Variations In Structuring "Whole Fund" And "Deal By Deal" Carried Interest Or Promote In Real Estate Funds And Joint Ventures

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A number of variations in distribution waterfall terms enable managers and investors to tailor the timing of distributions of profits to the particular characteristics of their fund or joint venture, including the fund's or joint venture's investment strategy and expected financial performance. In this article, the authors analyze these variations and explore some of the considerations underpinning their use.

Disproportionate profit-sharing for managers of real estate funds and joint ventures,[1] called ''carried interest'' or ''promote,''[2] is typically thought of as calculated on either a ''deal by deal'' or a ''whole fund'' basis. This simple dichotomy, however, conceals a number of variations which enable fund managers and investors to tailor the timing of distribution of profits to the particular characteristics of their fund, including the fund's investment strategy and expected financial performance. This article analyzes these variations and explores some of the considerations underpinning their use. Perhaps most critically, an appropriately constructed fund distribution waterfall can assist in aligning the incentives of managers and investors and properly motivate and compensate the individuals charged with executing a fund's investment mandate.

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The Basics: Manager Carried Interest and The Fund Distribution Waterfall

A manager's carried interest is one of the most important financial terms negotiated in the formation of a fund. Quite often, it is the most significant component of a manager's expected incentive compensation.[3] Commonly, a manager will not be entitled to carried interest until each investor in the fund recoups its applicable capital contributions (whether for a specific deal or for the whole fund) and achieves a preferred return thereon. Thereafter, a manager will begin to receive carried interest distributions equal to a percentage (or percentages) of remaining fund profits. Although the specific investor preferred return and manager carried interest percentages vary, a common

preferred return for real estate funds (at least successful, opportunistic real estate funds) is eight percent (8%) per annum, compounded annually, and a common overall carried interest percentage is twenty percent (20%).[4] After achieving the preferred return and return of capital for investors, the next question that arises is precisely how much of the next dollar of profits is given to the manager versus the investors. A manager may be entitled to up to one hundred percent (100%) of the next dollar of profits until such time as the manager has received twenty percent (20%) of the fund's total profits (known as a ''catch-up''). We will assume for all discussion purposes and examples throughout the remainder of this article that, after investors receive a return of their applicable invested capital (again, whether for a specific deal or for the whole fund), plus a preferred return of eight percent per annum (compounded annually) thereon, 100 percent of all profits of the fund will be distributed to the manager until the manager has received 20 percent of the total profits of the fund (a so-called ''100 percent catch-up'') and, thereafter, all additional profits will be distributed 20 percent to the manager and 80 percent to the investors.[5]

Overview of Whole Fund versus Deal By Deal Waterfall Models

After determining the basic features discussed above, the parties must decide whether carried interest will be distributed on a deal by deal or on a whole fund basis. Under the deal by deal model, returns are generally calculated for *each* investment, and the manager receives its carried interest as profits are realized on the particular investment. In contrast, under a whole fund model, the manager does not receive carried interest distributions until the investors receive distributions equal to their total capital contributions to the entire fund and a preferred return on all such contributions. Assuming that a fund incorporates a so-called ''claw-back'' feature,[6] both the deal by deal model and the whole fund model should result in the same aggregate sharing of profits over the life of the fund, with the only variable being the timing of receipt of such profits by the manager—earlier for a deal by deal model and later for a whole fund model. Of course, timing is everything as they say, and a number of interesting variations of the whole fund and deal by deal waterfall models can be employed in different circumstances to address different goals.

Income Source Variations on Waterfalls

One potential variation in carried interest arrangements is based on the source of income generated by a fund. The most common income source variation utilized in real estate funds is based on a distinction between ''current income'' (e.g., rents, hotel room revenue, and other forms of operating profit) and ''disposition proceeds'' (i.e., income resulting from the sale or other disposition of a fund's underlying investments). Under most real estate fund distribution waterfalls (whether structured to provide carried interest on a whole fund or on a deal by deal basis), current income simply flows through the same distribution waterfall as any other type of income. In contrast, those funds that distinguish between these different sources of income usually do so by creating separate distribution waterfalls, one governing the distribution of current income and the other governing the distribution of disposition proceeds. As we will explore in more detail, this type of distinction can be used in various circumstances to encourage a manager to execute the fund's mandate more efficiently, particularly for current income focused funds.

In the remainder of this article, we will review various possible forms (and combinations of forms) of these different models in detail and consider how their use affects the timing of distributions of profits to fund managers and investors.

The Whole Fund Model and Variations

Basic Whole Fund Model

In the basic whole fund model distribution waterfall, each investor must recoup its total capital contributions to the fund and receive a specified preferred return on those total contributions before the manager is entitled to receive any carried interest. In the simple illustration in Figure 1, we assume a fund with one investor made Investment A in Year 1 for $5 million, continued to make investments over the intervening years, such that the investor had contributed a total of $100 million as of the last day of Year 4, and that Investment A was sold in Year 4 for $12 million, with the resulting proceeds distributed at that time.

Figure 1
Basic Whole Fund Model

Year 4: Total Capital Invested	$	100,000,000.00
Year 4: Sale of Investment A	$	12,000,000.00
Cost of Investment A	$	5,000,000.00
Profits	$	7,000,000.00
Distributions		
Return of Capital	$	12,000,000.00
Preferred Return	$	-
Manager Catch-Up	$	-
Investor - 80% of Residual	$	-
Manager - 20% of Residual	$	-
Total Distributions to Investor	$	12,000,000.00
Total Distributions to Manager	$	-

Because the distribution waterfall reflected in Figure 1 is based on a whole fund model, the entire $12 million is distributed to the investor as return of capital. The manager will not receive a share of profits until the investor has received its entire capital contribution of $100 million plus the eight percent preferred return thereon, presumably following subsequent sales. The whole fund model is generally the most favorable to investors from a time value of money perspective since it defers distributions of carried interest to managers, and investors therefore receive more distributions of fund profits sooner.

Whole Fund, Income Source Variation

As noted above, the most common income source based variation utilized in real estate funds distinguishes current income and disposition proceeds. Specifically, a manager applying this variation to a whole fund model waterfall is permitted to receive carried interest from distributions of current income (but not distributions of disposition proceeds) as soon as investors receive the preferred return on all invested capital, even if investors have not recouped any of their capital contributions. Figure 2 is a basic illustration of this variation on the whole fund model. For purposes of this example we assume a fund with one investor who made total contributions to the fund of $100 million, that the fund distributes $12 million of current income received by the fund from the operation of its investments on the last day of Year 1. We also assume that Investment A was purchased on the first day of Year 1 for $5 million and sold on the last day of Year 1 for $12 million. For simplicity, we assume that the entire $100 million was contributed on the first day of Year 1 and that there have been no distributions prior to the last day of Year 1.

Figure 2
Whole Fund, Income Source Variation Model

Year 1 (beginning): Total Capital Invested			$	100,000,000.00
Year 1 (end): Total Current Income			$	12,000,000.00
Year 1 (end): Sale of Investment A			$	12,000,000.00
Cost of Investment A			$	5,000,000.00
Profits			$	7,000,000.00
Distributions				
		Current Income		Disposition Proceeds
Return of Capital		N/A	$	12,000,000.00
Preferred Return	$	8,000,000.00	$	-
Manager Catch-Up	$	2,000,000.00	$	-
Investor - 80% of Residual	$	1,600,000.00	$	-
Manager - 20% of Residual	$	400,000.00	$	-
Total Distributions to Investor			$	21,600,000.00
Total Distributions to Manager			$	2,400,000.00

In the case of Figure 2, the manager immediately receives some portion of its carried interest on the current income generated by the fund ($2.4 million), while the capital invested in each deal is returned pursuant to a separate disposition proceeds waterfall (in this case, $12 million). Note that because the manager is entitled to take carried interest on current income before any investments are realized (and before capital invested in any investments is returned), this model increases the need for a claw-back upon liquidation of the fund (relative to the basic whole fund model) in order to ensure the proper aggregate sharing of profits between the fund manager and fund investors.[7] This form of a whole fund waterfall represents a compromise between the basic whole fund and deal by deal approach: the manager obtains a more rapid monetization of carried interest from current income, while the separate disposition proceeds waterfall continues to operate in the same manner as described above in the basic whole fund model (and investors accordingly receive a full return of all capital contributed to the fund, plus preferred return thereon, from disposition proceeds resulting from realized investments prior to the manager receiving any carried interest distributions in relation thereto). Of course, the extent to which a manager's carried interest is monetized under this particular model depends upon the level of current income generated by the fund's underlying investments.

A Closer Look: Refinancing Proceeds as Distributable Profits

The rationale for the distinction between current income and disposition proceeds is the notion that return of capital is only realized upon the sale of an asset and therefore current income should be treated as pure profit (or at least only applied to recoup preferred return versus capital). This reasoning is sometimes extended to distributable proceeds realized from a refinancing transaction. In a typical refinancing transaction that would result in distributable proceeds, a manager replaces existing equity in an investment with additional debt, and the proceeds from the refinancing are then distributed to investors. Managers sometimes take the position that such proceeds constitute profits akin to current income and should be distributed 80 percent to investors and 20 percent to the manager as carried interest from the first dollar of proceeds (or after only the preferred return has been recouped), whereas investors favor treating the proceeds as return of capital, thereby normally delaying any carried interest payments until the final sale of the investment. One compromise is to treat a pro rata portion of the proceeds of such transaction as a return of capital based on a ratio of the total capital funded to such investment to the fair value implied by the refinancing proceeds. This middle road gives the manager credit for the value it has realized, but does not treat the full proceeds as profits.

The Deal by Deal Model and Variations

Strict Deal by Deal Model

In the strict deal by deal model, each deal stands alone, and the profits and losses of each deal are insulated from the profits and losses of other investments made by the fund. Under this model, the manager receives carried interest from proceeds of an individual investment as soon as each investor recoups its capital contribution and corresponding preferred return attributable to such investment. The manager is entitled to keep any carried interest distributions regardless of whether the fund's other investments are (or even the fund as a whole is) profitable.[8] This model essentially provides a manager a series of independent options on investment profits—managers only have the possibility of being rewarded for making good investments and have no possibility of being punished for making bad ones.[9] Accordingly, this model is rarely seen in discretionary real estate funds in the marketplace today.[10]

Deal by Deal, Realized Loss Model

Due to the concerns with the strict deal by deal model discussed above, the more common permutation of a deal by deal approach includes a make-up for realized losses. Under this model, the first tier of the fund waterfall requires a return of capital invested in all *realized* investments (plus a preferred return thereon), but not capital invested in unrealized investments (or a preferred return with respect thereto). Therefore, if an investment has been realized at a loss,[11] distributions from future realized deals will be required to make up for such loss prior to reaching any other tier of the waterfall. Figures 3.1 and 3.2 illustrate the basics of this model. In Figure 3.1, we assume the fund makes two investments—Investment A in which it invests $10 million and Investment B in which it invests $15 million. For simplicity, we assume all capital was funded on the first day of Year 1, that Investment A's proceeds were distributed on the first day of Year 2 and Investment B's proceeds were distributed on the first day of Year 3, with no other distributions made during such period. The fund then first sells Investment A and realizes distributable proceeds of $8 million. It then sells Investment B and realizes distributable proceeds of $25 million. The assumptions for Figure 3.2 are the same, except that the fund sells Investment B first and Investment A second.

Invested Capital and Realized Proceeds (Figures 3.1 and 3.2)					
Investment A			Investment B		
Capital Invested	$	10,000,000.00	Capital Invested	$	15,000,000.00
Realized Proceeds	$	8,000,000.00	Realized Proceeds	$	25,000,000.00

Figure 3.1
Deal by Deal, Realized Loss Model - Scenario 1

	Investment A		Investment B			
Realized Proceeds Y1	$	8,000,000.00				
Realized Proceeds Y2			$	25,000,000.00		
	Investment A - Unpaid Preferred Return		Investment A - Distributions		Investment B - Unpaid Preferred Return	Investment B - Distributions
Year 1						
Return of Capital			$	8,000,000.00		$ -
Preferred Return	$	800,000.00	$	-	$ 1,200,000.00	$ -
Manager Catch-Up			$	-		$ -
Investor - 80% of Residual			$	-		$ -
Manager - 20% of Residual			$	-		$ -
Year 2						
Make-Up for Realized Loss on Investment A						$ 2,000,000.00
Return of Capital						$ 15,000,000.00
Preferred Return	$	1,424,000.00			$ 2,800,000.00	$ 4,224,000.00
Manager Catch-Up						$ 1,056,000.00
Investor - 80% of Residual						$ 2,176,000.00
Manager - 20% of Residual						$ 544,000.00
Totals						
Total Proceeds to Investor	$	31,400,000.00				
Total Proceeds to Manager	$	1,600,000.00				

Figure 3.2
Deal by Deal, Realized Loss Model - Scenario 2

	Investment A		Investment B			
Realized Proceeds Y1	$	25,000,000.00				
Realized Proceeds Y2			$	8,000,000.00		
	Investment A - Unpaid Preferred Return		Investment A - Distributions		Investment B - Unpaid Preferred Return	Investment B - Distributions
Year 1						
Return of Capital			$	-		$ 15,000,000.00
Preferred Return	$	800,000.00	$	-	$ 1,200,000.00	$ 1,200,000.00
Manager Catch-Up			$	-		$ 300,000.00
Investor - 80% of Residual			$	-		$ 6,800,000.00
Manager - 20% of Residual			$	-		$ 1,700,000.00
Year 2						
Return of Capital			$	8,000,000.00		
Preferred Return	$	1,664,000.00	$	-	$ -	
Manager Catch-Up			$	-		
Investor - 80% of Residual			$	-		
Manager - 20% of Residual			$	-		
Totals						
Total Proceeds to Investor	$	31,000,000.00				
Total Proceeds to Manager	$	2,000,000.00				

In the scenario presented in Figure 3.2, proceeds resulting from later, realized investments would be distributed first to the investor to make up the $2 million loss on Investment A. Figure 3.2 also illustrates why a claw-back is required to preserve the proper aggregate carried interest percentage in a deal by deal model. After the distribution of proceeds from Investment A in the Figure 3.2 example, the total profits of the fund were $8 million rather than $10 million and the manager has received $400,000 too much in carried interest. Without a claw-back, the manager would never be required to return this excess.

It is important to note that, under most versions of this waterfall model, current income earned before any investments have been realized is applied directly to carried interest and ''skips'' the return of capital and preferred return tiers of the waterfall. Furthermore, later distributions made in relation to realized investments are generally not required to make up such prior payments of carried interest on current income, and, absent a claw-back, a manager is not required to give back any portion of such current income carried interest following subsequent investment losses. As a result, this waterfall is also quite pro-manager, particularly when employed by a fund generating significant current income.

Deal by Deal, Realized Loss Model—Income Source Variations

As in the case of a whole fund model waterfall, the deal by deal, realized loss model waterfall can be split into two waterfalls so that current income from an individual investment is treated differently from disposition proceeds resulting from the sale of such investment. One possibility is to utilize a ''whole deal'' approach for current income, with current income from each investment going first as a return of capital funded to all realized investments, then as a return of capital with respect to the capital invested in that particular investment (plus preferred return thereon), prior to allowing any carried interest distributions with respect

to current income. Another possibility is to provide that current income goes first to return capital funded to all realized investments, then to the preferred return (but not return of capital) on capital invested in the particular investment generating such income, prior to allowing any carried interest distributions with respect to current income.[12] The important distinction between these two approaches is that, as long as there have been no *realized* losses, the first approach requires a return of capital plus preferred return with respect to an investment before permitting distributions of carried interest with respect to the current income generated by such investment, whereas the second approach only requires a recoupment of preferred return with respect to the capital invested in the investment generating current income before permitting distributions of carried interest with respect to such income. Like the basic deal by deal, realized loss model, all current income is applied directly to profits and the manager's carried interest and ''skips'' the return of capital tier prior to the sale of a fund's first investment (although, as noted, the preferred return on such capital must first be recouped). The treatment of disposition proceeds is the same under both approaches (and is the same as the basic deal by deal, realized loss model).

Figures 4.1 and 4.2 illustrate these two approaches. For purposes of Figures 4.1 and 4.2, we assume that the fund makes two investments on the first day of Year 1, Investment A, in which it invests $10 million and Investment B, in which it invests $15 million. Investment A generates $1.1 million, $0.65 million, and $0.65 million over a three year holding period and is sold on the last day of Year 3 for $7.9 million. Investment B generates $1.6 million, $1.6 million, $1.8 million and $2 million over a four year holding period and is sold on the last day of Year 4 for $25 million. All distributions are made on the first day of the year following that in which the funds are available, and current income is distributed prior to disposition proceeds in years where an investment is sold.

Figure 4.1: ''Whole Deal'' Income Source Variation

Invested Capital and Realized Proceeds (Figures 4.1 and 4.2)

Investment A			Investment B		
Capital Invested	$	10,000,000.00	Capital Invested	$	15,000,000.00
Current Income Y1	$	1,100,000.00	Current Income Y1	$	1,600,000.00
Current Income Y2	$	650,000.00	Current Income Y2	$	1,600,000.00
Current Income Y3	$	650,000.00	Current Income Y3	$	1,800,000.00
Realized Proceeds Y3	$	7,900,000.00	Current Income Y4	$	2,000,000.00
			Realized Proceeds Y4	$	25,000,000.00

Figure 4.1
Deal by Deal, Whole Deal Income Source Variation

Distributions

	Investment A - Unpaid Preferred Return	Investment A - Current Income Distributions	Investment A - Disposition Proceeds Distributions	Investment B - Unpaid Preferred Return	Investment B - Current Income Distributions	Investment B - Disposition Proceeds Distributions
Year 1						
Investor - Return of Capital		$ 1,100,000.00			$ 1,600,000.00	
Investor - Preferred Return	$ 800,000.00	$ -		$ 1,200,000.00		$ -
Manager - Catch Up		$ -				$ -
Investor - 80% of Residual		$ -				$ -
Manager - 20% of Residual		$ -				$ -
Year 2						
Investor - Return of Capital		$ 650,000.00			$ 1,600,000.00	$ -
Investor - Preferred Return	$ 1,576,000.00	$ -		$ 2,368,000.00		$ -
Manager - Catch Up		$ -				$ -
Investor - 80% of Residual		$ -				$ -
Manager - 20% of Residual		$ -				$ -
Year 3						
Investor - Return of Capital		$ 650,000.00	$ 7,600,000.00		$ 1,800,000.00	
Investor - Preferred Return	$ 2,362,080.00	$ -	$ 300,000.00	$ 3,501,440.00		$ -
Manager - Catch Up		$ -				$ -
Investor - 80% of Residual		$ -				$ -
Manager - 20% of Residual		$ -				$ -
Year 4						
Investor - Return of Capital		$ -			$ 2,000,000.00	$ 8,000,000.00
Investor - Preferred Return	$ 2,227,046.40	$ -		$ 4,021,324.80		$ 6,248,371.20
Manager - Catch Up		$ -				$ 1,637,092.80
Investor - 80% of Residual		$ -				$ 7,291,628.80
Manager - 20% of Residual		$ -				$ 1,822,907.20

Total Distributions

Total Distributions to Investor	$	38,840,000.00
Total Distributions to Manager	$	3,460,000.00

Figure 4.2: Preferred Return Only Income Source Variation

Invested Capital and Realized Proceeds (Figures 4.1 and 4.2)					
Investment A			Investment B		
Capital Invested	$	10,000,000.00	Capital Invested	$	15,000,000.00
Current Income Y1	$	1,100,000.00	Current Income Y1	$	1,600,000.00
Current Income Y2	$	650,000.00	Current Income Y2	$	1,600,000.00
Current Income Y3	$	650,000.00	Current Income Y3	$	1,800,000.00
Realized Proceeds Y3	$	7,900,000.00	Current Income Y4	$	2,000,000.00
			Realized Proceeds Y4	$	25,000,000.00

Figure 4.2
Deal by Deal, Preferred Return Only Income Source

Distributions	Investment A - Unpaid Preferred Return	Investment A - Current Income	Investment A - Disposition Proceeds	Investment B - Unpaid Preferred Return	Investment B - Current Income	Investment B - Disposition Proceeds
Year 1						
Investor - Return of Capital		N/A			N/A	
Investor - Preferred Return	$ 800,000.00	$ 800,000.00		$ 1,200,000.00	$ 1,200,000.00	
Manager - Catch Up		$ 200,000.00			$ 300,000.00	
Investor - 80% of Residual		$ 80,000.00			$ 80,000.00	
Manager - 20% of Residual		$ 20,000.00			$ 20,000.00	
Year 2						
Investor - Return of Capital		N/A			N/A	
Investor - Preferred Return	$ 720,000.00	$ 650,000.00		$ 1,120,000.00	$ 1,120,000.00	
Manager - Catch Up		$ -			$ 280,000.00	
Investor - 80% of Residual		$ -			$ 160,000.00	
Manager - 20% of Residual		$ -			$ 40,000.00	
Year 3						
Investor - Return of Capital		N/A	$ 7,900,000.00		N/A	
Investor - Preferred Return	$ 875,600.00	$ 650,000.00	$ -	$ 1,040,000.00	$ 1,040,000.00	
Manager - Catch Up		$ -	$ -		$ 260,000.00	
Investor - 80% of Residual		$ -	$ -		$ 400,000.00	
Manager - 20% of Residual		$ -	$ -		$ 100,000.00	
Year 4						
Make-Up for Realized Losses					$ 2,000,000.00	$ 100,000.00
Investor - Return of Capital					$ -	$ 15,000,000.00
Investor - Preferred Return	$ 411,648.00			$ 800,000.00	$ -	$ 1,211,648.00
Manager - Catch Up					$ -	$ 627,912.00
Investor - 80% of Residual					$ -	$ 6,448,352.00
Manager - 20% of Residual					$ -	$ 1,612,088.00
Total Distributions						
Total Distributions to Investor	$ 38,840,000.00					
Total Distributions to Manager	$ 3,460,000.00					

Note that in Figure 4.2 the manager receives carried interest as early as Year 1, and in Year 4 current income from Investment B is applied to return of capital from Investment A, which has been realized, prior to being applied to the preferred return.

A Hybrid Model: Full Current Yield Income Source Variation

The final ''hybrid'' income source variation on the deal by deal, realized loss model calculates the required preferred return for current income distributions on all capital invested in the fund at the time a distribution is made, rather than on the capital invested in the particular investment generating the current income being distributed. Essentially, this model distributes current income on a whole fund basis and disposition proceeds on a deal by deal basis. Once again, the disposition proceeds waterfall is the same as the basic deal by deal, realized loss model (and thus calculates the preferred return payable via disposition proceeds only in relation to realized investments).

Figure 5 provides an example of such a waterfall. For purposes of Figure 5, we assume (as with Figures 4.1 and 4.2) that the fund makes two investments on the first day of Year 1: Investment A, in which it invests $10 million, and Investment B, in which it invests $15 million. Investment A generates $1.1 million, $0.65 million and $0.65 million over a three year holding period and is sold on the last day of Year 3 for $7.9 million. Investment B generates $1.6 million, $1.6 million, $1.8 million and $2 million over a four year holding period and is sold on the last day of Year 4 for $25 million. All distributions are made on the first day of the year after that in which the funds are available, and current income is distributed prior to disposition proceeds in years where an investment is sold.

Figure 5: Full Current Yield Income Source Variation

Invested Capital and Realized Proceeds (Figure 5)					
Investment A			Investment B		
Capital Invested	$	10,000,000.00	Capital Invested	$	15,000,000.00
Current Income Y1	$	1,100,000.00	Current Income Y1	$	1,600,000.00
Current Income Y2	$	650,000.00	Current Income Y2	$	1,600,000.00
Current Income Y3	$	650,000.00	Current Income Y3	$	1,800,000.00
Realized Proceeds Y3	$	7,900,000.00	Current Income Y4	$	2,000,000.00
			Realized Proceeds Y4	$	25,000,000.00

Figure 5 Hybrid Model Distributions		Unpaid Preferred Return		Investment A and B - Current Income		Investment A - Disposition Proceeds		Investment B - Disposition Proceeds
Year 1								
Investor - Return of Capital				N/A				
Investor - Preferred Return	$	2,000,000.00	$	2,000,000.00				
Manager - Catch Up			$	500,000.00				
Investor - 80% of Residual			$	160,000.00				
Manager - 20% of Residual			$	40,000.00				
Year 2								
Investor - Return of Capital				N/A				
Investor - Preferred Return	$	1,840,000.00	$	1,840,000.00				
Manager - Catch Up			$	410,000.00				
Investor - 80% of Residual			$	-				
Manager - 20% of Residual			$	-				
Year 3								
Investor - Return of Capital				N/A	$	7,900,000.00		
Investor - Preferred Return	$	2,000,000.00	$	2,000,000.00	$	-		
Manager - Catch Up			$	450,000.00	$	-		
Investor - 80% of Residual			$	-	$	-		
Manager - 20% of Residual			$	-	$	-		
Year 4								
Make-Up for Realized Losses			$	2,000,000.00			$	100,000.00
Investor - Return of Capital			$	-			$	15,000,000.00
Investor - Preferred Return	$	2,168,000.00	$	-			$	2,168,000.00
Manager - Catch Up			$	-			$	642,000.00
Investor - 80% of Residual			$	-			$	5,672,000.00
Manager - 20% of Residual			$	-			$	1,418,000.00
Total Distributions to Investor	$	38,840,000.00						
Total Distributions to Manager	$	3,460,000.00						

This variation represents a compromise between the ''whole deal'' and ''preferred return only'' income source variations. It delays the distribution of carried interest with respect to current income (relative to the ''preferred return only'' variation), as the required preferred return amount will generally be higher, yet permits payment of carried interest on current income before any invested capital has been returned as a result of realizing investments (unlike the ''whole deal'' variation).[13]

Considerations

From a time value of money perspective, the increased deferral of carried interest entailed by a whole fund model (or those versions of the deal by deal model that defer carried interest more than others) is better for investors and worse for managers. In addition, investors generally cannot know with certainty that their investment in a fund will be profitable until they have received-at the very least-their capital contributions; and they do not know with certainty the ultimate level of profitability of a fund until the fund is liquidated and wound up. A whole fund model mitigates investor concern with earlier distributions of profits to managers because investors will recoup the whole of their capital contribution-plus some preferred return thereon-before the manager receives any distributions of profits on account of the manager's carried interest.[14] Those versions of a deal by deal model that defer carried interest more than others accomplish a similar investor goal by holding the manager more immediately accountable for later losses or less impressive performance. In practice, a large number of real estate private funds follow the whole fund model,[15] likely as a result of these well understood investor considerations.

Despite these investor advantages, the whole fund model can dampen the intended incentive effects of carried interest for managers for the very same reason that it benefits investors from a time value of money perspective—significant profits from prior realized deals are deferred, sometimes for significant periods of time. This is particularly troubling for savvy fund managers who seek to reward individual investment professionals for the performance of specific investments they had a hand in sourcing or closing and to align the interests of younger employees with more senior principals. Many younger employees have a shorter frame of reference than more senior principals. If carried interest is distributed on a whole fund basis, younger employees may not assume that they will be

employed by the manager for the entire (often lengthy) period necessary for them to enjoy the benefit of such carried interest. Thus, even when these employees play a lead role in making investments that are sold for significant profits prior to their departure, they may not expect to be rewarded for such performance (with any rewards not given to them distributed to other, presumably more senior, employees or principals). In comparison, if carried interest is distributed on some type of a deal by deal basis then managers can more easily reward the successful performance of individual employees (including junior employees) and principals, and profits realized in relation to particular investments can be distributed to the individuals most responsible for those investments as and when those profits are actually realized.[16]

The incentive effects of a basic whole fund model can also vary depending upon whether a fund's investments generate more or less current income. For example, the basic whole fund model may not have a desirable effect on the incentives of a manager of a value-add focused fund,[17] where an important goal is increasing investment cash flow on multiple investments at the same time. A manager operating under a basic whole fund model will have an increased incentive (relative to an income source variation of the whole fund model or a deal by deal model) to focus its attention fully on one or more investments early in the life of the fund and delay the draw-down of additional capital (including for capital investments made to improve long-term current income performance) so that once those initial investments have been sold, the manager is able to receive carried interest distributions. This is due to the fact that even though the whole fund model requires a full return of all capital (plus a preferred return thereon) prior to any carried interest distributions, the fund must only return capital (plus preferred return) contributed as of the time of any distribution. In the most extreme scenario,[18] a manager would purchase a single asset and cause the fund to sell it and distribute all proceeds prior to purchasing any other assets. In contrast, under a deal by deal model (or an income source variation of the whole fund model), a manager can receive carried interest distributions with respect to one or more investments prior to returning all contributed capital as of the date of any distribution (and potentially even prior to any sales of investments).

On the other hand, the more pro-manager versions of the deal by deal, realized loss model waterfall may be objectionable to investors in funds generating significant income (including value-add funds) for similar reasons. For example, such a fund utilizing the preferred return only variation on the deal by deal model waterfall described above may have one investment which performs extremely well, yielding strong increases in current income, and a second investment which breaks even or generates middling performance (as in the example shown in Figure 4.2). For the first investment, the manager is rewarded with early carried interest distributions from the robust current income stream, and due to the increased operational cash flow, the value of the investment upon disposition likely also increases, allowing for a full return of capital to investors. For the second investment, although the manager is unsuccessful in fulfilling its investment mandate, such manager need not account for the poor performance until realization. This delayed accountability for a poor current income yield on specific investments may lead a manager to hold poorly performing investments longer than consistent with the fund's risk profile in an attempt to turn those investments around, avoid realizing losses, or both. The ''hybrid'' current income version of the deal by deal model waterfall described above addresses such investor concerns to some extent by permitting manager carried interest on current income only if distributions to investors exceed a preferred return target that is calculated with respect to all of the fund's investments.

Conclusion

One of the advantages of investing in a private fund is that the parties can carefully tailor the manager's incentive profit-sharing arrangements or so-called carried interest to a fund's particular investment strategies and to a manager's desired goals. Investors and managers alike should carefully consider the numerous possible variations in crafting such arrangements to ensure that their interests are appropriately aligned and that they are properly compensated for their respective contributions, whether of expertise or capital.

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[1] Throughout this article, the term ''fund'' means an entity that will invest in multiple real estate assets over an extended time period, whether a traditional real estate private fund, programmatic joint venture or similar entity; the term ''manager'' means the active manager, managing member, general partner or other managing entity of a fund that is entitled to receive the carried interest or promote distributions based on the financial performance of the fund's investments; and the term ''investor'' means the limited partners, non-managing members, investor members or other non-controlling equity owners of a fund.

[2] The term ''carried interest'' is used exclusively throughout the remainder of this article instead of the term ''promote.''

[3] In addition to carried interest, a manager (or its affiliated operating companies) is often entitled to receive more certain compensation in the form of various fees, such as an investment or asset management fee, acquisition fees, financing fees, development management, or property management fees. A manager also commonly invests a certain amount of equity into the fund it manages alongside other investors and is entitled to returns on and of that equity investment on generally the same terms as other investors. For simplicity, this article ignores these forms of manager compensation and investment returns and focuses exclusively on the manager's carried interest. Of course, when analyzing the overall incen-

tives of a manager, these other forms of compensation and investment returns may have incentive effects that are not completely correlated with-if not directly contradictory to-the incentive effects of the manager's carried interest.

[4] Preferred return and carried interest percentages are often influenced by the same factors affecting the choice between ''whole fund'' versus ''deal by deal'' carried interest. For simplicity, this article assumes (a) the same investor preferred return/overall manager carried interest percentages for all examples and (b) that the fund distribution waterfall used in all examples, except where specifically noted, returns capital first and then preferred return (rather than first paying preferred return and then capital). In addition, this article assumes that investor preferred returns are calculated (i) as a separate ''yield'' on contributed capital, rather than on the basis of an internal rate of return, a net asset value test, whole dollar hurdle, or some other form of investment performance measure and (ii) on a cash basis, as and when cash is actually contributed by and distributed to an investor.

[5] As a result, this article does not address the distinctions between (i) a 100 percent catch-up (sometimes referred to as a ''disappearing'' preferred return or ''quickly disappearing'' preferred return (to distinguish it from the following item (iii)), (ii) waterfalls without such ''catch-up'' distributions (also known as a ''permanent'' preferred return), and (iii) the intermediate range of ''graduated'' catch-up possibilities.

[6] Most readers are likely familiar with the concept of a ''claw-back'' which provides, often at the liquidation of the fund, that if the manager has received carried interest and either (a) the investors have not received their specified preferred return on their total contributions to the fund through that point in time or (b) the total carried interest paid to the manager to that point in time exceeds 20 percent of the aggregate profits of the fund, the manager will pay to the investors the greater of (i) the amount of carried interest the manager has received in excess of 20 percent of the aggregate profits of the fund or (ii) the amount required to provide the investors their preferred return, but usually, with respect to amounts provided in both (i) and (ii), never in excess of the aggregate amount of carried interest the manager has actually received, net of taxes the manager has paid on such carried interest.

[7] There are some important additional complexities to note in the use of this variation (or other types of income source variations) that arise from the potential combination or netting of different tiers of the two distribution waterfalls to avoid the duplication of certain distributions and other unintended results. First, distributions made with respect to the preferred return tier of both waterfalls can be combined so that the total preferred return distributions are not duplicated. Second, the catch up portions of both waterfalls may be combined to cap the catch up distributions to the manager at the carried interest percentage of total profits of the fund to avoid duplication or over-distribution of carried interest. Third, if the disposition proceeds and current income waterfalls are not completely separate and distribution of profits under the disposition waterfall count towards paying the preferred return under the current income waterfall, then the order in which the distributions are made can result in different amounts being distributed to the manager at different times. Finally, the claw-back should be clear that it functions on an aggregate basis for both waterfalls with respect to all fund profits at liquidation.

[8] Of course, this assumes that there is no claw-back (which is probably a good assumption for this model if it is employed).

[9] Again, ignoring any incentive effect resulting from any capital invested by the manager.

[10] In the authors' experience, the strict deal by deal model is encountered, if at all, only in programmatic joint ventures where the investor retains significant rights in approving individual transactions.

[11] It is important to note that a ''realized loss'' need not be limited to the sale of an investment at a loss, but could include other measures of impairment of an investment's value. For example, it is common to treat any permanent write-downs of a fund's investments (as reflected in a fund's audited annual reports) as ''realized losses'' for purposes of the distribution waterfall.

[12] Note that, as a practical matter, a manager would be unlikely to receive any carried interest out of current income distributions under this variation.

[13] For this reason, it is even more important in this model to pay careful attention to the timing of distributions and other considerations referenced in Footnote 7.

[14] *See* Schell, James M. Private Equity Funds: Business Structure and Operations. New York: Law Journal Press, 2008, pp. 2-21, on the history of the deal-by-deal versus whole fund model in the leveraged buyout fund context, where some form of deal by deal model is more common. It should be noted that while the whole fund model reduces the need for a claw-back feature, it does not eliminate it entirely if commitments to the fund are drawn down over time and the funding of some commitments occurs later in a fund's life after earlier contributions have been returned and the manager has taken some carried interest. As a result, a claw-back is often still requested for funds with a whole fund model distribution waterfall. It should also be noted that a claw-back provision, in and of itself, should never be viewed as either a necessary or a sufficient condition to ensure the appropriate distribution of profits between investors and a manager as (i) various types of provisions can always be incorporated to defer carried interest even further (such as requiring achievement of some NAV or whole dollar return test before permitting the distribution of carried interest), which end up serving the same purpose (and are not that different than the more investor-friendly waterfalls discussed in this article) and (ii) other measures are usually required to actually give the claw back ''teeth,'' such as personal guarantees of the claw-back by a fund's investment professionals or a credit worthy investment firm, escrowing at least some portion of the manager's carried interest, interim testing of the claw-back or some combination thereof.

[15] *See* The 2008 Preqin Private Equity Real Estate Review. London: Preqin Ltd., 2008, p. 106, stating that of funds sampled, 82 percent used a whole fund model distribution waterfall.

[16] While a manager can of course still internally track and attempt to reward individual performance where carried interest is paid on a whole fund basis, the ultimate distribution of any carried interest actually paid is always deferred. It should also be noted that there are a variety of complex issues (which this article does not address) associated with attempting to reward individual performance in the manner described here, even when carried interest is distributed pur-

suant to a deal by deal model waterfall. This is largely due to the fact that in most versions of such deal by deal waterfalls, the performance of one investment can affect the carried interest paid with respect to other investments (e.g. where realized losses must be made up prior to payment of any carried interest on future deals) and different individuals may be responsible for different investments.

[17] A ''value-add focused'' fund generally means a fund with an investment strategy of purchasing underperforming properties and increasing their value through leasing expertise, rehabilitation or additional construction, changes in use, more efficient management or some other property-level, operational expertise.

[18] Although this particular scenario is extremely unlikely given the limiting effect of a fund's investment period, the principal it illustrates still applies in normal circumstances for most funds using the whole fund model.