Waterfall Distributions for Investors – Bruce E. Methven

Managers who are organizing an investment fund (or even raising money for an operating company) at times want to make the investment more attractive to investors by adding provisions that require at least some payments to the investors before management is fully paid for its efforts. These are often called "waterfall" provisions. (Think of a dry, tiered waterfall; as the rains come the water fills the top pool first, then flows over to fill the next lower tier and so on.)

Waterfall provisions can also be used to additionally reward the organizer/manager if profits exceed a stated percentage and to return capital over time to investors. There are many variations to these provisions. Waterfall provisions are generally used with limited liability companies and limited partnerships, although they can also be used with corporations depending on how preferred stock is structured.

Just to be clear, where management contributes cash to a fund or company, that contribution is generally treated the same as other investment money. The waterfall provisions apply to the manager's compensation (sometimes called a "carried interest") for organizing and managing the fund. (Investors in a fund often are more willing to invest if a manager has "skin in the game" in the form of the manager's own money.)

Waterfall provisions frequently provide that, after expenses are subtracted, revenues generated by the fund are distributed to the investors until a specified rate of return (often 8%, compounded annually) has been provided, then a percentage (which can be as high as 100%) of the remaining money is applied to return capital to the investors before the management is paid. (Real estate funds may provide for slightly more than 8% and debt-focused funds may have a lower rate, although current market conditions also have an effect.)

After the investors have been paid, usually there is a catch-up payment to the managers until they have received the same percentage of profits as the investors (not counting the return of the investor's capital contributions). The management "fee" is often 20%, although private equity funds and real-estate syndications sometimes pay management 15% initially, perhaps rising to 20% if certain financial goals are met. After the management catch-up amount is paid, the remainder may be distributed pro rata to both investors and management, counting management's percentage as ownership, at least until any total limit on the management's compensation or the investor's return is reached.

The return of capital can also employ a different waterfall schedule that is used when assets are sold.

The specified return to investors often applies to all capital contributions to the fund beginning with the date when the contributions are made until the times when those contributions are returned. Some funds, though, provide the preferred return only on invested capital only, so that it does not apply to capital used for expenses of the fund.

Of course, in general waterfall provisions tend to be more favorable to investors when a startup is involved or management does not have a track record.

--Bruce E. Methven

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