
DEMYSTIFYING CLAWBACK CLAUSES IN PRIVATE EQUITY INVESTMENTS: BALANCING INVESTOR INTERESTS AND CONTRACTUAL FAIRNESS

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Introduction: Understanding Private Equity Investment

Private Equity (PE) investments set off a new trajectory for the portfolio company with the goal to increase capital by investing in emerging or established companies, increasing their valuation, and ultimately turning profits through an exit strategy. PE firms initially performed investing as minority investor, but over time, control-based transactions have become more common in India. These funds include a structure that provides strategic direction to improve financial and operational efficiency, allowing early investors to exit, and reviving underperforming assets.

In a PE fund investors are generally High Net Worth Individuals, Funds of Funds (a pool of funds from different investors), and other Institutions. These investments are strong financial commitments over a long period of time with limited oversight which makes transparency and responsibility of these funds critical. An investor exercises his rights on investment instruments to formulate an exit, based on analysis of fund and exit opportunity, including liquidation, Leverage Buy-Outs, Initial Public Offering (IPO), and other fund structures.

Structure and Scheme of Investment

PE in India operates under structural regulatory mechanism, contractual obligations, and fiduciary principles. The current framework provides structured control mechanisms for the sector. A private equity structure has three key components: Limited Partners (LPs), General Partners (GPs) and a pooled investment fund that channels capital or assets into private companies. The Securities and Exchange Board of India (SEBI), through the Alternative Investment Funds Regulations, 2012 (**SEBI AIF Regulations**), created the regulatory framework for private equity funds. **Regulation 2(1)(b)** of the AIF Regulations, defines an Alternative Investment Fund (AIF) as; privately pooled investment vehicles aligned with

defined investment policies. The private equity model functions under **Category II AIFs** as established by **Regulation 3(4)(b)** for funds that take leverage only for temporary funding needs. In this structure, GPs and LPs enter into financial arrangements where LPs bring capital, while GPs are responsible for fund operations under fiduciary and regulatory compliance.

LPs are primarily passive institutional investors like pension funds, sovereign wealth funds, and high-net-worth individuals, which receive duties and protections under the Limited Partnership Agreement (“LPA”). The Supreme Court, in the case of ***SEBI v. Sahara India Real Estate Corporation Ltd.***, emphasized strict disclosure requirements that protect investors’ interests and thus reinforce fiduciary duties toward LPs. Furthermore, the LPs under SEBI (AIF) Regulations have the right to receive periodic reports according to **Regulation 22** to ensure transparency about investment decisions, fund performance and risk parameters. LPs generally receive profits through distributions that stem from the fund’s profitability by taking advantage of carried interest and preferred returns mechanisms.

GPs on the other hand, exercise both managerial responsibility and leadership tasks for executing the fund investment strategy. According to **SEBI AIF Regulation 2(1)(g)**, a Manager refers, “to a person or entity responsible for managing the AIF, encompassing all functions of investment decision-making and governance.” The GPs as managers possess legal fiduciary responsibilities toward LPs by committing to work in good faith, exercising due diligence and avoiding conflicts. These principles align with the essentials laid down in the landmark case of ***DDA v. Joint Action Committee, Allottee of SFS Flats***; where the SC reiterated the need for accountability in the fiduciary relationships. GPs are compensated through a fixed management fee and a share of profits via carried interest. **Regulation 20(13)** of the AIF mandates that “GPs disclose their direct conflicts of interest and maintain an arms-length transaction approach in related-party dealings.”

Private equity funds manage investments through common investment pools which facilitate aggregation of LP funds to acquire portfolio businesses based on established investment criteria. These funds are governed by SEBI’s **Regulation 15**, which limits leverage, holding periods, and mandates diversification. The distribution of profits follows the waterfall structure where they are allocated first to cover expenses and then return to the LPs’ original investments before sharing the remaining returns through carried interest. The private equity structure in India operates under a regulated system that safeguards investor interests and market

proficiency according to international standards and national regulatory requirements.

Overpayment & Clawback Clause

The GP receives distributions from interim profits through overpayment, which cannot be sustained upon the fund's liquidation. GPs earn "*deal-by-deal*" carried interest under this model before the fund reaches its final performance target. Carried Interest in simple terms is a performance and incentive fee, which the GP receives based upon the investor's liquidation of assets. The subsequent investments doing poorly, GPs are subjected to their early distributions, their overall share of the profits may be paid twice since they are drawn more of what could be their portion. To solve this, the LPs who put in money negotiate clawback terms in their contracts. The provision will compel a GP to refund overcharge money received, so that the profit-sharing mechanism works properly according to the set conditions and fund performance outcomes

The Reserve Bank of India ("**RBI**"), through its guidelines, now defines the term clawback, in respect of banking and financial institutions as part of their compensation policies. The RBI defines clawback as a "*contractual agreement wherein an employee agrees to return previously paid or vested remuneration under certain circumstances, such as misconduct or a downturn in financial performance.*" Such provisions act as crucial remedial provisions that would help an institution recover any money paid as compensation in cases where compensation was unwarranted or excessive.

These provisions exist to safeguard stakeholders' interests and strengthen the ethical behavior and long-term performance alignment. These compensation clauses are set by the companies to avoid dangerous conduct and base pay on lasting accomplishments instead of temporary performance. In India, explicit statutory provisions for clawbacks are not widespread but RBI promotes institutional clawback to encouraging corporate governance standards in India. The RBI's compensation policy on Whole Time Director and Chief Executive Officer payments contains rules that mandate companies to include clawback provisions to address subdued or negative financial performance.

Excessive payments in private equity and executive compensation situations lead to major financial instability and undermine stakeholders' interests. Thus, companies require clawback

provisions as a fundamental mechanism to rectify such unjustified payments and ensure ethical standards for compensation and profit distributions.

Trigger Conditions

Clawback clause ensures to return the previously distributed interest, as a result of underperformance of such fund, by enforcing an obligation on the sponsor. A trigger occurs on underperformance of a fund, as it fails to meet the hurdle rate, which is the minimum expected rate of return. A clawback clause can be structured in the private placement memorandum as a mechanism to ascertain a waterfall mechanism in case a trigger condition arises. A certain threshold maybe established in form of a preferred percentage of return, beyond which if the fund underperforms, the clawback provision gets enforced. LPs trigger clawback when GP's collected fees exceed what's deserved based on performance.

There are no statutory regulatory standards for specifically enforcing a clawback clause. A memorandum may mention such clause to be triggered in specific events, which are not merely terms of intent and can be legally enforced. One of the challenges faced in clawback mechanism occurs due to the multi-layered distribution of capital in such funds. Offshore structures, GP entities, and management companies makes it difficult for the LPs to clawback from entities rather than individuals. Clawbacks also arise at the end of a fund's life, which occurs long after the carried interests have been distributed making it difficult to recover and trace the structure of distribution.

Conclusion

The incorporation of a clawback clause in agreements related to PE investments will safeguard the investments in the long run. Such mechanisms are vital for maintaining the equitable distribution of profits and safeguarding LPs' interests. The drafting of such clauses is another crucial aspect which have to be done with utmost clarity. Since these clauses play a significant role during disputes arising out of the distribution of interests during/after the investments.

India is witnessing a boom in investment sectors, the suggestions for enhancing corporate regulations concerning PE/VC investment in India could be done by the regulatory authorities by issuing guidelines, which inform the investors regarding such clauses and the risk associated with investment. Such safeguards will project India towards a more protectionist approach for

investors (who play a major role for companies). Investors and fund managers must conduct due diligence to ensure enforceable clawback terms. The fund managers and sponsors should ensure that they mitigate the risks and challenges of the investors, promoting trust and increasing the promotion of such investments.

Due diligence plays a crucial role before any PE investment takes place, and hence, it becomes a primary reason for these clawback clauses to be well-drafted and structured. In such cases, the enforceability depends upon the terms of the contract that have been entered into between the parties and the legal interference is only limited to contractual clauses. Although, it is pertinent to ensure through the terms and negotiations of such clauses that the sponsor does not receive overpayment, it should also ensure that they do not receive underpayment. These clauses should ensure a fair balance between investor interests and fund practices.