Preface

In 2008, I decided to raise some questions that had been puzzling me since I started practicing law. Was there a standard way to do the various calculations contemplated by the distribution provisions we regularly encounter in real estate joint venture documents? And if not, did it really matter? I prepared questionnaires with simple problems requesting numerical answers. I sent them to numerous real estate professionals with the understanding that the questionnaires would remain confidential but the conclusions reached would be shared. I expected that there might be a split of opinion between operators and developers, on the one hand, and institutional investors, on the other hand. I was wrong. It was hard to find much of a consensus. Some points of departure:

- A few participants used IRR calculations even when the promote hurdle didn't mention any IRR (i.e., when the promote hurdle referred instead to a preferred return and return of capital).
- Some participants increased the promote hurdle balance by the full amount of each new contribution regardless of the amount of prior distributions; some did not.
- Some participants used (in effect) continuous compounding (without expressly stating it); others used discrete compounding with simple returns between compounding.
- Those participants who used discrete compounding (with simple returns between compounding) had different ways of compounding. Some had the compounding period for each cash flow start when the cash flow occurred (so that there were different compounding periods for different cash flows, although they all had the same duration). Others had the compounding periods occurring at the same time for all cash flows, but the commencement of that fixed compounding period varied: it might start when the venture was formed, but it might start at other times (e.g., annual compounding might be based on calendar year periods regardless of when the venture was formed).
- Some participants used timing conventions. There were many conventions, including familiar lending conventions (e.g., 30-day months and 360-day years). Most notably: some participants assumed all cash flows occurred at

the beginning of a period (e.g., a month, quarter, or year, and usually the stated compounding period); some assumed all cash flows occurred at the end of a period; and some applied a different convention to a cash flow depending on whether it was an outflow or an inflow.

Although many differences seemed minor, I was surprised by the amount of variation and wondered whether there might be circumstances when these varied approaches could lead to materially different results. This inquiry led to the series of articles that appear (with slight modification) as Chapters 1 through 12 of this book. The Introduction (Chapter 0) discusses, in question-and-answer format, the most interesting and prevalent variations I encountered—namely, differences in the usage of IRRs, on the one hand, and preferred returns, on the other hand (which are discussed in more detail in Chapter 2). Many of these questions and answers were presented by me and David Weiss to the American College of Real Estate Lawyers (ACREL) on April 22, 2014 and in an ACREL/Bloomberg presentation on November 2, 2015. The Introduction also raises several commonly encountered questions concerning JV distribution waterfalls and then points to the relevant chapter where that question is discussed in more detail.

When I wrote these articles, I wrote each to stand on its own (with occasional references to prior articles), so there is frequent and sometimes significant overlap. Ideally, I would have gone back and redone everything in a more organized and streamlined format for this publication. Unfortunately, I did not have the time. I apologize for the repetition and, of course, any errors.

How to Use This Book

This book is a compendium of articles that trace the author's journey through the subject matter. Only portions of that journey may be relevant to any particular reader. Here are some suggestions to make this book more useful:

Part A

- The Introduction, which is Chapter 0, is a good starting place, providing some basic background and some of the highlights (especially the differences between preferred returns and IRRs) that are discussed in more detail in subsequent chapters. Unlike other chapters, this chapter is presented in a question-and-answer format that is intended to be a user-friendly introduction.

Part B

- Chapter 1 is intended to provide a brief summary of basic issues and concepts relating to promote hurdles, many (but not all) of which are addressed in more detail in other chapters. If the reader is merely looking for an overview, I recommend Chapter 1. If the reader has little experience and limited time but wants more than an overview, I recommend the Introduction and Chapters 1 and 5 (especially the fundamentals discussed in Appendix 5A).
- Chapter 2, like much of the Introduction (and Section 1.6 of Chapter 1), discusses the differences between preferred returns and IRRs, but goes into

more detail. Although Chapter 2 has some appendices that may be of interest (e.g., Appendix 2A, which discusses the order in which distributions may be applied to recoup capital or to pay return), it can be skipped without missing much.

- Chapter 3 discusses *soft* hurdles, which arise frequently in fund documents. This chapter might not be of interest until soft hurdles become relevant to the reader's practice. But it may be worth reading in any case because it identifies and explains one of the most common errors encountered by the author in distribution waterfalls—namely, confusing the partnership and a partner as a source of payment: using the partnership to pay, through a distribution to one partner, what should, in effect, be paid by the other partner. There is a summary of soft hurdles, and the alternative Look-back and Catch-up provisions that may be used to implement them, in Section 1.14 of Chapter 1, but this summary does not address the more general issue (regarding the source of payment), which often arises in the context of Catch-up provisions.
- Chapter 4 discusses *recycling profits*, which is one of the two key potential differences between IRR and preferred return/return of capital hurdles, but which may occur in either type of hurdle. This subject is also addressed in the Introduction, Section 1.6 of Chapter 1, and Chapter 2. In those chapters, it is sometimes discussed with reference to "negative balances" of promote hurdles. The subject of recycling profits is revisited in Chapter 11 in the discussion of multiple IRRs. Chapter 4 could be skipped, although it goes into some details that are not covered in these other chapters.

Part C

- Chapters 5 through 10 reflect general background and analysis undertaken to support Chapter 2, and cover more territory than Chapter 2. They discuss how rates of return may be used in a promote hurdle and three different generalized types of promote hurdles: a present value hurdle, a future value hurdle, and an amortization hurdle. The specific topics covered are as follows: (Chapter 5) the terminology used in real estate finance and the confusion, in practice, between nominal and effective rates (especially in the context of IRRs); (Chapter 6) the intricacies of simple interest; (Chapter 7) the different types of compound interest; (Chapter 8) how returns accrue for partial compounding periods; (Chapter 9) the so-called myth of reinvestment, especially when using an IRR; and (Chapter 10) different approaches when using the three different promote hurdles.

Part D

- Chapters 11 and 12 reflect a related part of the analysis addressed in the six articles upon which Chapters 5 through 10 are based. They were broken out as separate chapters because they are more technical in nature. They discuss some of the confusion associated with "multiple IRRs" and "effective rates" and include a practical solution to avoid multiple IRRs in the context of multiple IRR promote hurdles.

Final Warnings

This book is not a comprehensive treatment of the subject matter. But hopefully it will provide a useful primer to those readers who are first encountering JV distribution waterfalls and promote hurdles, and an opportunity to compare notes for more experienced readers. This book is not intended to provide legal advice. The views expressed (which may vary depending on the context) are not necessarily those of the individuals acknowledged as having discussed or reviewed any portion of this work, Pircher, Nichols & Meeks, the publishers of the articles upon which this book is based, or the American Bar Association. It is important to remember that every transaction is different and what is appropriate for one transaction may not be appropriate for another. Any errors are those of the author.