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## The Real Estate Finance Journal

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### **REAL ESTATE JV PROMOTE CALCULATIONS: BASIC CONCEPTS AND ISSUES (UPDATED 2013)**

*By Stevens A. Carey\**

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(Updated 2013)

by Stevens A. Carey\*

*One of the more popular ways an institutional investor invests in real estate is to team up with a local operator/developer (a service partner) who has the expertise and experience to locate, develop and manage a real estate asset that may be of interest to the investor. In such a transaction, the service partner is often given the right to earn an incentive bonus or potential reward through a so-called “promote”,<sup>1</sup> which in its simplest terms, is an extra share of the upside from the transaction. This Article will provide, from the standpoint of the investor, a basic introduction to the concept of a promote and some of the issues it presents.*

**1. FRAMEWORK FOR DISCUSSION – HYPOTHETICAL FACTS**

To illustrate the concepts of this Article, unless otherwise stated, we will utilize a hypothetical venture, formed to acquire real estate, between a financial partner who provides 90% of the equity capital required by the venture and a service partner who provides 10% of the equity capital. Although many, if not most, U.S. real estate ventures today are formed as limited liability companies (except in the fund<sup>2</sup> context and when state and foreign tax considerations<sup>3</sup> dictate otherwise) rather than as partnerships, such limited liability companies are usually partnerships for income tax purposes and the members frequently refer to themselves as partners in any case. Therefore, for ease of reference, we will assume that the venture is a partnership. Unless otherwise stated, we will also assume that there are only two levels of distributions (which may be referred to as the “distribution waterfall” or simply the “waterfall”),<sup>4</sup> namely:

*first level:* pro rata in accordance with partnership percentages, which (subject to possible adjustment in the event of a contribution default) are 90% and 10%, until the financial partner has achieved what the partners loosely refer to as a “12% hurdle” based on a 12% annual rate of return; and

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*second level*: any balance (the “**residual**”) is distributed 72% to the financial partner and 28% to the service partner (distributions under this second level may sometimes be called “**residual**”, “**excess**”, or “**surplus**” distributions).

Both partners think the 12% hurdle requires that the financial partner recoup its investment and receive a 12% annual return on its investment, but as discussed later, they may have different ideas as to how the 12% hurdle is calculated. With this general framework (our “**Hypothetical Facts**”), we begin our discussion of promotes.

## 2. WHAT IS A PROMOTE?

What is a promote? Basically, it is a special type of profit-sharing compensation payable to the service partner. It is given in exchange for creating value or bearing a disproportionate share of the downside risk, which may be done in various ways that usually include one or more of the following:

- locating a profitable investment opportunity;
- having useful relationships, expertise, experience or knowledge;
- providing asset, construction or development management services;
- providing loan guaranties (which may not only involve a greater share of risk, but may also get a lender to provide cheaper debt that makes the partnership more profitable);
- providing indemnities required by sureties to issue performance and other bonds the partnership must provide to governmental entities or others; and
- taking responsibility for construction cost overruns.

A promote generally takes the form of extra distributions made to the service partner over and above the distributions attributable to its capital contributions to the partnership. Exactly what those “extra” distributions are depends upon how the promote is calculated.

## 3. WHAT IS THE AMOUNT OF PROMOTE?

Under our Hypothetical Facts, the service partner receives 18% more of the total residual than it would have received without a promote. However, the amount of the promote is not necessarily 18% of the total residual. Indeed, depending on how the partnership agreement is drafted, the portion of the service partner’s 28% share of residual distributions that constitutes the promote might be either:

- 18% of the total residual; or
- 20% of the total residual.

**3.1 18% Alternative.** The service partner may receive 18% of the total residual as a promote *in addition to* 10% of the total residual on account of its capital interest. In that event, the promote comes *after*, and *does not dilute*, the 10% share of the total residual the service partner would have received had there been no promote:

$$(10\% \times 100\%) + 18\% = 28\%$$

**3.2 20% Alternative.** Alternatively, the service partner may receive 20% of the total residual as a promote and then 10% of the 80% balance on account of its capital interest. In that event, the service partner still ends up with a 28% share of the residual:

$$20\% + (10\% \times 80\%) = 28\%$$

This latter formulation is the one typically encountered by the author. Under this approach, the promote comes *before*, and *does dilute*, the 10% share of pro rata distributions the service partner would have received without a promote.

#### **4. WHO IS BEING PROMOTED?**

A key distinction between the 18% and 20% alternatives is the source of the promote (i.e., whose distributions are diluted, and consequently reduced, to pay the promote). The source of payment may be either (1) the partnership (i.e., both partners) or (2) only the financial partner. The source is sometimes referred to as the party (or parties) being promoted. This may appear to be an odd use of the English language because being “promoted” may also mean being elevated in status, whereas here it means being diluted economically. Perhaps it makes a little more sense considering the role of the service partner as a “promoter”, especially one who is “promoting” the sale of limited partnership interests.

**4.1 Promoting Only Financial Partner (18% Alternative).** If the promote is payable only by the financial partner so that it comes out of, and reduces, only the residual distributions to the financial partner, then the service partner is promoting only the financial partner and the service partner is not promoting itself. This is the case under our Hypothetical Facts, if the service partner is receiving a promote equal to 18% of the total residual. The service partner’s 10% distributions are not diluted and its 18% promote is coming solely out of the financial partner’s 90% distributions.

**4.2 Promoting Both Partners (20% Alternative).** If the promote is payable by the partnership (i.e., both partners) so that it comes out of, and reduces, all residual distributions on a pro rata basis, then the service partner is promoting both partners, including itself. This is the case under our Hypothetical Facts if the service partner is receiving a promote equal to 20% of the total residual. Both partners’ 90/10 distributions are diluted on a pro rata basis: the financial partner bears 90% of the promote (18%) and the service partner bears 10% of the promote (2%).

**4.3 Common Approach (20% Alternative).** In the author’s experience, with the exception of preferred equity transactions, the financial partner often wants all capital to be treated alike, as in the 20% alternative.<sup>5</sup> The financial partner does not want the service partner taking the position that its interest may never be diluted. The financial partner may want the

right to give a promote to a replacement service partner, should there ever be one, and, if so, it wants that new promote to dilute all partners on a pro rata basis. However, to ensure that the service partner will be obligated to share in the cost of a replacement promote, it may not be necessary (or even sufficient) to provide that the service partner is promoting itself. What may be necessary is simply to address the manner in which the replacement promote is to be borne.

**4.4 Identifying the Promote.** Thus, the replacement promote issue may not necessitate knowing whether there is an 18% or a 20% promote. However, there may be other reasons to have the promote separately stated. For example, if the partnership percentages change (whether under a dilution formula or otherwise), then it may be easier to adjust the distribution percentages in an appropriate manner.<sup>6</sup> More generally, a common understanding of the promote may help avoid confusion when dealing with promote matters.

**4.5 Shorthand (Ambiguous?) Promote Structures.** See the Appendix attached to this Article for a discussion of shorthand ways to describe a promote structure which illustrates the points addressed in part 3 and this part 4.

## 5. PROMOTE HURDLES – WHAT IS THE EFFECTIVE RATE?

Under our Hypothetical Facts, the partners have agreed on a 12% annual rate to establish the return that must be received by the financial partner (in addition to recouping all of its capital) before the service partner receives a promote. Usually, the rate is compounded, but it is not always clear how the compounding works. Consequently, there may be a misunderstanding as to the compounding period or the effective rate per compounding period.

**5.1 Silence Is Simple.** We have not stated whether there is compounding. If the partners fail to do so, there may be no compounding.<sup>7</sup> For this reason, compounding should be addressed (and the sooner the better).

**5.2 Increasing the Effective Rate.** Generally, the service partner wants to use annual compounding of the stated 12% rate because daily, monthly, quarterly or semiannual compounding of 1/365, 1/12, 1/4 or 1/2 of the 12% annual rate will yield an effective annual rate that is greater than 12%.

**5.3 Reducing the Effective Rate for Partial Periods.** Of course, the service partner will be happy to use daily, monthly, quarterly or semiannual compounding if the rate to be compounded yields an effective annual rate of 12% (e.g., the daily rate would be  $(1.12)^{1/365} - 1$  and the monthly rate would be  $(1.12)^{1/12} - 1$ ). However, for any such compounding period (or any other compounding period that is less than a full year), this would mean an effective rate that is even less than 12% per annum simple interest. For example, the return that would accrue for one month at a simple annual rate of 12% would be 1%, while the return that would accrue for one month at a monthly rate of  $(1.12)^{1/12} - 1$  would be approximately 0.95%, a difference of approximately 5 basis points. If the annual rate were 25%, then the monthly differential would be over 20 basis points!

**5.4 Avoiding Misunderstandings.** When there is compounding, it may be worth explaining to avoid confusion. For example, a financial partner might refer to a 12% annual rate

with quarterly compounding to mean a quarterly rate of 12%/4, compounded quarterly (which yields an effective annual rate of approximately 12.68%). This appears to be the accepted meaning in most basic financial textbooks. Nonetheless, the service partner might misinterpret this to mean a quarterly rate of  $(1.12)^{1/4} - 1$ , compounded quarterly (because it is mistakenly thinking of a 12% *effective* annual rate, which of course is less). This confusion may be avoided by simply identifying the quarterly rate (or more generally, the rate for the compounding period). Another solution to this problem is to include an example (which should use, and thereby establish, the applicable quarterly rate or more generally, the rate for the compounding period). This subject is discussed further in a prior article by the author.<sup>8</sup>

## **6. PROMOTE HURDLES – PREFERRED RETURN AND RETURN OF CAPITAL VS. IRR**

Even if the parties agree on the compounding period, and the effective rate per compounding period, there may still be a disagreement over how the promote hurdle is calculated. Two common approaches are:

- a preferred return and return of capital hurdle; and
- an IRR hurdle.

**6.1 Preferred Return and Return of Capital Example.** If a preferred return and return of capital hurdle were utilized, then assuming annual compounding, the distribution levels under our Hypothetical Facts (assuming the partners adopt the 20% promote alternative described in part 3.2) might be written as follows:

*first level:* pro rata in accordance with partnership percentages until the financial partner has received under this first level an amount equal to (1) all of its capital contributions, and (2) a 12% annual return, compounded annually, on the outstanding balance from time to time of its unrecovered capital contributions (with the understanding that all amounts distributed to the financial partner under this first level shall be applied first to pay the then accrued but unpaid return and then to the financial partner's unrecovered capital contributions); and

*second level:* any balance is distributed (x) 20% to the service partner as a promote and (y) 80% to the partners pro rata in accordance with partnership percentages.

**6.2 IRR Example.** If an IRR hurdle were utilized, then assuming annual compounding, the distribution levels under our Hypothetical Facts (assuming the partners adopt the 20% promote alternative described in part 3.2) might be written as follows:

*first level:* pro rata in accordance with partnership percentages until the financial partner has achieved a 12% annual IRR; and

*second level:* any balance is distributed (x) 20% to the service partner as a promote and (y) 80% to the partners pro rata in accordance with partnership percentages.

**6.3 The Differences.** Some professionals believe that these two hurdle alternatives are merely two different ways to achieve the same result. In many, if not most, cases, they would be correct. But on occasion there can be a material variance. In the author's experience, two key differences may arise (which are explored in more detail in another article by the author)<sup>9</sup>:

- preferred return/return of capital hurdles often, if not usually, do not allow for negative hurdle balances, whereas IRR formulations generally do<sup>10</sup>; and
- preferred returns are often, if not usually, calculated using simple (proportionate or linear) returns for partial compounding periods, whereas the IRR generally uses equivalent continuously compounded (exponential) returns.<sup>11</sup>

Negative hurdle balances can lead to double-counting, as discussed in part 15.6 below. This problem is often addressed with the reserves and clawbacks discussed in part 15 below, in which event the first difference may not matter much. But some relatively common clawbacks may not correct the double-counting problem. When such a flawed clawback or no clawback is used, there is potential for a shocking result.<sup>12</sup> The second difference doesn't arise at all unless there are cash flows or hurdle calculations that do not occur at the beginning of one of the stated compounding periods.<sup>13</sup> But when it does arise, the two approaches may reflect different effective rates for partial compounding periods, which, in turn, can lead to materially different hurdle balances.

**6.4 Equivalence Assumed.** For the balance of this Article, unless otherwise stated, it is assumed for simplicity that the promote hurdle is equivalent to a common IRR hurdle regardless of whether it is couched as a preferred return/return of capital or IRR hurdle. To be clear, unless otherwise stated, it is assumed that if there is a preferred return/return of capital hurdle, it allows for negative balances (which earn a return at the hurdle rate) and provides for equivalent continuously compounded returns for partial compounding periods. By making these assumptions, it will be possible to consider the promote hurdle either as a typical IRR hurdle or as an equivalent preferred return/return of capital hurdle.<sup>14</sup> In particular, it will be possible to view the IRR hurdle through the lens of a preferred return/return of capital hurdle (the calculation of which may be more intuitive than a typical IRR calculation). In this way, there will always be an amortizing balance, which earns an equivalent continuously compounded return and is increased by contributions and decreased by distributions. It will not matter whether distributions are first applied to capital or return because of the continuous compounding, which instantaneously converts return to capital so that all dollars are fungible.

## 7. PROMOTE HURDLES – WHAT IS THE INVESTMENT?

Generally, the rate of return is applied to the investment of a partner in the partnership, but the partners do not always pay sufficient attention to what should be included and excluded



from the investment in the promote hurdle calculation. In the context of an IRR, the question is what are the outflows? Frequently, the investment (or outflows) of a partner for this purpose is (are) simply all of its contributions to the partnership. However, there are many possible exceptions and additions:<sup>15</sup>

**7.1 Adding Third Party Debt?** It is possible to have an unleveraged promote hurdle, as described later in part 11, which would take into account not only a partner's equity contributions, but also its share of any third party loan advances invested in the project.

**7.2 Adding Cost of Additional Partnership Interest?** If the financial partner purchases an additional interest in the partnership (whether from the service partner or another partner), the purchase price may be a direct payment to the selling partner and not a contribution. Nonetheless, the cost of the additional partnership interest is a part of the financial partner's investment. Although the financial partner may want this additional investment to be recouped and earn the stated return as part of its hurdle balance, the financial partner is likely simply to inherit the hurdle balance associated with the additional partnership interest (whether it is less or more than the additional investment).<sup>16</sup>

**7.3 Grossing-Up the Investment.** Sometimes, the financial partner may require that its investment be grossed-up (e.g., by a certain number of points or dollar amount) in lieu of a fee for providing capital or services (e.g., a commitment fee or acquisition fee), where the increase is payable only out of distributions (and to that end is taken into account as part of its investment for purposes of the IRR calculation). In effect, this would be giving the financial partner a carried interest for its capital commitment or services, which (if realized and eligible for capital gain treatment) may be more attractive than a fee generating ordinary income.<sup>17</sup>

**7.4 Adding Partner Loans.** What happens if there is a loan by the financial partner to the partnership or the other partner? Should that loan be taken into account as part of its investment? For example, how should the partnership agreement treat a partner loan made by the financial partner to the service partner (to fund the service partner's share of a discretionary contribution that it elected not to fund)? What if the partner loan has a 10% annual rate? Admittedly, a loan is not the same as a contribution and among other matters, requires priority payment. But if the partner loan is excluded from the hurdle calculation, then the net effect is that the promote may be paid prior to the time the financial partner achieves a 12% annual return on its entire cash-outlay (including such partner loan). However, the financial partner may not want to include all loans as part of its investment for hurdle calculation purposes. For example, if the investment included a default loan with an interest rate that is higher than the hurdle rate, it would effectively reduce the rate required to be achieved on the other capital (including the capital contributions) taken into account in the hurdle. Moreover, it would soften the blow (and any intended deterrent or penalty) associated with using a high default rate. If a partner loan is taken into account in the hurdle calculation, then the amount of the loan is treated as part of the investment and payments of principal and interest under the loan are treated the same as distributions.

**7.5 Excluding Special Preferred Contributions.** What happens if the service partner fails to make a contribution and the partnership agreement treats the financial partner's contribution as a preferred contribution with a 25% annual return (payable before any other

distributions)? If all contributions are to be included in the hurdle calculation, then this contribution would be included as well. However, including such a contribution is like including the default loan described in part 7.4: it may take some of the sting out of the 25% annual rate of return (because it would no longer be necessary for the other contributions to achieve a 12% annual return in order for the aggregate investment of the financial partner to reach the 12% hurdle). Consequently, the financial partner may wish to exclude such contributions from the investment that is taken into account in establishing the hurdle.

**7.6 Excluding Certain Pre-Formation and Formation Costs.** What about pre-formation and formation costs? There is a tension here for the financial partner. On the one hand, the financial partner would like to capitalize, and get its threshold 12% annual return on, its entire investment, including pre-formation and formation costs. On the other hand, the financial partner may not want to allow the service partner to do the same thing. Indeed, to the extent capitalized costs are shared 90/10, it may not be in financial partner's interest to capitalize costs, such as the legal fees in negotiating the partnership documents, where the service partner is otherwise incurring (for its own benefit rather than for the benefit of the partnership) significantly more than 10% of the total costs. Moreover, if the service partner has brought the project to the financial partner, it may have considerably more time and expense associated with its pursuit of the project. Generally, the financial partner will limit the pre-formation and formation costs that are capitalized to specific costs that are scheduled and approved before the partnership agreement is signed.

**7.7 Including Investment Maintenance Costs.** Although the financial partner is often a passive partner, it will generally have some meaningful involvement with the operation of the partnership (e.g., reviewing capital calls and approval requests). It may incur costs as part of this process (e.g., having its legal counsel review proposed leases, loan documents or sale documents). The financial partner may want to capitalize these costs and include them as part of its investment for purposes of the hurdle calculation. However, in many deals, the partnership will have sufficient cash to pay these costs, in which event contributions may not be necessary to pay them and they may not be part of the financial partner's investment.

**7.8 Impact of Dilution Formulas.** The amount of the investment might change due to the application of a penalty dilution formula in connection with a contribution default. Partnership agreements with dilution formulas typically give the contributing partner credit for 100% or more of the default contribution (i.e., the defaulting partner's share of the capital call that is advanced by the contributing partner) for purposes of recalculating the partnership percentages.<sup>18</sup> While the dilution will result in a shift in capital percentages, as discussed in part 8 below, and this may sometimes affect the ratio in which distributions recouping capital are shared, most of the formulas encountered by the author appear to be intended primarily to alter the manner in which profits are shared. They generally do not result in the capital deemed invested being more or less than the actual capital invested, except for purposes of adjusting the partnership percentages. However, this is not always the case. Some penalty dilution formulas that give the contributing member credit for more than 100% of its capital in recalculating partnership percentages go further. Some formulas also provide that the contributing partner is deemed to have contributed the excess percentage of the default contribution for all purposes, including determining capital account balances and the outstanding amount of capital the

contributing partner is entitled to recoup under the promote hurdles. Some of these agreements also provide that the defaulting partner's contributions are deemed reduced; some do not.<sup>19</sup>

## 8. PROMOTE HURDLES – WHOSE INVESTMENT?

Another question that should be considered in establishing the applicable investment is whether it is appropriate to consider the *partnership's* investment, *each partner's* investment or only the *financial partner's* or the *service partner's* investment.

**8.1 Financial Partner's Investment: Avoiding Complications of Promote.** It is common to focus on the financial partner's IRR (and therefore the financial partner's *investment*), and not the project IRR or the service partner's IRR. The reason for this practice is that both the project IRR and the service partner's IRR may be greater than the financial partner's IRR as soon as promote distributions begin.<sup>20</sup> This is especially problematic when there are multiple hurdles (as is often the case, the service partner getting a larger promote after each correspondingly higher hurdle)<sup>21</sup>: if the partnership agreement provisions or the computer model used for calculating the promote tracks the project IRR or the service partner's IRR, then without appropriate adjustment, the second (and any subsequent) hurdle may be achieved prematurely, resulting in a windfall to the service partner. In the context of hurdle calculations, the purpose of the IRR calculation is to determine whether and when promote distributions should be made. By including the promote distributions themselves in the IRR calculation, there is what might be viewed as an unintended circularity (or self-reference) that artificially accelerates the achievement of the IRR. Thus, for this purpose, the promote distributions (and any refunds of the promote distributions) should not be part of the calculation, which is perhaps most easily appreciated when one considers the case where 100% of the capital is contributed by the financial partner so that IRR calculations relate solely to the financial partner. These exclusions make it more cumbersome to define the IRR appropriately for the service partner or the project if and when the project IRR or the service partner's IRR is used in determining the hurdle.

**8.2 Fixed Capital Percentages and Consistent Timing.** Tracking the financial partner's IRR (and therefore the financial partner's investment) may work well under what may be considered very common circumstances: if all contributions are made in accordance with fixed percentages at the same times by each partner, and non-promote distributions are made to each partner at the same times in accordance with the partners' shares of capital contributions (the "**capital percentages**"), as is the case under our Hypothetical Facts (assuming the partners adopt the 20% promote alternative described in part 3.2).<sup>22</sup> Under these circumstances, it would be equivalent to take into account *each partner's* investment and distribute in accordance with capital percentages until *each partner* achieves its hurdle. The hurdles should be achieved simultaneously (unless promote distributions are taken into account, in which event the financial partner's IRR would be achieved at the same moment or later, which leads to the same result).

**8.3 When Capital Percentages Change or Timing Doesn't Match.** However, in some deals, not all contributions are made simultaneously in fixed proportions throughout the deal:

- Sometimes a disparity is anticipated and expected; for example, where one partner contributes a disproportionately large amount at the outset and the

other partner is expected to catch up over time to reach the intended capital percentages.

- Sometimes a disparity is anticipated but not expected; it may occur, for example, as a result of the application of a dilution formula because a partner failed to make a mandatory or discretionary contribution.
- Sometimes a disparity is not anticipated at all; it may occur, for example, because of a change in the business plan that is to be funded in different proportions (which the author has encountered on more than one occasion).

**8.4 Impact of Change in Capital Percentages or Relative Timing.** If there is a shift in capital percentages, then making first level distributions in accordance with capital percentages (as adjusted to reflect the shift) may result in one partner achieving its IRR before the other partner (and a windfall to the partner who achieves its IRR first). A similar disparity may occur if the partners fund their respective contributions (or receive their respective distributions) at different times.<sup>23</sup> The problem is that the ratio of the partners' hurdle balances will no longer be the same as the ratio in which first level distributions are being shared (assuming first level distributions are made in accordance with capital percentages).

**Example.** Assume that under our Hypothetical Facts, (1) the service partner agrees to contribute 100% of the \$20X cost to purchase an adjacent parcel in order to facilitate a sale of the property by the partnership to a buyer interested only in buying both assets, (2) the only prior contributions were initial contributions of \$72X and \$8X (for a total of \$80X), which have grown over several years to create outstanding capital and accrued return of \$90X for the financial partner and \$10X for the service partner (i.e., the hurdle balances or equivalently, the hurdle deficiencies or equivalently, the amounts required for each partner to achieve a 12% annual IRR, have grown to \$90X and \$10X), (3) the service partner contributes \$20X to change the ratio of total invested capital from 72/8 (i.e., 90/10) to 72/28, (4) the partners amend the partnership agreement to provide for new partnership percentages that match the new capital percentages of 72% and 28%, and (5) the sale of both assets generates a distribution (on the same day as the additional contribution through simultaneous closings) of \$120X of net sale proceeds.

According to the partnership agreement, as amended, distributions would be made as follows<sup>24</sup>:

	<u>Financial Partner</u>	<u>Service Partner</u>	<u>Total</u>
Distribution:	\$86.4X	\$33.6X	\$120X
Calculation:	72% of \$120X	28% of \$120X	
Annual IRR:	< 12%	> 12%	

While the ratio of the capital contributions (i.e., the capital percentages) and the ratio of the hurdle deficiencies were the same (90/10) before the additional (disproportionate) contribution, at the moment the additional contribution is made, they no longer match. The reason is that

hurdle balances take into account not only capital but also *accrued return*, and the partners' accrued return at that point in time is still in the ratio of 90/10:

	<u>Capital Contributions</u>	<u>Accrued Return</u>	<u>Hurdle Balances</u>
	FP/SP	FP/SP	FP/SP
Actual Amounts:	\$72X/(\$8X+\$20X)	\$18X/\$2X	(\$72X+\$18X)/(\$28X+\$2X)
Ratio (as %s):	72/28	90/10	75/25

### 8.5 Each Partner's Investment: Changing Ratio of Distributions

A solution to this problem is to allocate first level distributions in accordance with the ratio of the partners' hurdle balances (i.e., their hurdle deficiencies = their outstanding capital and accrued return) which is now 75/25 (= 90/30).<sup>25</sup>

	<u>Financial Partner</u>	<u>Service Partner</u>	<u>Total</u>
Distribution:	\$90X	\$30X	\$120X
Calculation:	75% of \$120X	25% of \$120X	
Annual IRR:	12%	12%	

This solution may be used to address the more general problem of the partners reaching their respective hurdles at different times because the stated ratio of the partners' shares of first level distributions may not match the ratio of their hurdle deficiencies (whether due to a change in their contribution shares, a difference in the timing of their contributions, or otherwise). When this is done, the partners should, as noted earlier, exclude from the calculation of the service partner's hurdle balance any promote distributions and any refund of promote distributions, respectively.<sup>26</sup> Note, however, that this solution (of using the ratio of hurdle balances) could under certain facts effectively eliminate the impact of a penalty factor in a contribution default dilution formula.<sup>27</sup> Moreover, any time there may be a change in the ratio of the outstanding capital and accrued return of the partners, tax counsel should be consulted.<sup>28</sup>

## 9. PROMOTE HURDLES – RETURN FOR WHAT PERIOD?

Even if the rate of return and applicable investment have been specified, the partners must still establish the period during which the return applies. Often, the partnership agreement will provide the return on a partner's investment should be calculated for the portion of the term of the partnership while the investment is outstanding. However, that is not always the case.

**9.1 When Does the Return Start?** It is possible that the financial partner has invested funds prior to formation (e.g., a loan to the service partner to fund a deposit under a purchase agreement or an application or commitment fee for acquisition financing). Under these circumstances, the financial partner may want its return to begin the moment that its funds are invested, whether through an escrow, loan or otherwise. Note that if the service partner has not invested a proportionately equivalent amount of money in advance, then merely starting the return early is an imperfect solution because it gives the service partner too much. As explained in part 8, using contributions only to set the distribution ratio ignores the time value of money, which leads to disparities if the contributions are not made in fixed percentages by the partners at the same times: under these facts, the service partner will have exceeded its hurdle before the hurdle is reached for the financial partner, as occurred in the example in part 8.4. As discussed in

part 8 above, a more complete solution to this problem is to change the allocation of the first level distributions from 90/10 to the ratio of each partner's hurdle deficiency (but the financial partner should make sure that the service partner's hurdle does not take into account promote refunds as part of the service partner's investment).

**9.2 When Does the Return End?** The return generally ends when distributions have been made to recoup the investment and to pay the applicable return on that investment. However, as we will see in the next section, it is possible to artificially extend this period to achieve what is sometimes called a "whole dollar hurdle".

## 10. WHOLE DOLLAR PROMOTE HURDLES – TOO LITTLE TOO SOON?

When the financial partner's investment is liquidated quickly, the requisite IRR may be achieved, but the profit may constitute a comparatively small amount of money. This may be a problem. The benefits of such an investment may be outweighed by the uncanceled transaction costs<sup>29</sup> and any consequent increase in down-time (while the financial partner's funds remain uninvested).<sup>30</sup> (Although less likely, a similar problem may occur in connection with an early refinancing that causes the service partner to reach the promote level prematurely.)

**10.1 Example of Whole Dollar Issue.** Assume (1) our Hypothetical Facts except that the 12% annual return is compounded monthly, (2) after three months of difficult negotiations to finalize a partnership agreement with the service partner, the financial partner contributes \$100X to purchase a project, (3) a sale of the project one month later generates \$103X of liquidation distributions, and (4) there are no other contributions or distributions.

Under these facts, the financial partner may have achieved a high rate of return, but it will have received a relatively small whole dollar profit. With a monthly hurdle rate of 1% (12%/12), the financial partner would receive \$2X of the \$3X profit (1% x \$100X = \$1X, and 50% of the remaining \$2X of profit = \$1X, for a sum of \$1X and \$1X = \$2X). This equates to a 24% annual return (12 x [\$2X]/[\$100X] = 24%), but \$2X may not be enough to justify the time and uncanceled costs associated with a \$100X investment. Assuming further that the \$102X earns an additional \$2X for the next 11 months (which is over 2% per annum) while the financial partner looks for a new investment, then the financial partner's annual return would be only 4%! And once the uncanceled costs are taken into account, both the whole dollar return and annual return would be even less.

**10.2 Solution.** To guard against this result, the financial partner may impose a minimum holding period during which the property may not be sold. However, this may preclude a great sale opportunity. Consequently, some financial partners require instead that they receive a minimum dollar amount (a "**whole dollar**" or "**multiple**" hurdle) after they have recouped their capital and before there is any right to receive the promote. This may be accomplished in a number of ways. One way is to require that distributions continue to be made on a pro rata basis until the requisite 12% annual IRR has been achieved and the financial partner has received a certain percentage (e.g., 125% or 140%) of its investment.<sup>31</sup> Another approach is to provide for a deemed minimum period of time (e.g., one year or two years) in calculating the 12% annual return.

## 11. PROMOTE HURDLES – UNLEVERAGED VS. LEVERAGED RETURNS

Many, if not most, real estate projects are capitalized in part by third party project financing (typically, mortgage financing). When this occurs, the actual partner distributions, and those that are taken into account in determining whether a hurdle has been met, are usually net of the payments under any project financing. However, such *leveraged* returns (sometimes called “levered” returns) are not always utilized.

**11.1 Unleveraged Return.** Some financial partners set their hurdles based upon the performance of the project on an *unleveraged* basis despite the existence of project financing. This may require a hypothetical calculation where all project costs (both the financial partner’s equity contributions and its share of the partnership’s debt, even debt from a third party lender) must be recouped and the requisite return must be achieved on the entire amount. For this purpose, the financial partner’s share of all loan advances and of all equity contributions may be treated as part of its investment, and the financial partner’s share of all payments of principal and interest under the loan and of all distributions may be treated as receipts that are applied towards recoupment and the requisite return.<sup>32</sup> In this way, any benefits from the financing are shared by the partners in accordance with their capital interests. Some financial partners feel that this is more appropriate because any additional value associated with favorable financing is more a function of interest rates than the work of the service partner. If the financial partner plays an equal or greater role in obtaining the financing for the partnership, there may be an even greater reason to calculate hurdles on an unleveraged basis. Generally, effective project loan rates are less than hurdle rates, so unleveraged hurdle rates are generally less than leveraged hurdle rates.

**11.2 Unleveraged Return – Alternative Approach.** For simplicity, an unleveraged hurdle rate is sometimes drafted merely to pass on the benefits of any leverage in accordance with capital interests. For example, under our Hypothetical Facts (assuming the 12% hurdle rate is an unleveraged hurdle rate), if the effective project loan rate were 8% (taking into account all loan costs), then the 4% per annum savings (12% - 8%) with respect to the project loan amount might be distributed 90/10 (after the 12% annual IRR is achieved and) before any residual distributions. The possibility that the hurdle rate is less than the effective project loan rate may be viewed as sufficiently remote that it need not be addressed.

**11.3 Leveraged Return.** If the hurdle is calculated on a leveraged basis, then it generally relates only to equity. As a result, financing with an effective rate that is less than the hurdle rate will accelerate the achievement of the hurdle and the payment of the promote. This may result in tension between the financial partner and service partner over how much and when financing should be obtained by the partnership: additional financing may increase the financial partner’s IRR, but may reduce the total dollars the financial partner receives from the project. Basically, positive leverage is a useful way to increase the project IRR, but because of the promote (unless returns are unleveraged), the service partner may obtain a disproportionate share of its benefits (in the same way that the service partner obtains a disproportionate share of profits generally through the promote).

**11.4 Example with Leveraged Return.** Assume, as we did in part 10.1, (1) our Hypothetical Facts except that the 12% annual return is compounded monthly, and (2) the financial partner contributes \$100X to purchase a project. Also assume that (1) there are no other

contributions or distributions until the anniversary of the acquisition (unless the financing described below is obtained), (2) one month after the acquisition, the project is under contract to be sold 11 months later which will generate \$103X of net sale proceeds (i.e., sale proceeds net of closing costs), (3) the project will generate \$8X of net operating income (i.e., cash flow before debt service) before the sale, which for simplicity is received immediately before the sale, and (4) the service partner has found a lender willing to make a no-cost, \$103X loan at the time the sale contract is entered into that is payable in one installment of \$109X at the end of 11 months. Under these facts, compare the results if:

- *No Financing*: the property is sold at the end of the 11-month contract period, without obtaining any financing, generating \$111X of distributions (\$103X of net sale proceeds and \$8X of net operating income) at the time of sale; or
- *Financing*: the property is sold at the end of the 11-month contract period, and the financing described above is obtained, generating \$103X of net financing proceeds immediately and \$2X (\$103X of net sale proceeds *plus* \$8X of net operating income *less* \$109X loan pay off) of distributions at the time of sale.

Under the “No Financing” alternative, the financial partner receives 100% of the distributions at the time of sale (\$111X) because they are less than its hurdle balance (1.12 x \$100X = \$112X); it does not achieve a 12% annual IRR. Under the “Financing” alternative, the financial partner’s IRR is more than 12% (because it achieves a 12% annual IRR when the loan funds and its IRR is increased by its share of the \$2X distributed at the time of sale), but the financial partner receives only \$103X, which means \$8X fewer overall dollars from the project, and the service partner receives \$2X of promote it would not have received without the financing.

	No Financing	Financing
Net Financing Proceeds	\$0	\$103X <b>\$101X + \$1X to FP; \$1X to SP</b>
Net Operating Income after Loan Payment	\$8X <b>\$8X to FP; \$0 to SP</b>	\$2X <b>\$1X to FP; \$1X to SP</b>
Net Sale Proceeds	\$103X <b>\$103X to FP; \$0 to SP</b>	\$0
Total	\$111X <b>\$111X to FP; \$0 to SP</b>	\$105X <b>\$103X to FP; \$2X to SP</b>
Financial Partner’s IRR	< 12%	> 12%

So how does the financial partner end up with both a higher IRR and \$8X less cash from the project in the case of the financing? The answer is simple: the numbers above do not take into account the time value of money, but the IRR does. The financial partner is getting \$103X eleven months earlier under the “Financing” alternative. It has the opportunity to reinvest this money during the final 11 months (between the financing and the sale). And, as explained in another article, the IRR hurdle may be calculated as of the date of sale by assuming that the \$103X of net financing proceeds generates a 12% per annum return.<sup>33</sup> Obviously, such



reinvestment may not actually occur for a number of reasons (including the fact that the financial partner may have other money to invest and not enough potential investments generating adequate returns). If the financial partner can actually reinvest the net financing proceeds and obtain more than \$8X (which is roughly an 8.5% annual return on the net financing proceeds) in the final 11 months, then although it may not get a 12% overall annual return (taking into account the actual reinvestment), it may still have more money due to this investment after the sale (when compared to the “No Financing” alternative). However, even an 8.5% per annum reinvestment is not always possible at a particular time or for a particular duration and therefore the financial partner will want some control over the financing process.

## 12. COMPONENT PROMOTE HURDLES – WHY NOT AGGREGATE?

The service partner may suggest that the promote be calculated separately for different parts of the transaction.

**12.1 Multiple Assets.** For example, in a multi-phase project in which two buildings are to be constructed and sold on a stand-alone basis, the service partner may want to treat each building separately so that it receives a promote from the distributions allocable to each building after the hurdle (under our Hypothetical Facts, the 12% annual IRR) has been achieved with respect to the portion of the investment allocable to that building.

**Example.** Assume our Hypothetical Facts except that there is a 0% (instead of 12%) annual return (so that the promote hurdle is merely a return of capital) and a separate identical distribution waterfall for each of two buildings A and B acquired by the partnership. Also assume that the only cash flows are a \$200X contribution by the financial partner made at the outset, \$100X of which is used to buy each building, a \$120X distribution from the sale of Building A and a \$80X distribution from the sale of Building B. Under these facts, the distributions would be made as follows:

	<u>Building A Distribution</u>			<u>Building B Distribution</u>			<u>Total Distributions</u>		
	FP	SP	Total	FP	SP	Total	FP	SP	Total
1st level	\$100X	\$ 0	\$100X	\$80X	\$0	\$80X	\$180X	\$ 0	\$180X
2nd level	<u>\$ 10X</u>	<u>\$10X</u>	<u>\$ 20X</u>	<u>\$ 0</u>	<u>\$0</u>	<u>\$ 0</u>	<u>\$ 10X</u>	<u>\$10X</u>	<u>\$ 20X</u>
Total:	\$110X	\$10X	\$120X	\$80X	\$0	\$80X	\$190X	\$10X	\$200X

Thus, the financial partner would fail to recoup \$10X of its \$200X investment while the service partner would receive a \$10X promote. The financial partner, however, may view the transaction as a single investment and may insist on aggregating all distributions in a single distribution waterfall. The financial partner may not want to reward the service partner for one successful building if the other building is a failure. By aggregating the distributions, a loss (or a failure to achieve the hurdle) for the first building sold would be recouped at the time of the sale of the second building before any promote would be payable.<sup>34</sup>

**Example.** Assume the same facts assumed in the prior example, except that there is a single distribution waterfall. Under these facts, the distributions would be made as follows:

	<u>Total Distributions</u>		
	FP	SP	Total
1st level	\$200X	\$0	\$200X
2nd level	<u>\$ 0</u>	<u>\$0</u>	<u>\$ 0</u>
Total:	\$200X	\$0	\$200X

However, aggregation may not eliminate the possibility of the service partner receiving a promote from the first sale even though the second sale results in a loss. (See discussion of clawbacks in part 15 below.) Aggregation may make this result extremely unlikely if most of the investment in both buildings has been made (and is taken into account) prior to the time the first sale occurs; a promote would not be payable until the aggregate investment to date were recouped and a 12% annual return achieved on that aggregate investment. Indeed, under such circumstances (assuming the two building investments are similar in size), there is not likely to be any promote until both buildings are sold or refinanced.

**12.2 Separating Operating Cash Flow and Capital Proceeds.** As another example, the service partner may suggest that operating cash flow from a rental-income producing project should be distributed separately from revenues from sale, financing or other capital events. The service partner may argue that it should not be required to wait until the financial partner recoups its investment (which is not likely to occur until a capital event) before the service partner receives its promote. Thus, the service partner may suggest that operating cash flow and capital proceeds be distributed under separate waterfalls and that the waterfall for operating cash flow simply require pro rata distributions to the partners until the financial partner has received a 12% annual return on its investment (but no recoupment of capital) and then a distribution in accordance with the residual allocation. Under this approach, it is possible that a project might yield promote distributions under the operating cash flow waterfall but not sufficient capital proceeds to achieve the hurdle under the capital proceeds waterfall. For example, an office building investment with low interest rate debt might yield operating cash flow promote distributions and then upon rollover, there might be difficulty re-leasing the property or a downturn in rental rates, which could yield a lower value and a failure to meet the capital proceeds hurdle upon a sale. In that event, the service partner may have received a promote even though the capital proceeds hurdle on sale was not met and possibly even though the financial partner may not have recouped its capital investment.<sup>35</sup>

### **13. NON-CUMULATIVE AND GUARANTEED PROMOTE HURDLES**

If the service partner has the bargaining strength to treat operating revenues separately from capital proceeds, it may also attempt to make the hurdle for the operating revenue promote non-cumulative. Thus, if the hurdle is not met in a particular year, the deficiency would not be carried over to the next year. This, of course, increases the chances that the hurdle may not be met on sale even though the service partner may have already received a promote. At the other extreme, some financial partners may require a service partner to guarantee any deficiency in its annual return.<sup>36</sup> Such arrangements are the exception rather than the norm.

## 14. SOFT AND HARD PROMOTE HURDLES

A promote hurdle may be soft or hard, although, in the author's experience, soft hurdles are rare in real estate partnerships (outside the fund context). A soft hurdle may be best understood by example.

**14.1 Lookback – Pay Service Partner First.** Assume that the financial partner is putting up all the capital and that distributions are made:

*first level:* 100% to the financial partner until it recoups its capital;  
and

*second level:* any balance is distributed 80% to the financial partner and 20% to the service partner as a promote, except that upon sale of the partnership's assets, if the financial partner does not achieve a 12% annual IRR, then the service partner will give the financial partner the service partner's distributions up to the amount of the deficiency.

In this example, the 12% annual IRR hurdle is a soft hurdle.<sup>37</sup> It is called "soft" because it is contingent: it applies only to the extent there are insufficient distributions. If 80% of all residual distributions is sufficient for the financial partner to achieve a 12% annual IRR, there is no 12% annual IRR hurdle at all! The 12% annual IRR hurdle is like a *threshold* that must be met (in order for the service partner to retain 20% of all the residual distributions) as opposed to a *deduction* that must be made (before establishing the portion of the residual distributions as to which the service partner is entitled to receive and retain 20%).

**Example.** In addition to the facts assumed above, assume that the only cash flows are a \$100X contribution by the financial partner made at the outset, a \$112X refinancing distribution (\$100X of which goes to recoup capital and the remaining \$12X of which is split 80/20) one year later, and a \$0 distribution on sale in connection with a foreclosure or deed in lieu.

Under these facts, there would be only one distribution, which would be allocated as follows:

	<u>Financial Partner</u>	<u>Service Partner</u>	<u>Total</u>
First Level	\$100.0X	\$ 0	\$100X
Second Level	<u>\$ 9.6X</u>	<u>\$2.4X</u>	<u>\$ 12X</u>
	\$109.6X	\$2.4X	\$112X

Immediately before the refinancing distribution, the financial partner's hurdle is \$112X and immediately after the refinancing distribution, its hurdle deficiency is \$2.4X (\$112X - \$9.6X). This hurdle deficiency grows to \$2.688X (\$2.4X x 1.2) at the time of sale. The \$2.4X received by the service partner is of course less than the financial partner's deficiency at the time of sale, so the service partner would refund the entire \$2.4X distribution it received:

	<u>Financial Partner</u>	<u>Service Partner</u>	<u>Total</u>
First Level	\$100.0X	\$ 0	\$100X
Second Level	<u>\$ 9.6X</u>	<u>\$ 2.4X</u>	<u>\$ 12X</u>
Subtotal	\$109.6X	\$ 2.4X	\$112X
Lookback Adjustment	<u>\$ 2.4X</u>	<u>-\$ 2.4X</u>	<u>\$ 0</u>
	\$112.0X	\$ 0	\$112X

This formulation creates a number of issues, not the least of which is that at the time of sale, the service partner may have already distributed or spent its distributions and the financial partner may have difficulty collecting if the service partner, or its affiliate(s), if any, guaranteeing the refund, are not creditworthy at the time. Another issue is the time value of the money: if, as in the example above, it turns out that the financial partner is entitled to all the distributions and still doesn't achieve a 12% annual IRR, then it would not have had the benefit of using its share of the distributions initially made to the service partner during the time they were held by the service partner. Of course, the partnership agreement may provide that the service partner will not only turn over all of its distributions, but also a 12% annual return on those distributions to the extent necessary to make up the deficiency. However, the service partner is not likely to want to pay 12% annual interest on the distributions it is required to refund; moreover, if there is already a collection issue, then adding additional dollars that may not be collectible may provide little comfort. Instead, when there is a soft hurdle, it is usually not quite so soft and distributions may be written more along the lines of the following example:

**14.2 Catch-Up – Pay Financial Partner First.** Assume that the financial partner is putting up all the capital and that distributions are made:

*first level:* 100% to the financial partner until it has recouped its capital;

*second level:* then 100% to the financial partner until it has achieved a 12% annual IRR;

*third level (catch-up):* then pro rata to both partners with the service partner receiving a certain percentage (more than 20% and for purposes of this Article is assumed to be 100%) which may vary depending on the deal, until it has received 20% of all profit distributions (i.e., distributions made after the financial partner recoups its capital); and

*fourth level:* then 80/20.

**Example.** Assume the facts from the example in part 14.1, except that the distribution waterfall is as set forth in this part 14.2. Again, there would be only one distribution:

	<u>Financial Partner</u>	<u>Service Partner</u>
First Level	\$100X	\$ 0
Second Level	\$ 12X	\$ 0
Third Level	\$ 0	\$ 0
Fourth Level	<u>\$ 0</u>	<u>\$ 0</u>
	\$112X	\$ 0

The whole dollar result is the same, but the financial partner receives its cash from the partnership and it receives it sooner.

**14.3 Time Value Considerations.** In the examples provided in parts 14.1 and 14.2, the service partner ended up with no cash in both cases. But it had the use of \$2.4X of funds between the refinancing and the sale under the Lookback approach and no use of funds under the Catch-Up approach. Thus, one might conclude that the Lookback had some benefits for the service partner but the Catch-Up had none. Indeed, getting money sooner than later is generally an obvious benefit under basic time value principles. But this is not necessarily true if one must give the money back and the repayment obligation may grow over time. What if there had been a \$0.288X distribution on sale under the facts assumed in parts 14.1 and 14.2? Under the Catch-Up formulation, the service partner would receive and retain 100% of the sale distribution. Indeed, assuming no further contributions under the Catch-Up formulation, the service partner would be entitled to 100% of the next \$2.5X of distributions (at which point it would have received 20% of the \$12.5X of profit distributions).

Catch-Up Approach

	<u>Financial Partner</u>	<u>Service Partner</u>	<u>Total</u>
First Level (Refi)	\$100X	\$ 0	\$100.000X
Second Level (Refi)	\$ 12X	\$ 0	\$ 12.000X
Third Level (Sale)	\$ 0	\$ 0.288X	\$ 0.288X
Fourth Level	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>
	\$112X	\$ 0.288X	\$112.288X

But under the Lookback formulation, 100% of this final distribution would ultimately go to the financial partner along with the service partner's prior distributions, leaving the service partner with nothing.

Lookback Approach

	<u>Financial Partner</u>	<u>Service Partner</u>	<u>Total</u>
First Level (Refi)	\$100.0000X	\$ 0	\$100.000X
Second Level (Refi)	\$ 9.6000X	\$ 2.4000X	\$ 12.000X
Second Level (Sale)	<u>\$ 0.2304X</u>	<u>\$ 0.0576X</u>	<u>\$ 0.288X</u>
Subtotal	\$109.8304X	\$ 2.4576X	\$112.288X
Lookback Adjustment	<u>\$ 2.4576X</u>	<u>-\$ 2.4576X</u>	<u>\$ 0</u>
	\$112.2880X	\$ 0	\$112.288X

The difference would be more material of course if the final distribution were larger and there were more time between the refinancing and the sale: the financial partner's return would then have more time to erode the service partner's share of any final distribution.

**14.4 Soft Hurdles – Summary.** When there is a soft hurdle, it acts like a *threshold* rather than a *deductible* and can be accomplished by a “**Lookback**” (where the service partner receives the percentage it would get assuming the hurdle will ultimately be met, and then later there is a refund if it turns out that the hurdle is not actually achieved) or a “**Catch-Up**” (where the financial partner first achieves the hurdle and then the service partner catches up to the extent there are sufficient distributions to give it the same amount of distributions it would have received had there been only a return of capital hurdle). Isn’t it better for the service partner to use a Lookback, so that the service partner gets its money sooner and pays a refund at the end of the deal only to the extent necessary, rather than a Catch-Up, under which the service partner gets its money later and only to the extent it is entitled to keep it? Not necessarily. With a Lookback, the service partner is making a bet that a refund won’t be required and that may be an expensive bet. The advantage of a Catch-Up is that it may stop the ticker on the financial partner’s hurdle earlier. Early payment of the financial partner’s hurdle can translate to significantly more whole dollars to the service partner by the end of the deal. Thus, if there is a soft hurdle, the service partner may prefer to use a Catch-Up (rather than a Lookback), which is likely to be favored by the financial partner anyway. This subject is discussed further in a prior article by the author.<sup>38</sup>

**14.5 Hard Hurdles.** By contrast, a hard hurdle is simply one that is not soft: it is a deductible; it is not contingent; and it is not eroded with a Catch-Up when there are residual distributions. However, there is another way to circumvent a hurdle, namely by getting premature promote distributions. Thus, one might say that in order for a hurdle to be completely hard, it must be met no matter what (assuming adequate distributions). There must not only be no contingency or Catch-Up, there must also be a clawback, which is the next subject of this Article.

## 15. CLAWBACKS

As noted previously, in a multi-asset partnership (which would include, for example, a partnership that owns or will own multiple land parcels), aggregating distributions protects the financial partner by allowing subsequent profits to offset prior losses (and prior hurdle deficiencies).<sup>39</sup> However, aggregation may not allow the financial partner to offset prior profits against subsequent losses (or subsequent hurdle deficiencies). If the profitable transaction occurs first, then the service partner may have already pocketed a promote distribution that would not have been paid had the order been reversed. This issue may also arise in a transaction involving a single asset because an investment may appear more profitable at one or more times during the life of the project (when there are promote distributions) than it is at the end.

**15.1 Premature Residual Distributions.** Intuitively, it may seem like the natural order of things for all contributions to occur (and be taken into account) before all distributions. If the cash flows follow this sequence under our Hypothetical Facts, then the hurdle calculation is straightforward: all the contributions are recouped and a return on all the contributions is received before any promote distributions are made to the service partner. When the partners agree to a disproportionate sharing of residual distributions (beyond the promote hurdle), they may have this simple structure in mind. But life in the real estate world is often not so simple. There are sometimes what might be called “**premature**” residual distributions<sup>40</sup> because they occur before a contribution is made or taken into account<sup>41</sup>; such a contribution may be referred

to as a “**post-promote**” contribution. When a premature residual distribution occurs, it may deviate from the intended sharing because in retrospect all or a portion of the promote included in that distribution may not be earned. If the residual distribution had been held back and used to pay the expenditures and reserves for which the post-promote contribution was used, then (to that extent) the residual distribution would not have been available for sharing at the residual level: the residual distribution, up to the amount of the expenditures and reserves, would have been applied to fund such expenditures and reserves (and would not have been used to pay promote). This problem may be handled in a number of ways.

**15.2 Promote Upon Liquidation Only.** One solution is to provide for a formulation of the promote (different from the formulation assumed under our Hypothetical Facts) that is payable only upon liquidation of the partnership. This is a safer approach for the financial partner but is not very common in the author’s experience and is beyond the scope of this Article.

**15.3 Reserves.** Another solution is for the partnership to reserve cash and not make distributions until all contributions have been made and taken into account. However, sitting on cash for significant periods of time may materially dilute everyone’s returns; and the service partner, in particular, may want to expedite, rather than delay, distributions to reduce the financial partner’s promote hurdle (so that not so much money is earning a return at the hurdle rate, which usually far exceeds any return the partnership is earning on its reserves). An alternative is for the partnership to withhold and reserve only promote distributions until the end of the partnership. However, this is rarely a practical solution because few service partners are willing to wait that long for their cash when it seems clear that a refund would not be required if it were paid currently. One variation of this approach is to withhold all or some portion of the promote distributions only until the financial partner is comfortable that the hurdle will be met in the future. However, this is not a complete solution, because the financial partner may be wrong: the reserve may not be sufficient. Therefore, the temporary or partial reserve solution, when used, may be accompanied by the other solutions below.

**15.4 Reverse Waterfall.** The partnership may require that subsequent contributions (made after residual distributions) be made in accordance with (and up to the amount of) prior residual distributions.<sup>42</sup> By contributing in this manner, the net effect is the same as a refund of the residual distributions to the extent of the future contributions. Under our Hypothetical Facts, if there were a \$100X contribution after \$100X of residual distributions, it would be contributed 72/28 instead of 90/10. Assuming the partners adopt the 20% promote alternative described in part 3.2, this means that \$80 would be contributed 90/10 and the \$20X of promote would be returned. Note that the contribution shares were not in fact altered if one ignores the promote refund: the reverse waterfall simply effected a refund of unearned promote to fund an equal portion of what is otherwise a 90/10 contribution.<sup>43</sup>

**15.5 Refund on Sale.** Another common solution to this problem is to wait until a sale or other capital event and then require the service partner to refund the promote to the extent intervening events indicate that it should not have been paid.

**15.6 Not Double-Counting.** Yet another approach is to reduce the need for a refund by eliminating double-counting of residual distributions (beyond the hurdle) that may result from negative hurdle balances. Under this approach, the hurdle balance is not allowed to go negative

so that when contributions occur (or are taken into account), they are not offset by prior residual distributions. Residual distributions are shared as non-hurdle distributions when they occur and this approach ensures that they are not counted a second time as hurdle distributions (when a contribution is subsequently made or taken into account). Thus, each new contribution gets a fresh hurdle. This approach is explained in more detail in two prior articles by the author.<sup>44</sup> The problem with this approach is that it may be far from a complete solution to the premature residual distribution/post-promote contribution problem: There may not be enough distributions to effectuate a true-up (namely, to repay the post-promote contribution and pay any return on it that has accrued since it was made). Also, this approach doesn't address certain clawback issues at all (e.g., there can be unearned promote distributions from operating revenues without double-counting).<sup>45</sup>

**15.7 Clawback: Enforcement.** The refund obligation (whether under a reverse waterfall or an adjustment upon a capital event or the end of the partnership) is often referred to as a "clawback" or "true-up". While a clawback in theory may provide for the desired adjustment, there is no guarantee that it can be enforced: The money may have already been distributed or spent at the time the refund is required and the service partner may not be well capitalized. The financial partner may therefore request some assurance (such as a guaranty) that the service partner will be able to honor this obligation and may utilize the reserve methods mentioned above to reduce the likelihood of a refund.

**15.8 Clawback: Time Value.** When considering a clawback, the financial partner may also want the service partner to account for the time value of money (i.e., the value of the use of the promote distribution before it is refunded). Observe that this might be accomplished by applying an interest factor based on the hurdle rate (i.e., increasing any refund of the promote by a hypothetical return on the refunded amount at the hurdle rate). For example, in a reverse waterfall, the partners could add an interest factor to the distributions that are required in effect to be refunded. The service partner may object that it is not likely to have actually earned such a return on the promote it refunds. But if there is no interest factor for the promote refund, then the financial partner may wonder why the residual distributions received by the financial partner do, in effect, have an interest factor in the typical IRR calculation.<sup>46</sup> For example, if there is a reverse waterfall, why should the financial partner be accountable for the time value of its share of residual distributions (i.e., the portion, if any, of each distribution that exceeds the relevant hurdle) in the IRR calculation, if the service partner is not accountable for the time value of its share of residual distributions in the reverse waterfall and specifically for the time value of the refund of the unearned promote? A possible response to this latter problem is not to accrue a return on the financial partner's residual distributions for purposes of calculating the financial partner's IRR. To avoid further inconsistencies (if no return accrues on the financial partner's residual distributions), no return should accrue on reverse waterfall contributions by the financial partner either.

## 16. EARNING AND LOSING A PROMOTE

When is the promote earned? And when may it be lost? These are critical questions to both partners.



**16.1 Immediate vs. Future Vesting.** Of course, the service partner would prefer a promote that is permanently vested from the moment the partnership is formed. The service partner may argue that the value has already been created and it should not be deprived of the promote regardless of what may happen in the future. The financial partner, by contrast, may view the promote as incentive compensation for future value to be created and future burdens to be borne rather than a brokerage commission for locating the property and closing the transaction.<sup>47</sup>

**16.2 Losing Promote for Cause.** Usually, the service partner will perform the day-to-day functions of the partnership and assume the development and managerial tasks that are required to create a successful project. If the service partner defaults in these obligations or otherwise engages in improper conduct, many partnership agreements give the financial partner the right to remove the service partner from its position as an administrative partner. Upon removal, the service partner may be converted to a silent capital partner which receives future distributions with the other partners on a pro rata basis in accordance with capital (subject to any promote the financial partner elects to provide to a new administrative partner).<sup>48</sup>

**16.3 Losing Promote Without Culpability.** Some financial partners will reserve the right to remove the service partner as administrative partner without cause or for a failure to meet certain clear-cut project performance standards that may have nothing to do with the service partner's performance. Under such circumstances, the service partner will, of course, object to losing the promote to the extent of the value created to date. The earned promote may be preserved by determining the amount of promote that would be distributed at a hypothetical sale for fair market value (which may be determined by appraisal) and using that amount to cap the demoted service partner's right to future promote distributions. In calculating this hypothetical promote, the financial partner should be careful about valuation methodology in the partnership agreement or used by an appraiser that accelerates the projected sale date. Such acceleration may ignore the further accrual of the financial partner's return and thereby artificially inflate the promote (assuming the applicable discount rate would be less than the applicable hurdle rate).

## 17. MULTIPLE PARTNERSHIPS – “CROSSING” PROMOTES

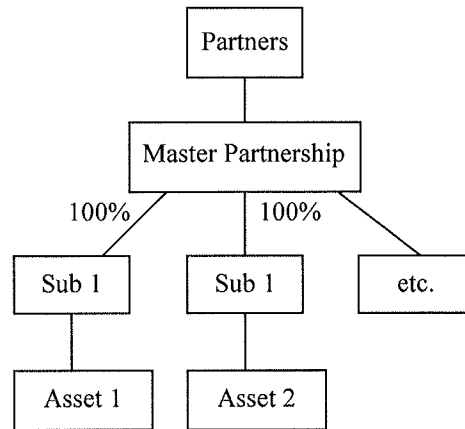
When a financial partner and a service partner are involved in multiple projects, they may pursue these projects through separate entities, whether because of liability concerns (so that the equity of one project is not at risk for the liabilities of another project), SPE requirements of lenders, or otherwise. Despite the use of separate entities, the partners may have an understanding that the overall economics should be blended and treated as a single investment. Under these circumstances, it is often stated that the promotes from each project will be “crossed”.

**17.1 Potential Confusion.** There may be confusion as to exactly what is involved when promotes are crossed. The financial partner may mean that all distributions are aggregated and that there is a clawback, but this intent should be clearly conveyed to avoid any misunderstanding. Each partner probably expects that it will be in the same position as it would be if all of the projects were owned by the same partnership. However, the financial partner may have a uniform requirement that there be a clawback whenever it is in a partnership with multiple assets, but the service partner may not know this if the partners have never been in a multiple-

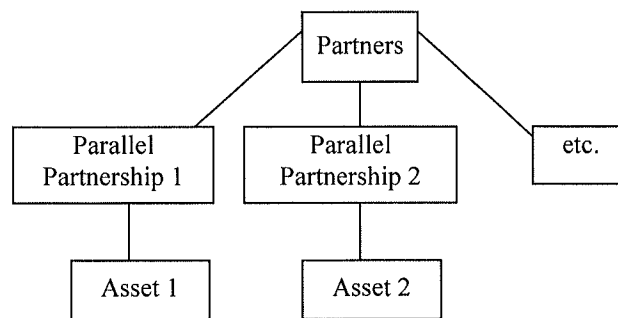
asset partnership together. Such a misunderstanding may be even more likely if the partners have previously done stand-alone single asset projects together in which there was no clawback.

**17.2 Alternative Approaches.** One way to cross promotes is to have the same partnership own all the projects and make sure that there is a single waterfall for distributions of the aggregate net revenues of the partnership and that there is a clawback.

*Master Partnerships.* However, as noted above, the partners may want to own each project through a separate entity for liability, financing and perhaps other reasons. Assuming there will be multiple entities, it is considerably simpler<sup>49</sup> to cross promotes through a single master partnership with wholly owned subsidiaries.



*Parallel Partnerships.* But sometimes the partners may consider using parallel partnerships with identical ownership (especially when the second project is not contemplated at the time the first property is acquired and there are financing or other issues with creating a new subsidiary to acquire the additional asset).



**17.3 Master Partnership Advantages.** When a master partnership is used, aggregation becomes almost automatic: all the contributions the service partner and financial partner make for the subsidiaries go down through the master partnership and distributions from the subsidiaries go up through the master partnership before reaching the service partner and financial partner.

**17.4 Parallel Partnership Disadvantages.** By contrast, with multiple parallel partnerships, will aggregation require in effect that all contributions to all parallel partnerships and all distributions from all parallel partnerships be taken into account in each partnership in calculating the hurdle for that partnership? If so, would this violate the SPE requirements of a lender or create liability or tax issues based on recharacterization of all of the partnerships as a single partnership? Of course, it may not be possible to aggregate if there are different economic deals for each partnership (and this may make it more difficult to cross the promotes). What happens, for example, if there are varying capital percentages, hurdle rates or promote percentages? In the author's experience, such disparities can lead to complicated documents. Even if the economics in the parallel partnerships are the same, there could be other differences (e.g., different owners of different but affiliated service partners) that make the arrangement complex. For example, a clawback may be more complicated with multiple partnerships if the partners want to allocate responsibility for the deficiency to the appropriate partnership. Similarly, default loans and default contributions may be treated in a less than optimal fashion (in terms of the source and priority of repayment) assuming they are to be repaid only within the partnership in which they are made. Many non-economic partnership provisions may also be more complicated (because of cross-default and similar issues raised by having multiple partnerships). An additional concern is the increase in time and cost involved: additional accounting and tax work for multiple partnerships, including allocation work (determining how common overhead and other costs should be allocated). Finally, if there are tax-exempt investors involved, it may not be possible to satisfy the fractions rule.<sup>50</sup> Although this tax issue is beyond the scope of this Article, the basic problem is that the Treasury Regulations, which permit the partnership to disregard certain otherwise offending allocations, were not drafted with multiple partnerships that constitute a single economic unit in mind.<sup>51</sup>

## **18. PROMOTE PHANTOM INCOME ISSUE**

A common concern of service partners is that the promote may result in taxable income without sufficient cash to pay their taxes (so-called "**phantom income**"). Indeed, if partnership income exceeds the 12% annual return under our Hypothetical Facts, then distributions of cash may be made at the 90/10 level (until a 12% annual IRR has been achieved and, in particular, all capital has been recouped) while taxable income in excess of the 12% annual return may be allocated 72/28, thus resulting in phantom income for the service partner. It may not be likely that taxable income from operations will exceed the 12% annual return, but sometimes it does. Also, if multiple assets are involved, partnership income from the sale of less than all of the assets may exceed the 12% annual return without generating sufficient cash to get beyond the 90/10 distribution level.

**18.1 Profits to Follow Cash?** The author has encountered service partners who have suggested that, as a solution to this phantom income problem, the partners specially allocate taxable income to follow cash distributions. However, such special allocations would require, among other things, that the partners liquidate in accordance with capital accounts to ensure that they are respected.<sup>52</sup> This could have the effect of changing the economics if, for some reason, there is not sufficient gain on sale to make up for the allocations of income the service partner should have received; in this event, the service partner might end up paying less taxes but not getting its full promote on sale. To illustrate this point, consider the following example.

**18.2 Example – Assumptions.** Assume, for simplicity, that (1) 100% of the capital is contributed by the financial partner, (2) there is a 0% (as opposed to 12%) required annual return so that distributions are made 100% to the financial partner until all capital is recouped, and the balance is shared equally by the service partner and financial partner (i.e., there is a 50% promote), (3) the partnership acquires two parcels of land for \$10X each (and the financial partner contributes nothing other than the \$20X to acquire the land), (4) each parcel is subject to a triple-net, break-even farm lease so that there is no net operating income or expense to the partnership, and (5) the first parcel is sold for a net price of \$20X and the second parcel is sold a year later for a net price of \$10X.

If the two sales had occurred simultaneously in a single sale, then there would have been \$10X of gain and the partners would have received \$10X of profit distributions: each partner would have received \$5X of profit distributions and would have been allocated \$5X of gain. But the unprofitable land parcel is sold a year later than the profitable land parcel so the distributions from the first sale (including the distributions attributable to the profit from that sale) go 100% to the financial partner to recoup the capital for both land parcels. Thus, the \$10X of gain is recognized one year earlier than the \$10X of residual distributions (and in particular, the service partner's receipt of its \$5X share of distributions). The question is how should that \$10X of gain be allocated?

**18.3 Typical Allocation – Phantom Income.** Under the facts assumed in part 18.2, what would happen if the partners agreed to use typical income allocations intended to reflect the distribution provisions described above (e.g., a target capital account approach)? In that event, the \$10X of gain would be allocated 50/50.<sup>53</sup> More specifically, such allocations would work as follows:

- the financial partner and service partner would start with capital accounts of \$20X and \$0, respectively, reflecting their capital contributions to the partnership.
- Upon the sale of the first parcel, the partnership would recognize \$10X of gain, which would be allocated equally between the partners so that after the sale, the capital account of the financial partner would be \$5X (\$20X of contributions *minus* \$20X of distributions *plus* \$5X of gain) and the capital account of the service partner would be \$5X (\$0 contributions *minus* zero distributions *plus* \$5X of gain).
- Upon the sale of the second parcel at cost, there would be no gain or loss to allocate, and the \$10X proceeds would be shared equally in accordance with their capital account balances (on a tax-free basis) and the capital account of each partner would be reduced to \$0.

**Typical Allocation**

	Financial Partner					Service Partner				
	<u>C</u>	<u>D</u>	<u>G</u>	<u>Total*</u>	<u>CAB</u>	<u>C</u>	<u>D</u>	<u>G</u>	<u>Total*</u>	<u>CAB</u>
Acquisition	\$20X			\$20X	\$20X	\$0			\$0	\$0
1 <sup>st</sup> Sale		(\$20X)	\$5X	(\$15X)	\$5X		(\$0)	\$5X	\$5X	\$5X
2 <sup>nd</sup> Sale		(\$5X)	\$0	(\$5X)	\$0		(\$5X)	\$0	(\$5X)	\$0
Total	\$20X	(\$25X)	\$5X	\$0		\$0	(\$5X)	\$5X	\$0	

**Legend:** C = Contributions; D = Distributions; G = Gain; CAB = Capital Account Balance<sup>54</sup>

\*Total (as column heading) means the annual total of C + D + G, which is the capital account adjustment for the year; by contrast, CAB is the cumulative total of C + D + G for the current and prior years.

In this example, the service partner would have \$5X of phantom income at the time of the first sale (a year before it receives any cash).

**18.4 Allocating in Accordance with Cash – Real Losses.** Under the facts assumed in part 18.2, what would happen if the partners agreed instead to have income follow cash? In that event, the \$10X of gain would be allocated entirely to the financial partner because it received all the cash proceeds of the sale. However, these income allocations would be respected for tax purposes only if the distributions of the sale proceeds from the second property (i.e., liquidating distributions) are made in accordance with the partners' positive capital accounts.<sup>55</sup> The service partner might be shocked by the result:

- Upon the sale of the first parcel, the financial partner would be allocated all of the gain because it would receive all of the cash, and therefore its capital account would be \$10X (\$20X of contributions *minus* \$20X in distributions *plus* \$10X of gain), and the service partner's capital account would remain at \$0.
- Upon the sale of the second parcel, again there would be no gain to allocate to the service partner, and the financial partner would be entitled to all of the proceeds in order to zero out its \$10X positive capital account and the service partner would end up with nothing!

**Allocating in Accordance with Cash**

	Financial Partner					Service Partner				
	<u>C</u>	<u>D</u>	<u>G</u>	<u>Total*</u>	<u>CAB</u>	<u>C</u>	<u>D</u>	<u>G</u>	<u>Total*</u>	<u>CAB</u>
Acquisition	\$20X			\$20X	\$20X	\$0			\$0	\$0
1 <sup>st</sup> Sale		(\$20X)	\$10X	(\$10X)	\$10X		\$0	\$0	\$0	\$0
2 <sup>nd</sup> Sale		(\$10X)	\$0	(\$10X)	\$0		\$0	\$0	\$0	\$0
Total	\$20X	(\$30X)	\$10X	\$0		\$0	\$0	\$0	\$0	

**Legend:** C = Contributions; D = Distributions; G = Gain; CAB = Capital Account Balance<sup>56</sup>

\*Total (as column heading) means the annual total of C + D + G, which is the capital account adjustment for the year; by contrast, CAB is the cumulative total of C + D + G for the current and prior years.

**18.5 Tax Loans.** This and other phantom income problems may be addressed with tax loans. However, in the author's experience, with the exception of multi-asset deals, the risk of phantom income due to the promote is usually not raised as a significant concern.

**18.6 Incentive Fees.** Another possible solution to this problem is to pay the promote as an incentive fee and not as a distribution: all distributions under our Hypothetical Facts would be made 90/10, but there would be an incentive fee, equal to what the promote would have been, to the service partner in its capacity as a service provider. Although this solution results in ordinary income to the service partner, in some transactions (e.g., lot sales), all the income from the partnership may be ordinary income anyway.

## 19. OTHER COMPLICATIONS

One frequently encounters other complexities that make the promote analysis more complicated and increase the chances of error.

**19.1 Returning to a Prior Hurdle.** Look back at the distribution waterfall in our Hypothetical Facts. Query whether someone could use a literal interpretation of the language to assert that there are no further first level distributions once the 12% hurdle is achieved? The problem, of course, is that contributions subsequently being taken into account could result in the 12% hurdle no longer being met. To avoid this argument, consider drafting the partnership agreement to make clear that at the time of each distribution, the hurdle must be satisfied before any second level distributions are made again. Thus, if the first level of distributions requires distributions 90/10 “until the financial partner has achieved a 12% annual IRR”, then one might add “and in no event will any distributions be made under the subsequent provisions of this section at any time when the financial partner has not achieved a 12% annual IRR”. Perhaps a more elegant solution to this problem is simply to provide that “each distribution” be made in accordance with the distribution waterfall and to refer to the “then” achievement of the hurdle.

**19.2 Contributions and Distributions of Property.** There should be a clear understanding as to how contributions and distributions of non-cash property are valued for purposes of calculating the promote. The financial partner may want the right to veto any distribution in kind.

**19.3 Tax Treatment vs. Termination Right.** Characterizing the consideration for the promote in the partnership agreement may raise competing concerns for the service partner and financial partner. The service partner, on the one hand, may want the promote to be treated as part of its partnership profits interest for income tax purposes and may be concerned that if the promote is characterized as compensation for services, then the IRS may treat it as ordinary income. The financial partner, on the other hand, wants to be able to eliminate the promote if the services are not satisfactory and may feel that this right is more secure if it is clear that the promote is compensation for these services. In the author’s experience, the service partner usually gets comfortable that any tax risk arising from the fact that the promote is explicitly tied to services is not significant.<sup>57</sup> The greater concern is that legislation may be enacted that eliminates the possibility of capital gains treatment for promote distributions.<sup>58</sup>

**19.4 Promote to Party Not Providing Consideration.** It is not uncommon for some of the services that support the promote to be provided by affiliates of the service partner (e.g., an affiliate may enter into a development agreement or management agreement). Sometimes *all* the relevant services are provided by an affiliate (e.g., in states, such as Texas and Pennsylvania, where limited partnerships are sometimes used instead of limited liability companies and the

service general partner wants the promote to go to an affiliated limited partner to minimize the assets of the service general partner, which is liable to third party creditors of the partnership). This arrangement creates issues as to potential defenses that may be raised if and when the promote is to be eliminated by reason of a default in those services. Under these circumstances, the party receiving the promote is, in effect, acting as a surety or guarantor by allowing for the offset or elimination of the promote to secure the performance of the party providing the applicable services.<sup>59</sup> When such an arrangement is utilized, appropriate suretyship and guarantor defense waivers should be added.

**19.5 Reserves Upon Liquidation.** When all of the real estate assets are sold, it may be prudent to set aside a reserve to pay for contingent liabilities (whether contractual liabilities under the sale contract or otherwise). Unfortunately, the service partner may have conflicting concerns about such reserves. On the one hand, it may want to set aside funds to deal with third party creditor claims (especially if it is a general partner in states where limited partnerships are used in lieu of limited liability companies). On the other hand, the service partner may want to distribute more money and keep less of a reserve if that money is required to meet a hurdle to reach the residual level. The financial partner should keep this conflict in mind in evaluating the amount to be reserved (and in establishing who gets to make this decision under the partnership agreement).

**19.6 Whole Dollar Hurdles vs. IRR Hurdles.** A similar conflict may arise in real estate partnerships that have both whole dollar hurdles and IRR hurdles, which is not uncommon. An IRR hurdle may create an incentive for the service partner to *reduce* reserves and *accelerate* distributions to stop the IRR hurdle from growing too quickly. A whole dollar hurdle, on the other hand, may create an incentive for the service partner to *increase* reserves and *delay* distributions to minimize the likelihood of further contributions that would be entitled to whole dollar protection.

There are countless additional examples of promote issues, but further discussion is beyond the scope of this Article.

## 20. CONCLUSION

Compensation in the form of promote distributions is a relatively common feature in real estate ventures today. It is important that the computer models, the legal documentation and the understanding of the service partner all match how the financial partner intends to calculate the promote. To this end, this Article has raised a number of questions to be considered at the outset, including:

- What does the stated promote percentage really mean (who is paying the promote and to what is the promote percentage applied)?
- What does the stated hurdle rate really mean (how often is it compounded, what is the effective rate for a compounding period, and is that effective rate achieved proportionately or exponentially during each compounding period)?
- Are there both whole dollar and time value hurdles?

- What cash inflows and cash outflows are to be taken into account in the promote hurdle and for what period?

If the answers to these questions are understood at the outset, the parties are much more likely to avoid any dispute over the promote calculation.

It is also important to appreciate the partnership dynamics that affect, or are affected by, the promote. While the incentive nature of the promote structure is intended, in part, to align the interests of the partners, it should be clear that it may also create some misalignment. For example, a typical time value hurdle may incentivize the service partner to increase the amount, and accelerate the timing, of distributions. Although many service partners have a long-term view and value the relationship with the financial partner as much or more than the economic outcome of any particular deal, it is possible that this misalignment of interests might lead to less than optimal results (e.g., a premature or excessive financing). The financial partner may therefore want some control over decisions on matters (e.g., distribution and financing decisions) where the interests of the partners may diverge.

While the promote structure may be a key element in a real estate partnership between a financial partner and a local service partner, a good promote structure does not guarantee a successful investment for the financial partner. What Warren Buffett once said about buying companies applies equally (with a little editing) to promote structures: it is far better to have a fair promote hurdle in a partnership with a wonderful asset, than a wonderful promote hurdle in a partnership with a fair asset.<sup>60</sup> Moreover, a promote structure that keeps the service partner motivated is more likely to influence the success of the project in a positive way than one that does not. Thus, there is much to balance in determining the right promote structure and one must not lose sight of the even more important need to have a good partner and a good asset.

\* \* \*



## APPENDIX

### AMBIGUOUS PROMOTE STRUCTURES?

This Appendix will discuss notation frequently used to describe a promote structure. The Delaware Supreme Court, citing the 2003 publication of the original version of this Article, has described this notation as “industry shorthand”.<sup>61</sup>

It is not uncommon for real estate professionals to describe a promote structure with succinct phrases such as “a 20 over a 12”. In the author’s experience, this notation typically means that there is a 20% promote when the financial partner has achieved a 12% hurdle. If the parties have a common understanding as to who is being promoted and by how much, such shorthand may be useful. If not, the ambiguity may be problematic. This formulation does not identify the residual split and does not establish whether the service partner is promoting itself.

**20% of What Is Paid by Whom?** There are two questions lurking here, which may be left unanswered until the distribution provisions are drafted.

- One relates to the amount of the promote: 20% of what?
- The other relates to the source of payment: is it paid by the partnership (i.e., both partners) or only the financial partner?

Thus, a 20% promote after a 12% hurdle might mean any one of three things, as described in the following chart (although, in the author’s experience, the financial partner usually intends only the first alternative and the third alternative would be unusual).

<b>20% Promote After 12% Hurdle</b>			
<i>Amount of Promote</i>	<i>Source</i>	<i>Promote (as % of total residual)</i>	<i>Service Partner's Share of Residual</i>
20% of total residual	Partnership	20%	$28\% = 20\% + (10\% \times 80\%)$
20% of financial partner's share of residual	Financial Partner	18%	$28\% = 10\% + (20\% \times 90\%)$
20% of total residual	Financial Partner	20%	$30\% = 10\% + 20\%$

Set forth below are sample (but not necessarily model) provisions that have been used to document these three alternatives:

**Alternative One (20% of total residual from partnership):**

*First*, each distribution will be made to the partners in accordance with their partnership percentages until the financial partner has achieved the 12% promote hurdle; and

*Second*, the balance will be distributed (a) 80% to the partners in accordance with their partnership percentages, and (b) 20% to the service partner as a promote.

**Alternative Two (20% of financial partner's share of residual):**

Each distribution will be made to the partners in accordance with their partnership percentages; provided, however, that the balance of any distribution to the financial partner remaining after the financial partner has achieved the 12% promote hurdle will be distributed (a) 20% to the service partner as a promote, and (b) 80% to the financial partner.<sup>62</sup>

**Alternative Three (20% of total residual from financial partner):**

*First*, each distribution will be made to the partners in accordance with their partnership percentages until the financial partner has achieved the 12% promote hurdle; and

*Second*, the balance will be distributed (a) 10% to the service partner on account of its capital interest, (b) 20% to the service partner as a promote and (c) 70% to the financial partner.<sup>63</sup>

**Neither Promote Percentage Nor Residual Splits Tell Full Story.** Thus, “a 20 over a 12” could mean a 70/30 or 72/28 residual split. Moreover, as discussed in the body of this Article, the residual split may not be enough information to know who is being promoted, as can be seen from the first and second alternatives above (each of which has the same residual split of 72/28). In the first alternative, the promote is 20% of the total residual (and the service partner is promoting itself), and in the second alternative, the promote is 18% of the total residual (and the service partner is not promoting itself).

\* \* \*

## ENDNOTES

- <sup>1</sup> A promote is often called a “carried interest” (especially in the fund context) and sometimes even other names. *See, e.g.*, CARLA J. GARRETT & HAYDEN J. TRUBITT, *LAWYERS GUIDE TO FORMULAS IN DEAL DOCUMENTS AND SEC FILINGS* (Matthew B. Swartz ed., 2012) § 8.01[1] at 8-4 (“The share of profits allocated to a fund manager of a private equity fund in exchange for services (i.e., independent of its capital contribution) is typically called, and referred to herein as, a ‘Carried Interest.’”); JAMES M. SCHELL, PAMELA LAWRENCE ENDRENY & KRISTINE M. KOREN, *PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS* (2012) § 2.02 at 2-7 (“The most important element of incentive compensation takes the form of a profits interest that is significantly greater than the Sponsor’s capital interest. This profits interest is commonly referred to as a ‘carried interest’, ‘carry’, ‘performance allocation’, a ‘promote’ or ‘promoted interest’ or an ‘override.’”).
- <sup>2</sup> By “fund”, the author means a real estate fund, which is an investment vehicle through which a sponsor raises capital to invest in real estate usually from more than one investor and usually for more than one asset acquisition. In the typical venture that is the subject of this Article, the financial partner is often such a fund and the service partner is a local operator or developer. In the author’s experience, the fund itself has its own promote structure. Thus, some of the same issues discussed in this Article may also arise in the fund context. Indeed, the sponsor of the fund may be on both sides of those issues when the fund forms a partnership with a local partner: on the service partner side when receiving a promote as sponsor of the fund; and on the financial partner side when the fund gives a promote to its local partner. But funds are not the focus of this Article. For information regarding real estate funds, *see, e.g.*, SCHELL, *supra* note 1, § 1.07 at 1-45; *see also* STEPHANIE R. BRESLOW & PHYLLIS A. SCHWARTZ, *PRIVATE EQUITY FUNDS: FORMATION AND OPERATION* (2012) § 1:3.5 at 1-27.
- <sup>3</sup> *See, e.g.*, Bruce P. Ely, Christopher R. Grissom & William T. Thistle, *State Tax Treatment of LLCs and LLPs – An Update*, 67 ST. TAX NOTES 6 at 401 (February 11, 2013); Hans Martin Schmid & Christian Schmidt, *Double Taxation of Profits from a Hybrid U.S. LLC*, 10 PRAC. EUR. TAX STRATEGIES 10 (October 2008); Rob Whittall, *U.S. LLCs for U.K. Tax Purposes*, THE TAX ADVISER (October 1, 2012).
- <sup>4</sup> “Waterfall” imagery has been used in a number of contexts when there is a tiered payment scheme. As explained by one author, such a distribution structure may be called a waterfall “. . . because of the similarity to a champagne waterfall with tiers of glasses balanced on top of one another.” Under our Hypothetical Facts, a distribution is initially made 90/10 until the financial partner has achieved its 12% hurdle. “This is analogous to the highest tier of champagne glasses . . . being filled first (being paid first).” If the 12% hurdle has been achieved under our Hypothetical Facts, then the balance of the distribution is split 72/28. “In a sense, the second tier of champagne glasses is now being filled . . .” Sally Gordon, *How to Build A Bond*, CMBS WORLD at 16 (Special Borrower Edition 2002).
- <sup>5</sup> *But see infra* note 26.
- <sup>6</sup> For example, under the facts of Alternative One in the Appendix, assume there is a dilution formula that adjusts the partnership percentages from 90/10 to 95/5 so that there has been a 50% reduction in the service partner’s partnership percentage. How would the dilution formula address the promote distributions? If there were a 50% reduction in the promote, then the new second level aggregate shares would be 85.5/14.5 (because 50% of 20% = 10% would be distributable as promote and the remaining 90% would be split 95/5, giving the financial partner 95% of 90% = 85.5%). However, if the promote was not separately stated and there were instead a 50% reduction in the service partner’s second level aggregate share, to match the 50% reduction in its partnership percentage, then the new second level aggregate shares would be 86/14 (because 50% of 28% = 14% and 72% + 14% = 86%). The difference between these two alternatives is .5%.
- <sup>7</sup> *See, e.g.*, Cal. Civ. Code § 1916-2 (“. . . in the computation of interest upon any . . . agreement, interest shall not be compounded, nor shall the interest thereon be construed to bear interest unless an agreement to that effect is clearly expressed in writing and signed by the party to be charged therewith.”).
- <sup>8</sup> Stevens A. Carey, *Real Estate Joint Venture Promote Calculations: Rates of Return Part 1 – The Language of Real Estate Finance*, REAL EST. FIN. J. at 5 (Spring 2011).

9 Stevens A. Carey, *What is the Difference Between an IRR and a Preferred Return?*, BNA/BLOOMBERG  
(forthcoming 2013) (on file with author) [hereinafter, Carey, *IRRs vs. Preferred Returns*].

10 It is possible for an IRR formulation not to allow for negative balances by not taking into account the  
portion of each distribution that exceeds the applicable IRR hurdle. Carey, *IRRs vs. Preferred Returns*,  
*supra* note 9; Stevens A. Carey, *Real Estate JV Promote Calculations: Recycling Profits*, REAL EST. FIN. J.  
(Summer 2006) [hereinafter, Carey, *Recycling Profits*]; Stevens A. Carey, *Real Estate JV Promote*  
*Calculations: Avoiding Multiple IRRs*, REAL EST. FIN. J. at 5 (Spring 2012) [hereinafter, Carey, *Multiple*  
*IRRs*].

11 In practice, there is usually some rounding that occurs. For example, the XIRR rounds to an equivalent  
nominal daily rate that is compounded daily (and in effect assumes that distributions occur at the same time  
of each day) and then compounds that daily rate to generate the equivalent effective annual rate.

12 *See* Carey, *IRRs vs. Preferred Returns*, *supra* note 9, Example 5.

13 While daily conventions are typically adopted in practice, this Article assumes for convenience a continuous  
approach. In particular, the *end* of a compounding period is assumed to be a point in time rather than the  
last day, and it is the same as the *beginning* of the next compounding period (which is also assumed to be a  
point in time, and not the first day of the next compounding period).

14 Carey, *IRRs vs. Preferred Returns*, *supra* note 9.

15 Caution must be exercised when adjusting partner cash outflows that are taken into account in the promote  
hurdle calculation. Such adjustments may result in the partners' unrecouped capital and accrued but unpaid  
return being out of sync with the original percentages pursuant to which hurdle distributions are being  
shared (*e.g.*, 90/10 under our Hypothetical Facts). As discussed in part 8, this problem can be addressed by  
making hurdle distributions in accordance with the relative shares of the partners' unrecouped capital and  
accrued but unpaid return (or what is sometimes called their respective hurdle deficiencies or hurdle  
balances).

16 If the acquisition costs (including the price) for the newly acquired partnership interest do not equal the  
unrecouped capital and accrued but unpaid return associated with the newly acquired partnership interest,  
then the financial partner would no doubt prefer to add to its hurdle balance the larger amount, while the  
other partners would prefer to add the smaller amount, to the financial partner's hurdle balance. However,  
regardless of which amount is larger, the financial partner's future hurdle calculations will likely be adjusted  
only to take into account the actual unrecouped capital and accrued but unpaid return associated with the  
newly acquired partnership interest and any differential between that amount and the acquisition costs will  
likely be taken into account in making the purchase.

17 If both partners' contributions are grossed up by their share of what the fee would have been, then the net  
effect may simply be to defer and reduce the service partner's promote. If only the financial partner's  
contributions are grossed up, then the partners' contributions may be out of sync with their partnership  
percentages, as discussed in part 8.

18 *See, e.g.*, Stevens A. Carey, *Squeeze-down Formulas: Do They Work the Way You Think They Do?*, REAL  
EST. FIN. J. at 43 (Fall 1997).

19 This capital shift not only has an economic impact, it may also have a significant tax impact. Indeed, tax  
consequences are sometimes the driving force for using these stronger forms of dilution formula, which may  
keep the capital accounts in line with the dilution formula. Be sure to consult tax counsel regarding the tax  
consequences of a dilution formula.

20 However, even if promote distributions are taken into account in the hurdle calculation, it may be equivalent  
either to require that *the financial partner* achieves its hurdle or to require that *each partner* achieves its  
hurdle as long as capital percentages do not shift (as discussed later in part 8). The reason is that the  
financial partner's hurdle balance will generally be equal or larger due to the fact that promote distributions  
reduce only the service partner's hurdle balance.

21 There can be an issue even if there is only one hurdle, if negative balances are permitted or there are  
promote refunds.

22 Another circumstance in which it may work well to track the financial partner's investment is when the  
promote is paid solely out of the financial partner's distributions. *See infra* note 26.

23 If the partners fund their contributions (or receive their distributions) at different times, then the partner who  
funds its contribution first or receives its distribution later may have a disproportionately larger accrued  
return. Of course, the resulting disparity may not be a concern unless the time differentials are significant  
and the problem is not otherwise addressed (e.g., by increasing the subsequent contribution or distribution  
by a time value factor).

24 All distributions will be made under the first level of distributions because the financial partner's share of  
the total distributions is less than its hurdle balance of \$90X.

25 When all hurdles have been achieved, however, how are the remaining non-promote distributions shared?  
Typically, in the author's experience, they are shared in accordance with partnership percentages; and  
partnership percentages are often equal to the capital percentages at the outset, but may be subject to  
adjustment later due to contribution defaults.

26 Another way to avoid issues with shifting hurdle ratios is to make the promote completely independent of  
the service partner's capital: if the service partner does not promote itself, only the financial partner's  
hurdle is relevant. This approach also avoids the potential problem of nullifying (or limiting) the impact of  
a dilution formula, as discussed *infra* in note 27. In addition, less of the service partner's distributions will  
be characterized as promote because the service partner would not be diluting its capital interest (*see, e.g.*,  
parts 4.1 and 4.2); a smaller promote could be attractive to a service partner concerned with the prospect of  
the carried interest legislation mentioned in part 19.3. If this alternative approach is followed, then as noted  
in part 4.3, the financial partner will want to make clear that the partners will share the cost of any promote  
payable to a subsequent operator.

27 This could occur if distributions never reach a level where partnership percentages are the basis for sharing  
any distributions, assuming the dilution formula, as many do, adjusts only partnership percentages, and does  
not otherwise give the contributing partner credit for contributing the deemed penalty contribution, as  
discussed in part 7.8. For example, if under our Hypothetical Facts, first level distributions are made in  
accordance with hurdle balances, then the partnership percentages will no longer be relevant for  
distributions unless they are made at the second level. And the second level may not be reached. However,  
as noted in part 7.8, some dilution formulas change the amount a partner is deemed to have contributed for  
purposes of calculating outstanding capital. For the latter type of dilution formula, distributions in  
accordance with the relative shares of outstanding contributions and accrued return should reflect the impact  
of the penalty dilution (assuming, of course, that the excess percentage of the default contribution is taken  
into account in determining these shares).

28 Among other matters, there may be fractions rule compliance issues for tax-exempt investors. I.R.C.  
§ 514(c)(9)(E).

29 *See* part 7.6.

30 Moreover, the financial partner may not have the right to redeploy the capital of its investors. *See, e.g.*,  
SCHELL, *supra* note 1, § 1.03[8] at 1-27 ("Proceeds from sales of investments are rarely subject to  
reinvestment, although exceptions are sometimes crafted for capital (but rarely profits) recovered from  
investments held for less than a specified period (e.g., 12 months)."); *cf.* BRESLOW, *supra* note 2, § 2:5.8[A]  
at 2-38 *et seq.*

31 Some financial partners require that the investment include (for this purpose) subsequent contributions that  
have already been budgeted.

32 However, appropriate adjustments may be necessary if the payment or prepayment of the loan will not  
occur when distributions would otherwise be made to recoup the capital attributable to the loan. *See*  
alternative approach under part 11.2.

33 Carey, *IRRs vs. Preferred Returns*, *supra* note 9; *see also* Stevens A. Carey, *Real Estate JV Promote  
Calculations: Rates of Return Part 5 – Deemed Reinvestment – A Myth?*, REAL EST. FIN. J. (Summer  
2012).

34 The financial partner may want to aggregate for other reasons including avoiding the time, cost and complications associated with treating each building as a separate investment. For example, aggregation may avoid the need (1) to account for the use of operating cash flow from one building to pay operating deficits of the other building, and (2) to allocate common legal, accounting, overhead and other costs between the buildings.

35 *See* discussion of clawbacks below in part 15.

36 *See* I.R.C. § 707(c).

37 There are actually two hurdles in this example. The first hurdle is a return of capital hurdle, which as will be seen, is a *hard* hurdle, because the first level distributions are deducted (permanently) before any promote distributions. The second hurdle is referred to as the 12% annual IRR hurdle. But in light of the fact that capital has already been recouped under the first level of distributions before any distributions under the second level, the second hurdle separately covers only the balance of what is needed (after capital is recouped) to achieve the 12% annual IRR. Thus, one could also think of this second hurdle, which is *soft* in this part 14, as the return component of the 12% IRR. But we simply refer to the 12% annual IRR hurdle (keeping in mind that the recoupment of capital is separately addressed under the first level of distributions). This cumulative approach is common in the author's experience when there are multiple hurdles. Thus, if our Hypothetical Facts were changed so that the second level of distributions stopped when the financial partner achieved a 15% IRR, and then there was a third level of 50/50 distributions, there would be two promote hurdles. They may be referred to as the "12% IRR hurdle" and the "15% IRR hurdle", even though the distributions under the second level represent only the incremental difference required to achieve the larger IRR.

38 Stevens A. Carey, *Real Estate JV Promote Calculations: Catching Up With Soft Hurdles*, REAL EST. FIN. J. (Spring 2008).

39 More generally, it was observed that a single aggregate waterfall may avoid one waterfall yielding a promote when the other waterfall does not reach the hurdle (e.g., one waterfall for operating cash flow and one waterfall for capital proceeds), but aggregation is not a complete solution to this problem.

40 Keep in mind that, under our Hypothetical Facts, all residual distributions include promote distributions.

41 When calculating the promote hurdle to allocate a distribution, sometimes a contribution that has previously occurred may not be "taken into account". For example, in some fund partnership agreements covering multiple real estate assets, the contributions taken into account in the hurdle calculation (to allocate a distribution of capital proceeds) may be limited to contributions for assets sold and write-downs for unsold assets. *See, e.g.,* SCHELL, *supra* note 1, Appendix D, § 6.2(b)(i) at D-64 (and definition of Realized Investment at D-16 and definition of Disposition at D-6); *see also* GARRETT, *supra* note 1, § 8.01[5] at 8-16; BRESLOW, *supra* note 2, § 2:8.1, Example 2-1 at 2-48, 2-49.

42 This may not address contributions that were made but not taken into account at the time of a prior distribution. It also may be complicated if there are multiple waterfalls (e.g., separate waterfalls for capital proceeds and operating cash flow).

43 Regardless of whether the 18% promote alternative (under which the service partner promotes only the financial partner) or the 20% promote alternative (under which the service partner promotes both partners) is chosen, the reverse waterfall effects a refund of the promote: in the 18% alternative, the refund is (in effect) to the financial partner to fund an equal portion of *its share* of the contribution and in the 20% case, the refund is (in effect) to both partners (or the partnership) to fund an equal portion of the contribution.

44 Carey, *Recycling Profits*, *supra* note 10; Carey, *Multiple IRRs*, *supra* note 10.

45 The issue of premature promote distributions/post-promote contributions generally subsumes the double-counting issue. In other words, you usually don't have double-counting unless there is a post-promote contribution (i.e., a contribution that is made or taken into account after a promote distribution). And you never have double-counting unless there is a premature promote distribution: if there is double-counting of a residual distribution first as a non-hurdle distribution and later as a hurdle distribution, then the promote portion of that residual distribution is a premature promote distribution. But there need not be double-

counting to have a premature promote distribution. Consider, for example, separate distribution waterfalls for operating revenues and capital proceeds (where there is no return of capital hurdle in the operating revenue distribution waterfall): there may be operating revenue promote distributions before the capital contributions are returned at sale (and none of the operating revenue distributions may have been double-counted). Also, if the hurdle is drafted so that there is no double-counting (because the hurdle balance is not allowed to go negative and each new contribution gets a fresh hurdle), then there may still be premature promote distributions.

46 Keep in mind that the typical IRR hurdle takes into account residual distributions, but it is possible not to do so. If residual distributions are *not* taken into account, then the hurdle calculation would not take into account an interest factor on residual distributions either. However, if there is a reverse waterfall, then residual distributions are typically taken into account because to do otherwise could result in a promote refund when none is presumably intended.

47 Closely related to promote vesting is the notion of locking in the promote by converting it to equity, although this is rarely done in the author's experience. Some service partners may be concerned that if too much time passes, the financial partner's hurdle will eventually encompass all the profit in the deal and there will be nothing left to share at the promote level: value creation may occur quickly but may be eroded over time because appreciation may not keep pace with the hurdle rate. Some service partners would therefore prefer to value their promote at a pre-set time before it is eliminated and then convert it to equity. For example, if a hypothetical liquidation after a sale of the property at its appraised value would yield an 80/20 split of liquidation proceeds as of the designated time, the partnership would then be converted to a straight-up 80/20 partnership. This structure involves a number of issues (including tax issues) beyond the scope of this Article.

48 In many partnership agreements, if there is a contribution default by the service partner, and the financial partner does not elect to remove the service partner as the administrative partner and eliminate the promote, then assuming the financial partner elects to proceed with a dilution remedy, there may be a corresponding adjustment to the promote. *See, e.g., supra* note 6.

49 If there are state tax concerns with having a wholly owned LLC subsidiary of the master partnership, consider using a wholly owned subsidiary of the master partnership to be the sole GP (with a small economic interest, if any) of a single asset partnership in which the master partnership is also the sole limited partner.

50 I.R.C. § 514(c)(9)(E).

51 Treas. Reg. § 1.514(c)-2.

52 I.R.C. § 704(b).

53 *See generally*, STEPHEN I. GLOVER & CRAIG M. WASSERMAN, PARTNERSHIPS, JOINT VENTURES & STRATEGIC ALLIANCES (2012) § 18.04[4] at 18-27 *et seq.*

54 Although partnership losses and deductions are taken into account in determining a partner's capital account, there is no column in the charts for partnership losses and deductions because there are no partnership losses or deductions under the facts assumed in part 18.2. For the same reason, the "Gain" column covers only partnership gain and not partnership income and gain. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(b).

55 *See* GLOVER, *supra* note 53.

56 *See supra* note 55.

57 *See, e.g.*, GERALD J. ROBINSON, FEDERAL INCOME TAXATION OF REAL ESTATE: ANALYSIS AND TAX-PLANNING IDEAS (6th ed. 2005) ¶ 8.02[3][b][iii] at 8-38.

58 *See, e.g.*, Chester W. Grudzinski, Jr., *How Carried Interest Legislation Could Change Real Estate Investing*, 39 J. OF REAL EST. TAX'N 4 (Third Quarter 2012) at 147; SCHELL, *supra* note 1, § 6.03 at 6-14.1. Fear of such legislation might prompt a service partner to push for the 18% alternative in part 4.

59 *See, e.g.*, Cal. Civ. Code § 2787; Restatement (Third) of Suretyship and Guaranty § 1.

60 Warren Buffett, CEO Berkshire Hathaway (Chairman's Letter, 1989 Annual Report), <http://www.berkshirehathaway.com/letters/1989.html> ("It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price.").

61 Scion Breckenridge Managing Member, LLC v. ASB Allegiance Real Estate Fund, No. 437, 2012 (Del. May 9, 2013) at fn. 9. Other issues are presented by the facts of this case, which involved multiple hurdles. Setting aside the question of what "preferred return" means, the parties' interpretation of the so-called industry shorthand, as reflected in the provisions of their documents quoted by the court, appears to be similar to Alternative One discussed in this Appendix, which is consistent with the author's experience.

62 Alternative Two could also be drafted as follows: *first*, each distribution will be made to the partners in accordance with their partnership percentages until the financial partner has achieved the 12% promote hurdle; and *second*, the balance will be distributed (a) 10% to the service partner on account of its capital interest, (b) 18% to the service partner as a promote and (c) 72% to the financial partner.

63 Alternative Three could also be drafted as follows: each distribution will be made to the partners in accordance with their partnership percentages; provided, however, that the balance of any distribution to the financial partner remaining after the financial partner has achieved the 12% promote hurdle will be distributed (a) 2/9 to the service partner as a promote, and (b) 7/9 to the financial partner.