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Crystallization of Carried Interest in Joint Ventures

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A carried interest, also known as a promote, is a form of incentive compensation typically used in real estate joint ventures (as well as in other real estate and non-real estate investment vehicles) in order to reward a sponsor for generating profits. The promote is usually structured as an additional share of the profits from the venture after all investors have received distributions fully returning their invested capital, together with some stipulated return on that capital (at an agreed 'hurdle rate'). (It should be noted there are many variations on the theme, including promotes on operating cash flow prior to return of capital and 'catch-up' distributions, that are generally beyond the scope of this article).

Traditionally, a promote is not earned or paid until there is a capital event, such as a sale or refinancing, that generates enough proceeds to provide for the return of capital and the required hurdle return. However, in certain situations, in particular when the business plan of the venture contemplates a long-term hold, the parties may agree that the promote will be earned and paid where the sponsor has created value in advance of the occurrence of a capital event (sometimes referred to as a "crystallized carry" or "crystallized promote"). This article discusses the use of such a crystallized carry structure.

How Promotes are Typically Calculated

The traditional commercial real estate joint venture typically includes one or more investors that fund the majority of the required equity contribution (collectively, the "capital partner") and a managing member or sponsor entity that identifies the investment opportunity, devises a strategy for the investment, manages the day-to-day development and/or operation of the property and handles the financing, refinancing and ultimate disposition of the property. The promote is intended to compensate the sponsor for creating value in the investment.

Since an investment's ultimate value is a function of the amount of and timing of the investor's cash returns, both in the form of rent or other operating income and in the form of sale, refinancing or other capital proceeds, the promote is typically built into the distribution waterfall in the venture's joint venture agreement. Although distribution waterfalls can vary widely, a relatively simple example follows (assuming that both the capital partner and the sponsor have contributed capital to the venture):

This model is especially appropriate where sponsors are partnered with capital partners with a long-term hold strategy and where sponsors do not have the ability in the joint venture documentation to trigger a capital event.

- *first*, 100% to both the capital partner and the sponsor, in proportion to the amount each has invested in the venture, until each such member receives proceeds sufficient to provide each member with an 8% internal rate of return (including a return of capital); and
- *thereafter*, (x) 80% to both the capital partner and the sponsor, in

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proportion to the amount each has invested in the venture, and (y) 20% to the sponsor (which 20% is the promote).

Crystallized Carry

In recent years, it has become more common (although it is still the occasional exception) for ventures to pay promotes in the absence of a capital event. Instead of calculating and paying the sponsor's promote on the basis of actual cash generated, the promote is calculated (and sometimes paid) upon the occurrence of a specified event that corresponds with the creation of value but which does not necessarily generate cash for distribution—for example, completion of development or the lease-up and stabilization of a development project. This crystallization of the promote compensates the sponsor for increases in value resulting from the sponsor's efforts at the time those efforts are expended, even though the ultimate performance of the investment might not have yielded any (or the same amount of) promote due to a drop in value, poor cash flow or additional capital contributions required after crystallization.

This model is especially appropriate where sponsors are partnered with capital partners with a long-term hold strategy and where sponsors do not have the ability in the joint venture documentation to trigger a capital event. Sponsor entities often share the promote with key employees as incentive compensation, and some of the employees who are the ultimate recipients of some or all of the promote may not be expected to remain with the sponsor for the entire life of the investment or may be disinclined to wait until the ultimate disposition of the investment to be compensated for their efforts. The crystallized promote structure allows the sponsor to compensate the employees within a period shorter than the actual holding period of the investment.

The crystallized promote bears some resemblance to the incentive allocation paid to the general partner in open-ended hedge funds and mutual funds, which do not require the disposition of assets within a fixed time and in which the promote is computed and paid on the basis of periodic determinations of the net asset value of the fund's investments rather than the proceeds of asset dispositions. In recent years this model has been imported into open-ended real estate funds, which provide for a similar promote structure.

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Mechanisms for Crystallization

There are various mechanisms for crystallization of promotes. In the case of ground-up development, the sponsor may have a right during a specified period following a milestone event within which to elect to crystallize its promote. For example, the sponsor may have one year from completion of the project or stabilized occupancy to elect to crystallize. Alternatively, the crystallization may be automatic upon the occurrence of the milestone event. In the sponsor's view, by crystallizing the promote when the sponsor has finished the development or completed leasing activity, the sponsor's compensation may more accurately reflect the value the sponsor actually brought to the project, without subsequent fluctuations in value that are, at least in part, beyond the sponsor's control due to market fluctuations and other external factors.

In joint ventures where partnership interests are transferable, the promote may be crystallized, and the amount of the promote determined, based on the price received in connection with such transfers. One possible hybrid approach is to pay a portion of the promote upon completion of construction or stabilization, with the remaining portion payable at some future point if the value of the property increases above the value on which the crystallized promote was based.

Where the promote is paid following a refinancing or sale of the underlying property, the refinancing or sale proceeds determine the amount of distributed cash and therefore the calculation of the promote is relatively simple. However, where the promote is crystallized, there is no extrinsic event to determine the value of the property for purposes of calculating the promote, and the parties will therefore need to agree on an alternative method. This may be based on the amount that would be distributed to the sponsor as promote under the agreed upon distribution waterfall if the underlying asset were sold to a third party as of the specified crystallization date for an all cash price equal to the appraised value of such asset, but after deducting from the proceeds of the sale (and after taking into account any cash on hand) (i) some set percentage (e.g., 1%) of such appraised value for hypothetical closing costs customarily paid by a seller; (ii) any amounts that would be payable to the joint venture's lenders and other creditors, and (iii) the amount of all obligations of the joint venture to a member. The joint venture agreement will typically specify an appraisal process for the parties to follow in connection with the crystallization.

For example, the parties may pre-agree on a list of approved appraisers, required appraiser qualifications and specified valuation methodologies. One issue that may arise in negotiating the calculation of the promote is whether to deduct from the hypothetical sale proceeds an amount representing the reserve that an actual seller may set aside for liabilities arising out of the sale; the investors may argue that deducting such a reserve causes the hypothetical sale to more closely resemble an actual sale, while the sponsor would argue that in most sale transactions there is no actual post-closing liability and that reserves established for funding such liabilities are typically released to the seller.

When a promote is crystallized outside of a capital event, there are several ways in which the crystallized promote may be paid to the sponsor. Options may include: (i) each of the capital partners paying the sponsor such partner's pro rata share of the amount of the crystallized promote out of its own funds, or (ii) having the crystallized promote treated as a capital contribution by the sponsor to the joint venture (which would dilute the equity interest of the capital partners on a *pro rata* basis) or paying the amount of the promote, possibly with interest, out of distributions that would otherwise be made to the capital partners (which effectively treats the promote as a member loan to, or preferred equity in, the joint venture).

Drafting the Agreement

Joint venture agreements should specify how distributions are made after the promote is crystallized. At that point there is no further promote to be paid to the sponsor (and with respect to multi-asset joint ventures, once promote is crystallized with respect to one asset, no further promote is paid with respect to that asset). In effect the sponsor is now *pari passu* with the capital partner to the extent the sponsor has contributed capital to the venture, and the sponsor has given up future upside, other than on account of its capital interest, in exchange for crystallizing the promote early.

In multi-asset real estate joint ventures parties typically agree that the sponsor's promote will be calculated based on the joint venture's overall performance as opposed to on a property-by-property basis, with the former method preferred by the capital partner in that any loss on one asset will offset gains on other assets and reduce the overall promote. However, the parties will sometimes agree to pay an interim promote in connection with a property-specific capital event (i.e., the sponsor's promote will be calculated and paid following the disposition of a single asset).

Because underperforming assets can often be held the longest the sponsor may receive a disproportionately large promote following early property-specific capital events in light of the joint venture's overall performance calculated on the entire portfolio when the joint venture winds up. As a result, it is common for joint venture agreements to include a "claw-back" provision which requires the sponsor to return previously distributed amounts of promote that were, in retrospect, "incorrectly" distributed following early capital events.

Sponsors should keep in mind that where the promote is crystallized, a traditional clawback will not be appropriate if the partners' intent is that the promote be based on increases in value at an interim point in the investment's life without regard to its ultimate performance. In that case, any clawback would not be based on the final aggregate distributions actually made by the joint venture to all partners, but would instead be based on the aggregate amount of distributions that were (or should have been) made following each crystallization event.