distributed 100% to all partners in proportion to their respective capital commitments; and
  - Next, the gain component of each portfolio security giving rise to a distribution shall be distributed 80% to all partners in proportion to their respective capital commitments and 20% to the General Partner.

Observation About Distribution Approaches

Any distribution approach other than the Pro-Limited Partner Approach may result in overdistributions to the General Partner if investment losses follow investment gains

Example of Overdistribution Under Pro-General Partner Approach

1. Fund purchases Security A for $10 million
2. Fund purchases Security B for $10 million
3. Fund sells Security A for $20 million
4. Fund distributes proceeds $2 million to General Partner and $18 million to all Partners
5. Security B declines in value to $0
6. Fund dissolves
7. Net result: General Partner has received $2 million carried interest distribution even though net profits were $0
8. Clawback?

Observation About Distribution Approaches

Any distribution approach other than the Pro-General Partner Approach may create perverse incentives for the General Partner to manipulate distributions

Example of Perverse Incentive Under Pro-Limited Partner Approach

- Assume:
  - Unreturned contributions: $10 million
  - Value of "Dog" Security A: $10 million
  - Value of "Superstar" Security B: $10 million
- Assume:
  - Due to thin trading market, the value of Security A would decline to $5 million if there were uncoordinated sales by Partners following a distribution
  - Robust trading market for Security B

Example of Perverse Incentive Under Pro-Limited Partner Approach

- Question: Which Security does the General Partner distribute first?

- Answer: Security A, because the Limited Partner will suffer 99% of the decline in value, leaving the General Partner to receive a full 20% carried interest distribution of Security B

Additional Information

For a more detailed discussion of distribution approaches, see article by Axelrad and Wright

Distribution Provisions in
Venture Capital Fund Agreements