Real Estate Joint Venture Promotes and the Distribution Waterfall Provisions

A Practical Guidance® Practice Note by Kris Ferranti, Shearman & Sterling LLP

Kris Ferranti
Shearman & Sterling LLP

This practice note examines issues to consider when drafting the promote mechanic provisions of a limited liability company operating agreement (also referred to as the joint venture agreement). Sample provisions illustrating the concepts discussed in this practice note are included in the exhibit.

This practice note assumes that the limited liability company is formed in a state with a statute similar to the Delaware Limited Liability Company Act (6 Del. C. Sec. 18-101 et seq.). The members of the limited liability company may be referred to herein as members or partners. This practice note assumes familiarity with basic principles of real estate joint ventures agreements.

For additional real estate joint venture resources, see Real Estate Joint Venture Resource Kit (90/10 Real Estate Joint Venture).

The Promote

Promote mechanics are built into the distribution waterfall provisions of a joint venture agreement. To understand promote mechanics, one must also understand the distribution waterfall provisions.

The distribution waterfall provisions dictate which of the parties will receive cash returns on their investment and the relative priority and timing of distribution of such returns. The "waterfall" refers to the order in which available cash is distributed to the parties, and the "promote" is embodied in the waterfall.

The waterfall varies from deal to deal and is typically tailored to the specifics of the transaction. The waterfall may also vary within the same joint venture agreement for different categories of available cash, such as operating cash flows and capital event proceeds.

It is called a waterfall for good reason. The waterfall structure can be visualized as water cascading down a series of ponds. The water represents the available cash to be distributed to the parties. Water fills the first pond in the sequence and, if there is enough water, the excess water flows over the rim and down into the next pond in sequence. Each pond represents a separate agreement between the parties as to how available cash will be split among them at that level.

The rim of each pond in this illustration is what is referred to as the "hurdle." Prior to reaching the rim of the first pond (i.e., achieving any of the hurdles), the joint venture typically distributes available cash pari passu, meaning each party's return ranks equally in priority, and pro rata in amount, meaning relative to each parties' respective percentage ownership in the joint venture.

After a hurdle is achieved, a party may be entitled to a share of profits that is greater than the pro rata share that the party would otherwise be entitled to based on its ownership percentage. This disproportionate share of the proceeds is the promote, or, as known in other forms of alternative investment, "carry," and the right to a promote or carry is often called a promote interest, carried interest, profits interest, or colloquially as sweat equity.

The Sponsor and the Sponsor's Promote

There are typically two types of parties to a real estate joint venture: the sponsor and the capital investor(s). Sponsors play an active role in the venture, sourcing, and securing property investments, financings, and other equity investors. Underwriting and due diligence for investments is often handled by the sponsor. Sponsors also usually act as the managing member, managing the joint venture and potentially the venture assets, including day-to-day construction and development, operation and leasing of the property, and its ultimate disposition. Greater risk comes with the role of sponsor who often assumes responsibility for cost overruns and provides a guaranty of recourse obligations in financings, thereby likely reducing the cost of financing to the venture. In this role, sponsors contribute their valuable relationships, expertise, and experience to the venture.

While joint ventures of other alternative investment types may be owned relatively evenly (e.g., 50/50 or 60/40), it is more common in real estate joint ventures for the sponsor to own a much smaller equity stake than the capital investors, for example, 2%-15% owned by the sponsor and 85%-98% owned by the capital investors. Determining the percentage ownership interest of the sponsor requires balancing two of the capital investors' goals: to have greater control over key major decisions typically given to those with a significant majority equity stake and, at the same time, for the sponsor to have a sufficient investment (or "skin in the game") so that the sponsor and investors' interests are aligned and the sponsor remains committed to maximizing value.

The promote can be thought of as both compensation for the sponsor's critical role in the venture as well as a powerful incentive tool motivating the sponsor to create value or discover hidden value, and ultimately generate profits that exceed budget and business plan expectations. Upon achieving such superior returns, the sponsor would be entitled to the promote, that is, the sponsor would receive an excess share of distributions at a level greater than the sponsor's percentage interest in the joint venture. This kind of graduated profit-sharing mechanism incentivizes the sponsor to outperform so that greater distributions will flow into the downstream ponds in which the sponsor will be entitled to a larger share. The details of the profit-sharing agreements of the different ponds are called the promote mechanics.

Keep in mind that a promote is separate and distinct from fees that a sponsor may earn in a deal. Fees may include acquisition fees, disposition fees, asset management fees, development fees, financing fees, property management fees, leasing fees and commissions, license/franchise fees, technical services fees, pre-opening fees, purchasing fees, and guaranty fees. Although fees are beyond the scope of this practice note, it is worth noting that such fees may cause a misalignment of interest between the sponsor and any investor in that the sponsor may have a relatively small equity stake in the venture but can receive substantial fee income even if the venture's performance is below expectations and the capital investors do not achieve their anticipated returns.

Calculating Available Cash for Distribution

In a real estate joint venture, there are generally two sources for cash distributions:

- Operating cash flow (e.g., rental income from tenants) -and-
- Cash from liquidation, refinancing, casualty or condemnation proceeds, or the sale of capital assets (or capital proceeds)

Each are often referred to as available cash or cash available for distribution in the joint venture agreement. Available cash may be offset by liabilities, including costs of sale, sums required to redeem loans on a disposition, current liabilities such as debt service, taxes, insurance, general operating expenses, and other budgeted expenditures and reserves or other holdbacks for contingent liabilities. As noted earlier, the sponsor will often charge the joint venture a series of fees. These fees may be netted from property cash flow and reduce the overall return and cash available for distribution for the investors.

Parties to the joint venture agreement will heavily negotiate the definition of available cash for distribution. See Related Companies, L.P. v. Tesla Wall Systems, LLC, 159 A.D.3d 588 (2018) as an example of litigation that may ensue when a joint venture agreement fails to define available cash. Plaintiff *Related* argued in its summary judgment motion that "available cash" meant "any money that [the venture] has or is able to obtain, irrespective of whether [the venture] operates at a profit or loss." Defendant *Tesla* argued that the term referred only to "after-tax profits available to the company after the payment of all costs and expenses." Since the company had no cash, the court ruled

in favor of *Tesla* on *Related*'s motion and reversed the lower court's grant of summary judgment because the existence of available cash was a condition precedent to passing funds through the waterfall.

The sponsor may argue for an open-ended definition of available cash to include, simply, all net cash proceeds received by the venture from any source and determined by the sponsor or managing member to be available for distribution. This would allow the sponsor to exercise its judgment and reserve amounts for known or anticipated future obligations. The investors, however, may prefer that the definition of available cash set out the specific obligations, liabilities, and fees to be deducted from gross proceeds in determining available cash and will want a nondiscretionary requirement for the sponsor to distribute such available cash.

The net surplus cash then goes through the waterfall set out in the joint venture agreement which will provide for the return of equity, the payment of any agreed hurdle before the promote, and then payment of the balance in the pre-agreed proportions which gives the sponsor its promote. Available cash from revenue typically will be paid either monthly or quarterly or more frequently as the sponsor elects, and available cash from a capital event will be paid within an agreed number of days following the closing of the applicable transaction, such as five days, subject, in each case, to the distribution limitations imposed by any loan agreement.

The Hurdle Rate

As part of the waterfall provisions, the amount of proceeds to be distributed in priority to the promote and before the hurdle rate is met is often referred to as the return hurdle, the preferred return, the preference, or simply as the pref.

The return hurdle may be calculated using a variety of methods, including simple interest, compound interest, or an equity multiple, but the most commonly used method in real estate joint ventures is the internal rate of return or IRR.

IRR is a financial metric which measures the profitability and returns of potential and actual investments. The IRR is the annual discount rate that sets the net present value of all-cash flows, positive (cash coming in), and negative (cash flowing out), equal to zero. Because the IRR calculation is time dependent, it may be skewed higher for deals with shorter time horizons, so this should be considered carefully when setting the hurdle. IRRs are commonly used as hurdles in multi-tier promote waterfalls.

The joint venture agreement will define IRR and specify how the IRR is calculated. A common method of calculation calls for using the XIRR function on Microsoft Excel. Parties should be aware, however, that the XIRR function might misstate the true IRR because it assumes all-cash inflows and cash outflows occur on the last day of the time period for which the calculation is made. For purposes of IRR calculation, outflows typically include contributions to the venture but may except, for example, member loans, fees received, and the value of contributed services.

The hurdle rates in a joint venture are highly negotiated and will vary based on many factors including investor type, asset class, and risk level. Hurdle rates and tiers need to strike a balance between two goals: to attract investors while at the same time offering a sufficient reward to the sponsor to encourage its efforts to generate a successful investment. To attract investors to riskier investments, such as those where cash flow may be intermittent or investors' payoff may be delayed or uncertain, higher IRRs may be required. Lower IRRs may apply for safer ventures or where the sponsor has a strong track record with many previous investors. For example, higher IRRs may be set for new developments, value-add portfolios, and distressed portfolios. Lower IRRs are more common for core or core+-based assets. On the sponsor's side, when the hurdle is set higher for the investors due to the risk profile, the promote split after the hurdle will be more favorable to the sponsor. As a general rule, the harder the sponsor has to work to generate the targeted returns and/or the greater the complexity of the deal, the larger the promote or share of the profits will be for the sponsor for that deal.

After all available cash has passed through the hurdle provisions, the last tier of the waterfall will provide the agreed percentages for the distribution of any remaining available cash between the capital investors and the sponsor. This final tier is referred to as the residual split. In simple waterfalls, this may be the only promote a sponsor can earn. In more sophisticated multi-tiered structures, the sponsor's disproportionate percentage share of the distribution may increase with each successive tier up to this final bucket waterfall.

In addition to providing return hurdles, waterfall provisions typically will also provide for repayment of any member loans that may be permitted under the joint venture agreement, with interest, at the first tier of the waterfall. The waterfall provisions for joint ventures where the sponsor assumes the risk for cost overruns may also allow a sponsor to recoup any such cost overruns prior to the final bucket in the waterfall.

Calculating the Preferred Return and the Promote

Like the type and the rate of the preferred return or hurdle, the calculation methods also are market driven and dependent upon several qualitative and quantitative factors relating to the deal specifically and the sponsor in general.

When the hurdle is based on a hurdle rate, or minimum acceptable rate of return, the hurdle may be cumulative, meaning that any deficit resulting from a failure to meet a return hurdle over an agreed period of time will carry into the next time period thereby protecting the investor's return. Such deficits will accumulate until there is sufficient cash flow to pay the required returns, including the deficit, and will prevent the sponsor from receiving its promote before such time.

If the hurdle is cumulative (but not compounding), then the deficit is just added on top of the required return for the next period. However, if it is also compounding, the deficit is both added and multiplied by the preferred rate and payable before the promote. A compounding preferred return may be compounded daily, monthly, quarterly, annually, or in any other manner determined by the parties. If the agreement is silent, then no compounding may apply, depending on applicable law, except that an IRR hurdle is automatically cumulative and compounding because the IRR formula incorporates the concepts into the formula. Additionally, in calculating an IRR hurdle, the capital investor's capital must first be returned via distributions and then the required return on that capital investment calculated and paid to the investor.

Promote calculations may be based on hard hurdles or soft hurdles. Under a hard hurdle, once the investor achieves a threshold return, the sponsor will receive an agreed-upon disproportionate percentage of future profit distributions as its promote. Hard hurdles are common in real estate joint ventures. A soft hurdle is thought of as a contingency. If the hurdle is met, then the promote is calculated as a percentage of all distributions (not just distributions after the hurdle is met). Soft hurdles are sometimes found in real estate fund and programmatic joint venture arrangements but rarely in typical real estate joint ventures. The soft hurdle may include a "catch-up" or a "lookback." In one approach to a catch-up, the investor first achieves a threshold return before any promote may be paid to the sponsor and, thereafter, 100% of future profit distributions are paid to the sponsor until the sponsor receives, as its promote, a specified percentage of the total amount of distributions made by the venture after capital is returned to the investor and the sponsor. After that specified percentage is reached, profit distributions are made in accordance with the partners' promote splits. Sponsors may benefit from catch-up hurdles since the investor's return is paid more quickly in the waterfall and does not accrue as much interest as it would if paid later. A lookback is exactly that. The sponsor will receive an agreed disproportionate percentage of profit distributions early in the venture at the same time that the investor receives its profit distributions with the intention that the sponsor will receive its promote in advance. When the property is ultimately sold, the overall return to the investor is calculated. If the investor's overall return is less than the agreed-upon return threshold, the sponsor will be obligated to pay any deficit. Shortfall payment obligations may be paid from the venture's liquidating distributions if sufficient, from all distributions made (or to be made) to the sponsor in respect of its promote, or from all profits previously received by the sponsor. A confident sponsor may prefer this method, believing that it would never need to return any part of its promote due to the lookback. It is a gamble with some risk, however. If the sponsor bets wrong, it will have to repay the excess distributions with interest likely at the IRR hurdle rate.

The hurdle rate may be expressly based on a "levered" or "unlevered" IRR. If the IRR definition does not specify whether it is on a levered or unlevered basis, the IRR calculation will simply follow the capital outflows and inflows, taking into account any actual reductions or deductions, including capital contribution reductions due to loan advances made to the project and deductions to distributions resulting from debt service and other loan payments. Since real estate projects are so often leveraged through third-party debt financing, the hurdle rate is typically, as a consequence, based on a levered IRR. An unlevered IRR computes the return as if the financing did not occur. In computing an unlevered IRR, loan advances are added to capital outflows from the investor (as if contributed by the investor), and debt service and other loan payments (including financing-related costs) paid from capital contributions are deducted from capital outflows. Similarly, capital inflows would be deemed to include any debt service and other loan payments (including financing-related costs) paid from available cash flow thus treating those sums as if they had been distributed to investors. There may be reasons to stipulate that the hurdle rate is based on a "levered" IRR when there is, in fact, no debt financing or based on an "unlevered" IRR when there is debt financing. If a sponsor, for example, in promoting the project, projects heightened levels of value creation based on its operational and development expertise, then disaggregating the leverage component from the

IRR calculation will be a better measure of the sponsor's success in achieving its business plan. Additionally, when evaluating multiple projects, analysis of both the levered and unlevered projected IRR helps capital investors identify which project's IRR projections are dependent on aggressive debt terms and are therefore exposed to interest rate fluctuations. Conversely, if a sponsor excels at financial engineering or the capital investor requires that no debt financing be utilized, then including a leverage component may be more appropriate. The hurdle rate based on an unlevered IRR will generally be less than a levered hurdle rate. Unlevered hurdled rates are becoming more prevalent in real estate development joint ventures.

When calculating the preferred return, remember that percentage membership interests may change over the life of the venture due to additional capital contributions or other dilution. The joint venture agreement should clarify that waterfall distributions are to be adjusted to any change in the percentage membership interests.

Waterfall provisions containing a promote should specify whether the increased amount payable to the sponsor above the hurdle is in addition to the sponsor's percentage share of the applicable distribution based on the sponsor's percentage equity (e.g., sponsor to receive 20% of the distribution as its promote and then both sponsor and capital investor will each to receive its percentage share of the remaining 80%).

Investor Protections – Clawbacks and Holdbacks

Depending on the timing of distributions, a sponsor may receive more promote than it would be entitled to if the promote was calculated when the venture was dissolved. For example, excessive leverage or financing with an interest rate below the preferred return hurdle rate can lead to a faster return of equity and preferred return on that equity, thereby increasing the promote. Or, a promote may have been paid earlier in the venture's life but the project ultimately was less profitable when sold.

Excessive or premature promote distributions are particularly acute in programmatic joint ventures or portfolio joint ventures. Early promote distributions may be payable from the distribution of proceeds from the sale or refinancing of some assets before the remaining venture assets are liquidated. The sponsor may have decided to cherry-pick and sell winners early or the retained properties may simply perform poorly and not produce sufficient returns for the capital investor to achieve its threshold IRR. In such event, the sponsor will have received more in promote distributions than it would have earned based on the overall returns for the venture as a whole.

A holdback of all or a portion of the sponsor's promote payments may provide the investor with assurance that the sponsor will not receive distributions in respect of its promote that ultimately are unearned. The holdback should remain in place until dissolution and liquidation of the venture and thereafter be released and paid to the parties once the promote due to the sponsor is finally determined. Sponsors may object, however, as the amount held back in a bank account will not achieve high returns and the sponsor may not wish to wait for its reward.

In certain ventures, particularly multi-asset ventures, investors may prohibit the sponsor from engaging in capital events, such as asset sales or certain financings, prior to liquidation of the venture. This prevents the early distribution of the sponsor's promote based on a capital event before the overall returns are determined. This approach should be carefully considered, however, as it might not allow for transactions, such as sales of less than all assets, that would be more beneficial to the venture than holding each asset and selling as a portfolio.

The investor should attempt to put in place protective provisions so that the sponsor could sell or finance properties when it is optimal for the venture's overall returns, but limit the risk that the investor might not be paid its full return at the end of the venture. One such provision is a clawback. A clawback essentially looks at the overall return to the investor at a point in time (such as the occurrence of a capital event or the liquidation of the venture) and requires the sponsor to refund to the investor any distributions previously received by the sponsor in respect of its promote until the investor's overall return is equal to the investor's threshold IRR. Investors tend to hedge risks with less experienced sponsors by including a clawback. This clawback obligation is often secured by a guaranty from a parent or affiliate of the sponsor to ensure that the refund to the investor, if required, will be made.

Crossing Multiple Promotes

Programmatic joint ventures have an added layer of complexity for promote calculations. In a typical programmatic joint venture, the underlying assets will have varying success levels. Some may be home runs. Others may operate at a loss, and there will be an array of assets in between. Investors will often require that the promote be calculated on an aggregate basis rather than a deal-by-deal basis based upon the performance of the entire

portfolio of joint venture properties. This approach offers administrative advantages to the venture in that revenue and expenses applicable to all assets in the venture do not need to be allocated and accounted for separately for each project. Notwithstanding such administrative simplicity, calculating the promote and making distributions on a deal-by-deal basis is to the sponsor's advantage by maximizing the promote on successful projects while minimizing the effect on the promote of the poor performance of other projects. This will guarantee the sponsor will earn a promote on successful projects notwithstanding an overall negative performance of the venture as a whole and the sponsor's total promote for the venture will be higher than if calculated on an aggregate basis.

A hybrid approach treats the payment of the promote separately from the calculation of the promote. Payment may be made on an asset-by-asset basis but the calculation of the return and the promote will be trued up on an aggregate basis as additional assets are sold. The investor may retain a clawback for each calculation period in order to recoup any excess unearned promote previously paid. This allows the sponsor to receive its promote earlier than it would if the promote was calculated on an aggregate basis but ultimately, the sponsor will not receive as much as it would if the promote were calculated on a deal-by-deal basis.

In a large scale programmatic joint venture, the joint venture agreement may provide for projects to be segregated into separate pools rather than individual projects. Pools may be based on different features of the investment such as asset type, risk profile or venture investment periods, and each pool may have its own set of hurdles and promote splits based on the common features of the pooled investments. As examples, a separate pool of low risk, core projects may provide for a lower promote to the sponsor than an opportunistic pool, or assets acquired during different specified time periods may be allocated in separate pools. Distribution of available cash for each pool would be governed by a separate waterfall provision thereby determining the sponsor's promote on a pool-by-pool basis.

Crystallizing the Promote

Sometimes real estate joint venture partners contemplate, at the outset of the venture, that the asset or assets in the venture will be retained for a long-term hold. This is particularly true in development ventures so as to enable the venture to reap the cash flow from the property after development, but long-term holds may be desirable in other ventures as well. If a development sponsor does not receive its promote until the asset is sold or a capital event occurs (which is when the promote is typically paid), the sponsor will expend its efforts early in the venture but may not be compensated or rewarded with its promote until long after development is completed. Investors may also be concerned with maintaining an alignment of interest between the sponsor and the investors for the long term. One solution for both sponsor and investor concerns is the crystallization of the promote.

Crystallization of the promote is an incentive mechanism which rewards the sponsor for its efforts that bring value to the venture at the time that the value is generated rather than at the later occurrence of a capital event even though that value may not generate cash proceeds for distribution at the time that it is created. If the promote is crystallized, the sponsor will receive its promote early in the life of the venture. As such, the promote will not be affected by later poor performance of the venture or changing economic conditions or other fluctuations which are outside the control of the sponsor.

There are many ways a sponsor might generate value in the absence of a capital event. The joint venture agreement will set forth the milestones that the parties deem to have added value to the venture. A few examples are:

- Securing development entitlements
- Completion of development -and-
- Achieving stabilization of a property

A venture which plans for project phasing, for example, may consist of value-add assets which are intended to evolve into core assets. Once that evolution has occurred, value has been added to the venture. On the achievement of a milestone, crystallization may be automatic, or the sponsor may choose whether or not to elect to crystallize the promote.

In addition to setting out the relevant milestones, the joint venture agreement will also specify how the value of the promote is to be calculated and how it is to be paid or otherwise given to the sponsor. How do you calculate the value of the promote in the absence of refinancing or sale proceeds or other proceeds of a capital event? Typically, the promote calculation is based on the capital proceeds that would be derived from a hypothetical sale of the underlying asset at its appraised value as of the crystallization date. An all-cash sale is assumed and deductions will be taken for hypothetical seller closing costs (such as transfer taxes, title costs, and brokerage commissions), asset-level debt and fees payable to lenders and creditors, and amounts owed by the joint venture to a member. Parties may disagree on whether to deduct a number for a reserve that might

be required by the buyer for liabilities arising out of the sale. While such a reserve might be included in an actual sale, the sponsor will not want to include a deduction as the funds are often returned to the seller after a period of time. The appraised value of the asset will be determined in the manner provided in the joint venture agreement. The joint venture agreement should specify appraisal mechanics including approved appraisers, minimum appraiser qualifications, and valuation methodology to be used.

Once the amount of capital proceeds is determined, this number is run through the distribution waterfall to calculate the amount of the promote. Since there is no capital event generating proceeds to pay the promote, it may be paid to the sponsor in a number of different ways. It is not uncommon to pay the promote by reallocating the ownership interests in the venture. The promote would be treated as a capital contribution by the sponsor and would dilute the interests of the other investors. The sponsor would thereafter participate in greater cash flows as a result of its increased ownership interest. Alternatively, the capital investors may pay the promote to the sponsor in cash either out of their own funds or out of distributions that would have been made to the investors. Distributions that are so diverted to the sponsor would be treated as member loans or preferred equity in the venture.

Once the promote has been crystallized, no further promote will be paid to the sponsor in a single asset joint venture. Investors benefit from this as the sponsor has given up any further right to a disproportionate share of profits and the investors' capital is no longer at risk of being promoted. In multi-asset joint ventures, the sponsor may continue to receive a promote with respect to the other assets in the venture as to which the promote was not crystallized. After crystallization, sponsor and capital investor equity interests will be pari passu.

Forfeiting the Promote

The joint venture agreement may provide circumstances under which the sponsor may lose the promote. Forfeiture provisions are typically heavily negotiated, and the parties are very careful to delineate between those defaults which result in forfeiture and those which do not. If the sponsor defaults on major obligations (such as funding capital contributions) or engages in egregious or bad actor type acts such that the capital investor may remove the sponsor as managing partner, then, upon removal, the sponsor may be converted to a silent capital partner. Future distributions would be shared with the other partners on a pro rata basis in accordance with each parties' capital account, resulting in the forfeiture of the sponsor's promote.

A sponsor is less likely to forfeit its right to a promote for nonmaterial acts, or when removed as managing member for convenience and without cause or for a failure to meet certain identified performance standards. If the sponsor is removed and the promote is not forfeited, then typically there is a crystallization of the promote. Rather than being paid by the investors or converting it to equity, the sponsor is given an interest-free note payable upon the next capital event (or sooner, if the parties agree to an outside date).

Multilayered Promotes

As discussed above, sponsors generally contribute equity to the real estate joint venture but the sponsor's equity contribution is significantly smaller than that contributed by the capital investors. Nonetheless, sponsors often have less capital available to invest and prefer to minimize the amount of their required equity contribution. A solution for some sponsors has been to raise GP funds which essentially allows the sponsor to bring in other investors to join in the sponsor's equity contribution to the real estate venture.

GP funds are attractive to investors who are seeking a greater return than could be obtained by investing in the venture itself. Investors in the GP fund are entitled to the proceeds received from the underlying real estate investment vehicle attributable to their invested capital as if they had invested directly in the investment vehicle, but also commonly receive a portion of the sponsor's disproportionate share of profits (i.e., the sponsor's promote).

GP fund proceeds are typically distributed along the customary private equity fund distribution structure wherein capital contributions are first returned, then a preferred return is paid to investors, and any remaining profits are divided between the outside investors and the sponsor according to an agreed-upon split ratio.

Investors of the underlying real estate investment vehicle will want to ensure the sponsor remains in control and continues to have sufficient skin in the game in the joint venture after further syndicating its interest in this GP fund. While the investors may agree to the use of the GP fund, investors will require representations, restrictions on change of control, and key person provisions.

Tax Considerations

Although fees are a more certain form of compensation, the sponsor may prefer a promote because of the more favorable tax treatment of promotes. Fees are ordinary

income to the sponsor, but some or all of the income earned from a promote may qualify as capital gains.

Promote payments are taxed based on the character of the underlying venture's income. As such, if the promote distribution came from the sale of a property by the venture at a gain, then the promote payment would generally be taxed as capital gain. Until recently, the default rule was that so long as the venture held the property for rental or investment for more than one year before selling it, then the sponsor's promote would be taxed as long-term capital gain.

However, the Tax Cuts and Jobs Act of 2017 established a three-year holding period threshold for individuals to benefit from the favorable long-term capital gain rates on profits received in connection with substantial services provided to an "applicable trade or business." See 26 U.S.C. § 1061.

To the extent that a promote no longer qualifies as long-term capital gain under 26 U.S.C.S. § 1061, it would be treated as short-term capital gain which is taxable at ordinary income rates.

It is good practice to consult a tax lawyer and/or accountant when considering and drafting promote mechanisms.

Example: Waterfall Distribution Clause

One way to experiment with different waterfall structures is to use a free online waterfall modeling tool to see how various proceed distributions would be calculated. It is important to dig into the details for each transaction to determine if the split is fair and equitable for all parties involved and accurately reflects the business agreement. Although distribution waterfalls can vary widely, the following is an example of a waterfall distribution provision in a real estate joint venture agreement. This example provides for distributions to be considered on a quarterly basis and includes multi-tiered IRR hurdles. It also has different distribution structures for distribution of distributable cash from operating income and from capital proceeds.

Relevant Defined Terms

"[__]% IRR Threshold" means the amount of distributions from the Company which must have been received by the applicable Member in order that such Member will have received the return of all of its Capital Contributions and will have achieved an Internal Rate of Return of [percentage]% per annum on such Capital Contributions based on the date that such Capital Contributions were made and the date of such Member's receipt of such distributions.

"Capital Contribution Balance" means, for each Member, the cumulative Capital Contributions of that Member less the cumulative distributions to that Member in return thereof.

"Capital Proceeds" means funds of the Company arising from the sale, financing, refinancing or similar transaction of or involving any Project (including condemnation awards, payment of title insurance proceeds, or casualty loss insurance proceeds (other than business interruption or rental loss insurance proceeds)), net of any payments to, or the actual costs incurred by the Company with, third parties in consummating such transaction.

"Distributable Cash" means, for any period, Net Operating Income, reserves and all other cash distributable by the Company (including Capital Contributions that are in excess of cash needs and can be distributed) less (i) debt service on loans (other than Default Loans) to the Company or its applicable Subsidiaries, (ii) obligations of the Company and its Subsidiaries for capital expenditures not paid from the Member's Capital Contributions or the Company's capital contributions to the Subsidiaries and (iii) reasonable capital reserves for future obligations of the Company and its Subsidiaries set forth in the Operating Budget.

"Internal Rate of Return" or "IRR" means the discount rate, at which the net present value of a Member's Capital Contributions to and distributions from the Company equals zero, calculated for each such Capital Contribution from the date such Capital Contribution and distribution was (or is deemed) made. With respect to the Initial Capital Contributions, they shall be deemed to be made as of the Closing Date, and all distributions shall be deemed to be made on the date the distribution is withdrawn from the Company's bank accounts. Internal Rate of Return shall be calculated on the basis of the actual number of days elapsed over a 365 or 366-day year, as the case may be. A Member shall have received the specified Internal Rate of Return when such Member receives (or is deemed to have received) distributions from the Company in an amount that makes the following equation equal zero:

$$D = \sum_{i=1}^{N} P_i \times \left(1 + \frac{r}{y}\right)^{\frac{d_1 - d_i}{365} \times y}$$

where

r = the applicable rate.

di = the *ith*, or first, cash-flow date.

d1 = the current distribution date.

Pi = the *ith*, or first, cash flow.

y = the number of compounding periods per year, which shall be equal to [1].

D = the remaining distribution required to satisfy the applicable rate.

In applying the above methodology, Capital Contributions shall be treated as positive cash flows, and distributions made to a Member shall be treated as negative cash flows. *d1 - di* shall be computed using Microsoft Excel's DAYS function. For purposes of this definition, and for purposes of determining the [percetnage]% IRR Threshold, (a) member loans shall not be considered Capital Contributions and (b) interest, fees, reimbursements and other distributions received thereon or therefor by any Member shall not be considered distributions.

"Net Operating Income" means, for any period, the amount by which Operating Revenues exceed Operating Expenses for such period.

"Operating Expenses" means, for any period, the current obligations of the Company and its Subsidiaries for such period, determined in accordance with generally accepted accounting principles applied on a consistent basis applicable to commercial real estate for operating expenses of the Projects. Operating Expenses shall not include debt service on loans to the Company or its applicable Subsidiaries, obligations of the Company and its Subsidiaries for capital expenditures, capital reserves for future obligations of the Company or its Subsidiaries or any non-cash expenses such as depreciation or amortization.

"Operating Revenues" means, for any period, the gross revenues of the Company and its Subsidiaries arising from the ownership and operation of the Projects during such period, including forfeited tenant security deposits (to the extent treated as income for accounting purposes), proceeds of any business interruption or rental loss insurance maintained by the Company or any Subsidiary from time to time and amounts funded from Company or Subsidiary reserves, but specifically excluding Capital Proceeds and Capital Contributions.

"Percentage Interest" means (i) with respect to Investor Member, ninety percent ([90]%), and (ii) with respect to Sponsor Member, ten percent ([10]%). The Percentage Interest of a Member shall be adjusted by the Sponsor Member as appropriate to reflect the transfer by, or the transfer to, such Member of a Membership Interest (or portion thereof) made in accordance with this Agreement or as otherwise provided in this Agreement.

Example

ARTICLE I. DISTRIBUTIONS:

1. Distributions in General. From time to time, but not less often than quarterly, the Sponsor Member, acting reasonably, shall determine the amount, if any, by which the Company funds then on hand exceed the reasonable working capital needs of the Company. Any excess funds shall be distributed to the Members in accordance with the provisions of this Article I.

2. Distribution of Distributable Cash. Distributable Cash of the Company shall be distributed to the Members in the following order of priority:

   (a) *first*, to the Members who have advanced member loans, *pari passu* and in proportion to the respective outstanding principal amount of such member loans as of such date, until all accrued and unpaid interest on such member loans shall have been paid in full;

   (b) *next*, to the Members who have made member loans, *pari passu* and in proportion to the respective outstanding principal amount of such member loans as of such date, until all member loans shall have been repaid in full;

   (c) *next*, to the Members in proportion to their Percentage Interest on a *pari passu* basis until each Member's Capital Contribution Balance has been reduced to zero (0); and

   (d) *finally*, all remaining Distributable Cash shall be distributed to each of the Members pro rata in accordance with their respective Percentage Interest on a *pari passu* basis.

3. Distribution of Capital Proceeds. Capital Proceeds of the Company shall be distributed to the Members in the following order of priority:

   (a) *first*, to the Members who have advanced member loans, *pari passu* and in proportion to the respective outstanding principal amount of such member loans as of such date, until all accrued and unpaid interest on such member loans shall have been paid;

   (b) *next*, to the Members who have advanced member loans, *pari passu* and in proportion to the respective

outstanding principal amount of such member loans as of such date, until all member loans shall have been paid in full;

(c) *next*, to the Members in proportion to their respective Percentage Interest on a *pari passu* basis until the Investor Member has achieved the [9]% IRR Threshold;

(d) *next*, after the Investor Member has achieved the [9]% IRR Threshold and until the Investor Member has achieved the [12]% IRR Threshold, [85]% of such Capital Proceeds shall be distributed to each of the Members in proportion to their respective Percentage Interests on a *pari passu* basis; the remaining [15]% shall be distributed to the Sponsor Member as a promoted interest (in addition to its *pari passu* return);

(e) *next*, after the Investor Member has achieved the [12]% IRR Threshold and until the Investor Member has achieved the [15]% IRR Threshold, [80]% of such Capital Proceeds shall be distributed to each of the Members in proportion to their respective Percentage Interests on a pari passu basis; the remaining [20]% shall be distributed to the Sponsor Member as a promoted interest (in addition to its *pari passu* return);

(f) *next*, after the Investor Member has achieved the [15]% IRR Threshold and until the Investor Member has achieved the [18]% IRR Threshold, [75]% of such Capital Proceeds shall be distributed to each of the Members in proportion to their respective Sharing Ratios on a *pari passu* basis; the remaining [25]% shall be distributed to the Sponsor Member as a promoted interest (in addition to its *pari passu* return); and

(g) *finally*, after the Investor Member has achieved the [18]% IRR Threshold, [70]% of all remaining Capital Proceeds shall be distributed to each of the Members in proportion to their respective Sharing Ratios on a *pari passu* basis; the remaining [30]% shall be distributed to the Sponsor Member as a promoted interest (in addition to its *pari passu* return).

Kris Ferranti, Partner, Shearman & Sterling LLP

Kris Ferranti is the Real Estate Team Leader and a partner in the Real Estate practice. He has extensive experience representing clients in complex commercial real estate transactions, including in the areas of acquisitions, dispositions, joint ventures, development projects, foreign investment, financings and ground and space leasing.

Kris regularly represents financial institutions, sovereign wealth funds, investment funds, family offices, and individual and institutional investors and developers. He is recognized by *Super Lawyers*, *Law360*, and *Crain's New York Business* as a "Rising Star" in Real Estate.

Kris has authored several publications and has been involved in a number of speaking engagements at seminars and conferences and on podcasts and webcasts on various real estate subjects.

This document from Practical Guidance®, a comprehensive resource providing insight from leading practitioners, is reproduced with the permission of LexisNexis®. Practical Guidance includes coverage of the topics critical to practicing attorneys. For more information or to sign up for a free trial, visit lexisnexis.com/practical-guidance. Reproduction of this material, in any form, is specifically prohibited without written consent from LexisNexis.

LexisNexis.com/Practical-Guidance

LexisNexis®

LexisNexis, Practical Guidance and the Knowledge Burst logo are registered trademarks of RELX Inc.
Other products or services may be trademarks or registered trademarks of their respective companies. © 2023 LexisNexis