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Promote Crystallization in Real Estate Joint Ventures

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A Practice Note discussing promote crystallization in real estate joint ventures. This Note addresses the benefits and mechanics of promote crystallization provisions in real estate joint venture agreements, including drafting and negotiating considerations.

A promote, also known as carried interest, is a form of incentive or profit sharing mechanism that is often used in real estate joint ventures (JVs) (as well as in real estate and other types of investment funds) to incentivize and compensate the operating partner for creating value in the form of profit generation. The operating partner can create value by:

- Sourcing the investment opportunity.
- Leveraging its experience and relationships, including finding lenders and general contractors for the project.
- Providing guaranties related to a financing.
- Making strategic design and development decisions.
- Providing development management, leasing management, and property management services.

Although a promote is commonly used in real estate JVs to incentivize an operating partner, the operating partner often does not control when the promote is paid. Cash distributions are typically only made when the JV's property generates net operating income or net capital proceeds. Cash distributions from net operating income are also generally not sufficient to meet the hurdle return required for the operating partner to receive a promote.

A promote is therefore often not paid until a capital event occurs that generates net proceeds, usually from a sale or refinancing of the property. Therefore, an operating partner is typically not able to capitalize on its promote unless and until the property is sold or refinanced and the net proceeds are sufficient to achieve the hurdle return.

To address this timing issue, promote crystallization or freezing the promote is increasingly being used in real estate JVs. Promote crystallization (also sometimes known as carry crystallization) allows the operating partner to receive or realize its promote without a capital event.

This Practice Note discusses:

- The benefits of using promote crystallization.
- The mechanics of promote crystallization, including:
  - trigger events for crystallization;
  - how to calculate the promote; and
  - how the promote is paid.
- Negotiating and drafting considerations for promote crystallization provisions.

This Note assumes:

- A typical real estate JV structure with one operating partner and one capital partner.
- The JV invests in a single property.

If a JV plans to hold multiple assets, the parties must further consider the promote crystallization mechanism in that context. For example, the parties may need to decide whether to crystallize the promote on an asset-by-asset basis and whether a clawback mechanism is needed.

Typical Promote Structure

A promote allows the operating partner to receive a return on its investment that exceeds the pro rata or proportionate share of its equity investment in the JV and underlying real estate project. The operating partner receives a greater share of the distributions from the JV than the share of capital contributions that the operating partner made or must make to the JV, if any. While a promote can be structured in different ways, a common (and relatively simple) way to structure a promote is for the operating partner to receive a larger share of cash flow or net proceeds in the JV's distribution waterfall after the capital partner has received distributions equal to its

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invested capital plus a specified preferred or priority return (often referred to as the hurdle return or hurdle rate).

For example, an operating partner with a 10% capital investment and equity interest in the JV may be entitled to receive 20% of distributions after the capital partner receives the applicable hurdle rate (for example, an 8% return on invested capital). There may be different tiers of promote paid based on increasing hurdle returns (see Standard Clause, Waterfall Distribution Clause in a 90/10 Real Estate Joint Venture (Tiered Promote)).

For additional guidance on promotes in real estate JVs, see Practice Notes, Capital Contribution and Distribution Provisions in Real Estate Joint Ventures: Promote or Carried Interest and Promote Mechanics in Real Estate Joint Ventures.

Reasons to Include Promote Crystallization

Including a promote crystallization mechanism in a JV agreement aligns the operating partner's realization of its promote with the creation of value, versus the receipt of proceeds from a capital event.

While an operating partner may not mind holding a property for a long period of time and may even prefer it, sometimes an operating partner may want to sell the property after the occurrence of a milestone (or value creation) event so that it can monetize its promote and exit or cash out of the project and move on to other projects (especially if the project was successful).

The capital partner, on the other hand, may want to hold the project for a longer period than the operating partner for certain reasons. The capital partner may view the project as a long-term income-producing property for its portfolio or may not want to or cannot sell a project for tax-related reasons. For example, if a capital partner holds its interest in the JV through a real estate investment trust (REIT), the capital partner cannot liquidate for a certain period without risking adverse tax consequences.

With promote crystallization, instead of calculating and paying the operating partner's promote based on the cash generated from a capital event, the promote is instead calculated and paid on the occurrence of a specified milestone event corresponding with the creation of value. Sample milestone events for a development project can include:

- Completion of construction.
- Lease-up and stabilization of the property.

While there are alternatives to promote crystallization to address the timing issue (such as having a different distribution waterfall for net operating income that does not require a return of capital before paying the operating partner its promote), these alternatives are not the focus of this Note. For sample of separate distribution waterfalls for net operating income and capital proceeds, see Standard Clauses, Real Estate Preferred Equity Waterfall Distribution Clause (Separate Operating Cash and Capital Proceeds Waterfalls).

Benefits of Promote Crystallization

Including a promote crystallization mechanism in the JV agreement:

- Decreases the likelihood of a disagreement between the capital partner and the operating partner concerning when a project should be sold.
- Allows the operating partner to benefit from the value created by the milestone event without actually having to sell the property.
- Safeguards the operating partner's promote from market fluctuations and other external factors that may affect the property's value over time. Because market fluctuations and other external factors can affect the value of a property in a positive or negative manner (often unpredictably) after the milestone event, freezing the promote and basing it on the valuation of the project at or around the time of the milestone event may be viewed as more equitable and desirable by not only operating partners but also by capital partners. The value of the project and, correspondingly, the promote are then tied more closely to the actual value that was created by the operating partner.
- Protects the operating partner's promote from an accumulation of the capital partner's preferred return so less capital must be returned to the capital partner for it to achieve the required hurdle rate (especially if there is frequent compounding). A hurdle rate in a JV waterfall is typically tied to the amount of time that capital has been outstanding.

Although a promote crystallization mechanism may seem unnecessary if the operating partner has the right to exit the JV or to otherwise trigger a capital event, promote crystallization may be preferable to exit options (or a supplement to exit options). Common JV exit provisions, such as buy-sell rights, rights of first offer (ROFO), or rights of first refusal (ROFR), typically have structural drawbacks and conditions limiting their exercise that can frustrate the operating partner's goal of receiving the full amount of its promote based on the value it created.

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For additional information on exit rights in real estate JVs, see Practice Note, Exiting Commercial Real Estate Joint Ventures.

Promote Crystallization Mechanics

When drafting a promote crystallization provision, the parties must consider:

- When the operating partner can trigger promote crystallization (see Determining the Crystallization Trigger).
- Whether the crystallization happens automatically or at the operating partner's option (see Automatic Versus Election).
- How to calculate the promote (see Calculating the Promote).
- How the promote is paid (see Paying the Crystallized Promote).

Determining the Crystallization Trigger

Key to negotiating the promote crystallization mechanism is determining the promote crystallization event. The parties should base the crystallization event on what makes the most sense for the property. For a development project, promote crystallization is often tied to a milestone event, such as:

- Completion of construction.
- Stabilization of the project (for example, after the project is 90% leased).

By tying the crystallization event to the milestone event, the operating partner receives compensation in line with the project value it created. If there is no promote crystallization mechanism and the project is not sold or refinanced until years down the road, interim market fluctuations or other external factors are likely to affect the capital proceeds received from a sale or refinancing.

Automatic Versus Election

The JV partners also must decide whether crystallization occurs:

- Automatically when the applicable crystallization event occurs.
- At the operating partner's option.

In the latter case, the operating partner typically has a period to elect the crystallization, such as 90 days after the event occurs. While the operating partner may prefer a longer period to elect whether to trigger crystallization, the parties should specify in the JV agreement that the property value is determined as of a certain date, such as the date of the crystallization event or a certain number of days after the crystallization event.

If the valuation is determined as of the election date or if the operating partner has a lengthy election period, the operating partner may time its election to its advantage by waiting for favorable market changes. When selecting the valuation date, the parties should keep in mind that the longer the period between the milestone event and the valuation date, the more likely the property value is to be impacted by market fluctuations and other external factors.

Calculating the Promote

The parties must agree on a mechanism for calculating the promote, but because the property is not actually sold and no cash proceeds are generated to run through the JV's distribution waterfall, the parties must agree on an alternative way of determining the property value. This value functions as a hypothetical sales price.

The most common way to determine the operating partner's crystallized promote is to:

- Assume a hypothetical sale by agreeing on a valuation method and assuming certain hypothetical closing costs (see Determining Hypothetical Property Value and Sale Proceeds).
- Use the hypothetical net sales proceeds to determine how much each partner would receive under the distribution waterfall, inclusive of the operating partner's promote.

Determining Hypothetical Property Value and Sale Proceeds

There are various valuation methods that can be used to determine the property value and hypothetical sales price. The partners often agree to an appraisal method to determine the fair market value of the property. The appraisal method can itself be structured in many ways, such as:

- The parties agree on one appraiser to determine the fair market value of the property.
- Baseball style arbitration where each party selects an appraiser to determine the value of the property, with the two appraisers selecting a third appraiser to choose one of the parties' appraised values. The appraised value selected by the third appraiser serves as the hypothetical sales price for the property.

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- The parties select three appraisers, where each determines its own appraised value. The two that are the closest in value are averaged to determine the fair market value of the property.

The fair market value of the property as determined using the agreed-on valuation method becomes the hypothetical sales price for the property. However, if the property were actually sold, there would be expenses involved in the sale that would be deducted from the gross sales price to arrive at the net sales proceeds to be distributed under the JV waterfall.

The categories and amounts of costs and expenses to be deducted are subject to negotiation. The operating partner wants to deduct as little as possible and the capital partner wants to deduct more so that there is less promote paid at the lower tiers of the distribution waterfall. Examples of costs and expenses that the parties may negotiate include:

- Transfer taxes.
- Brokerage commissions.
- Legal fees.
- Other closing costs.

Instead of negotiating categories or amounts to be deducted from the hypothetical sales price, the parties may choose to deduct a certain percentage of the hypothetical sales price (for example, 5% to 10%) to arrive at the net sale proceeds. The appropriate percentage for these hypothetical transaction costs depends on the jurisdiction in which the property is located.

The hypothetical sale also typically assumes that all of the JV's (and its subsidiaries') lenders and creditors are repaid, as well as all member loans (to the extent these loans are not directly addressed in the distribution waterfall).

The parties must also determine whether they want to make a deduction for customary reserves that may have been held back from distributions to pay potential post-closing liabilities and other expenses of the JV had the property actually been sold.

Determining Crystallized Promote Amount

The amount that would be owed to each JV partner is determined by running the hypothetical net sales proceeds through the JV agreement's distribution waterfall. The crystallized promote amount equals the amount owed to the operating partner resulting from the promote tiers of the waterfall.

Paying the Crystallized Promote

The parties must decide how the crystallized promote is paid or otherwise realized by the operating partner. The common methods are:

- Adjusting the partners' percentage interests (see Adjusting Percentage Interests).
- Making a cash payment (see Cash Payment).
- A combination of cash and percentage interest adjustments (see Hybrid Approach).

Adjusting Percentage Interests

One way to crystallize the promote is to adjust the distribution percentages of the partners based on the ultimate amounts that each would have received in the distribution waterfall. An advantage to adjusting percentage interests is that the capital partner does not need to come up with cash to pay the crystallized promote.

For example, assume the operating partner has a 10% interest in the JV and the capital partner has a 90% interest. If the hypothetical net sales proceeds totaled $100 million and the capital partner would have received $75 million and the operating partner would have received $25 million in the distribution waterfall, the distribution percentage interests are adjusted to equal 75% and 25%, respectively, for the capital partner and the operating partner. Future distributions (after taking into account any outstanding member loans or other priority loans) are made 75% to the capital partner and 25% to the operating partner.

After adjusting the distribution percentages, the promote tiers of the distribution waterfall no longer apply and distributions are made on a *pari passu* basis to the partners, based on the adjusted percentage interests. The operating partner:

- Receives a higher percentage of distributable cash in the future.
- Gives up any further disproportionate distribution of upside that may have been realized based on an increase in the property value after the promote crystallization (including on account of external market fluctuations).

If a JV agreement does not distinguish between contribution percentage interests and distribution percentage interests, adjusting the partners' percentage interests as a part of the promote crystallization affects both the contribution obligations and distribution rights of the partners. Ideally, a project that has been completed

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and stabilized does not need future capital infusions (because the project generates sufficient cash flow to pay operating expenses and other project expenses). However, if future capital contributions are needed (for example, to pay for extensive capital improvements that are not otherwise paid for out of reserves or loan proceeds) and capital calls are permitted under the JV, the operating partner must contribute more going forward.

If the operating partner does not contribute its increased share based on its adjusted percentage interest, it risks the capital partner exercising remedies under the JV agreement. Common remedies include diluting the operating partner's percentage interest and making a loan to the JV or to the operating partner. If the dilution or loan is at a punitive rate (common if the capital call is mandatory and not discretionary), the operating partner's adjusted percentage interest is reduced and it receives a lower share of distributions going forward despite the promote crystallization. For guidance on capital contribution default remedies, see Practice Note, Capital Contribution and Distribution Provisions in Real Estate Joint Ventures: Defaulting Member Penalties and Standard Clauses, Additional Capital Contribution Provision in a 90/10 Real Estate Joint Venture (Base Provision).

The parties should consider whether it is preferable to only adjust distribution percentage interests independent of contribution percentage interests. By distinguishing between the two and keeping the contribution percentage interests the same as they were before the promote crystallization and the corresponding adjustment of distribution percentage interests, the operating partner can contribute a lower amount of equity towards future capital needs of the JV.

Only adjusting distribution percentages raises other issues that should be addressed, such as ensuring that the capital partner is compensated in the distribution waterfall for contributing a greater share of capital going forward. One way to do this is to have the adjusted waterfall include a separate tier for return of capital and possibly a specified preferred return before the rest of the distributable cash is allocated on a *pari passu* basis between the partners based on the updated distribution percentage interests.

Cash Payment

In lieu of adjusting percentage interests, the JV agreement can provide for a cash payout of the crystallized promote to the operating partner. In this case, the capital partner must make an equity contribution or otherwise obtain cash from other sources.

If the capital partner does not want to or cannot come up with the cash to pay the operating partner its crystallized promote, the JV agreement may provide for a payment of the crystallized promote over a certain period, often from cash that is otherwise distributable to the capital partner. If the crystallized promote is paid over time, it can be treated as a member loan from the operating partner to the capital partner or a company loan from the operating partner to the JV that, in either case, accrues interest and is paid out on a priority basis in the distribution waterfall.

Hybrid Approach

The above approaches to realizing or paying out the crystallized promote are not mutually exclusive. For example, the parties can pay out a portion of the promote when it is crystallized, with the remainder being reflected in an updated distribution waterfall with adjusted percentage interests. In this case, the percentage interests are only adjusted to reflect what the operating partner did not receive up front from the promote crystallization. How much the operating partner receives at the time of the promote crystallization and how much it receives in the future due to adjusted percentage interests is a matter of negotiation between the parties. The operating partner may have discretion to elect how much of the crystallized promote it receives at the time of the crystallization versus by adjusting percentage interests.

Tax Considerations

While beyond the scope of this Note, potential JV partners should involve tax counsel early on to evaluate any tax implications of the promote crystallization mechanisms they are considering. For example, tax counsel can opine on whether paying a crystallized promote or resetting percentage interests on a promote crystallization event results in additional taxable gain or taxable income to the operating partner.

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