PARTNER LOANS TO FUND CAPITAL CALL SHORTFALLS IN REAL ESTATE PARTNERSHIPS: LOAN TO NON-CONTRIBUTING PARTNER VS. LOAN TO PARTNERSHIP

By Stevens A. Carey

This Article examines two common loan remedies in a two-partner real estate partnership that may be available to a contributing partner when the other partner fails to contribute its share of a capital call: a partner loan to the non-contributing partner and a partner loan to the partnership. With an emphasis on the economics, the author discusses advantages and disadvantages of each approach as well as solutions to some of the perceived disadvantages.

When there is a capital call in a two-partner real estate partnership, one of the partners may be unwilling or unable to fund its share. In that event, many partnership agreements provide that the other partner may advance the entire amount of the capital call. Such provisions might apply when the capital contributions are required or when they are discretionary (i.e., whether or not the failure to contribute constitutes a default). In either case, the advance by the contributing partner of the non-contributing partner’s share might be treated in one of the following ways (among others):

(1) as a loan to the other (non-contributing) partner, in which event the loan is used by the other partner to contribute its share of the capital call so that the partners’ respective shares of contributions may stay in sync (i.e., in the sharing ratio contemplated for capital calls); or

(2) as a loan to the partnership, in which event the entire amount advanced by the contributing partner (i.e., both partners’ shares) is treated as a loan to the partnership so that the partners’ respective shares of contributions may stay in sync.

These two loan alternatives, which are the focus of this Article, are illustrated by the following example:

Example 1. In a partnership in which all contributions are to be shared equally, if one partner funds 100% of a $10 million capital call, then the two loan alternatives for the contributing partner would be:

(1) a $5 million loan to the non-contributing partner resulting in equal $5 million contributions from the partners (for a total of $10 million of contributions); or

STEVEN A. CAREY is a transactional partner with Pircher, Nichols & Meeks, a real estate law firm with offices in Los Angeles and Chicago. The views expressed in this Article (which may vary depending on the context) are those of the author and not necessarily those of Pircher, Nichols & Meeks or the publication. The author thanks John Cauble, Scott Farber, Danny Guggenheim, Richard Kaplan, Steve Mansell, Phil Nichols, Jeff Rosenthal, and Dan Schechter for providing comments on a prior draft of this Article, and Kaleb Keller and Tim Durkin for cite checking. Any errors are those of the author.
Both these alternatives involve a loan by the contributing partner (which will sometimes be called the “lending partner”), but they also vary in a number of respects, including:

- the identity of the borrower (the non-contributing partner vs. the partnership);
- the amount of the loan (the non-contributing partner’s share of the capital call vs. 100% of the capital call), and
- the amounts of resulting contributions (pro rata contributions of the entire capital call vs. no contributions).

But are the differences sufficiently material that it matters which loan alternative is used? They may be. This Article will consider potential areas of concern and how they might be addressed.

**PREVIEW**

There are a number of points to consider when deciding whether the partnership agreement should include one or both of the two loan alternatives above and when deciding to use one instead of the other. Points of consideration include: the creditworthiness of the borrower, enforcement, contractual restrictions, tax, accounting and economics. Any of these points may be significant in a particular deal. But, in the author’s experience, the economics may be an overriding concern when one of the partners is entitled to an additional share of profit distributions (through what may be called a “promote” or “carried interest”). The concern is that a loan to the partnership might defer or accelerate—and thereby decrease or increase the amount of—the promote. However, a partner’s insistence on using loans to the non-contributing partner may conflict with the other partner’s desire (and sometimes even its own desire, but for the economics) to use loans to the partnership for other reasons. Fortunately, in many deals, it may be possible to resolve this conflict. This Article will explain how after a brief discussion of the points listed above.

**CREDIT OF BORROWER**

From a credit standpoint, to whom would a partner prefer to lend its money? The partnership or the other partner? The answer may, of course, depend on the facts of the particular deal.

- If the partnership were in economic trouble with little or no equity, but the other partner had (or was willing to provide a guaranty from an affiliate with) a substantial liquid net worth, it may seem obvious that a loan to the other partner would be the better choice. However, in many partnerships, each partner uses a special purpose entity (“SPE”) with no meaningful assets other than its interest in the partnership (and is not willing to provide guaranties from creditworthy affiliates); consequently, the other partner may have equally doubtful credit whenever the partnership does.

- If the other partner is not an SPE, there may be other creditors competing for the partner’s assets. While a partner may have some control over creditor relationships of the partnership and whether and when the partnership will file bankruptcy, it may have no such control over
the other partner. And the last thing a partner wants is to be making a loan to a bankrupt partner and to become an unsecured creditor in the borrowing partner’s bankruptcy. These objections can be mitigated if a security interest is granted in the borrowing partner’s interest in the partnership, but all too often (in the author’s experience) these security interests are not granted until (or they spring into life only when) the loan to the non-contributing partner is made, and then it may be too late. It is possible to grant a security interest at the outset, but frequently one of the partners may not want to do so.

- Finally, with a loan to the partnership, if the amount is significant enough, it may be possible (under certain circumstances and subject to certain risks) to obtain a mortgage on partnership real estate (so that the lending partner is not only ahead of creditors of the non-contributing partner, but also creditors of the partnership).

For these reasons, many partners prefer to make their loans to the partnership.

**ENFORCEMENT**

Is a loan to a partner easier to enforce than a loan to the partnership? In particular, does the fact that the lending partner is on both sides of a loan to the partnership (as the lender to, and as a partner in, the borrower) create an irreconcilable conflict of interest? Fortunately, both the Delaware Revised Uniform Limited Partnership Act (“DRULPA”) and Delaware Limited Liability Company Act (“DLLCA”) provide that such loans may be made:

Except as provided in [the partnership agreement/a limited liability company agreement], [a partner/a member or manager] may lend money to . . . [the limited partnership/a limited liability company] and, subject to other applicable law, has the same rights and obligations with respect [thereto/to any such matter] as a person who is not a [partner/member or manager].

The dual role of the lending partner in a loan to the partnership may, however, make this loan alternative seem more cumbersome, especially when the partners want to allow for maturity or acceleration prior to liquidation of the partnership, cure rights or equity conversion rights. But it may be possible to address these problems with appropriate drafting (e.g., the partnership agreement could provide that the lending partner may not be required to tender its share of a loan to the partnership and treat the lending partner’s payment to itself as a paper transaction that occurs automatically and simultaneously with the payment by the other partner). Moreover, if the non-contributing partner has no assets other than its interest in the partnership (as is often, if not usually, the case), then a loan to that partner keeps the lending partner one step removed from the underlying assets that are the ultimate source of its recourse. Much has been written about the limited remedies (charging orders) of unsecured creditors of a partner; the solutions to these problems (including obtaining a security interest) are not free from risk (e.g., the uncertainty of the commercially reasonable requirement for a UCC foreclosure). Additional enforcement issues may depend on the facts (e.g., if there are more than two partners, a loan to a partner might not look as attractive if other partners may also enforce rights against the non-contributing partner that diminish its interest through, for example, dilution or loss or reduction of promote distributions).
Do either of the loan alternatives conflict with the contractual obligations of the partners or the partnership? A key factor to consider here is "indebtedness" restrictions which have become more and more common in secured real estate loans. If the partnership is, or is going to be, a borrower under a secured real estate loan, then it should attempt to carve out from the indebtedness restrictions loans by a partner to the partnership in accordance with the partnership agreement. Some lenders will accede to this request; some won’t. There may not be such a limitation in the case of a partner loan to a partner (although indebtedness and other SPE restrictions sometimes apply to more than one level of ownership); but if a security interest is granted in the borrowing partner’s interest in the partnership, the granting of the security interest or the foreclosure of that security interest or both may be prohibited by the transfer and encumbrance restrictions of the loan documents unless an exception is negotiated. Similarly, contractual restrictions in other documents (e.g., ground leases and development agreements) should be considered to make sure they don’t restrict the partner loan choice or choices under the partnership agreement. In some transactions it may be possible to use wholly owned subsidiaries to insulate the partnership from indebtedness and other SPE restrictions (which might otherwise be violated by a loan to a partnership), but they may not help with internal transfer restrictions (which might still be violated by a secured loan to a partner).

**Tax**

In the author’s experience, tax is usually not the driving force in choosing between the two loan types. Nonetheless, there may be some tax points to consider. For example:

- The interest income received under either loan type is ordinary income, which could be disadvantageous to a taxable investor to the extent the interest replaces a return that could (if the amount of the loan were funded instead as a capital contribution) otherwise be capital gain. When this is a problem, it is a bigger problem with a loan to the partnership (than a loan to a partner) if the corresponding interest expense is not currently deductible because the loan amount is the entire capital call (rather than just the non-contributing partner’s share); and hence the amount of taxable interest income may be proportionately larger.

- There could be liability allocation/basis issues because a loan to a partner will not provide the lending partner basis in its partnership interest (while a loan to the partnership might).

- There could be issues for partners (or direct or indirect owners of partners) who are subject to the UBTI rules. For example, if a partner is a pension fund that must be fractions rule compliant, it may be concerned about (1) a loan by the other partner to the partnership constituting “partner nonrecourse debt” as to which 100% of the losses would be allocated to the other partner (because allocation may result in a violation of the fractions rule), or (2) a possible recharacterization of a loan to the partnership as a preferred contribution to the partnership that may result in violation of the fractions rule.

- There could be issues for partners (or direct or indirect owners of partners) who are subject to the REIT rules. For example, partner loans may be securities for purposes of the 10% single issuer limitation that prohibits REITs from owning more than 10% of the securities
of certain entities. A loan to the partnership is more likely to be exempt from this test than a loan to the partner.

In any case, the partners should provide tax counsel with all the facts and circumstances to evaluate the alternatives from a tax standpoint.

**ACCOUNTING**

Like tax, accounting is not likely to be a determinative factor, but it should not be overlooked. Among other matters:

- If net worth is important to the partnership, then a loan to the non-contributing partner may be better than a loan to the partnership because a loan to the non-contributing partner creates additional net worth while a loan to the partnership does not: if the lending partner makes a loan to the partnership, it should have no immediate effect on the net worth of the partnership because the liability of the loan should be offset by the asset value of the loan proceeds; however, a loan to the other partner should increase the net worth of the partnership to reflect the contributions of the partners (recognizing that the loan proceeds are being used by the other partner to make a pro rata contribution alongside the lending partner, and there is no offsetting liability assumed by the partnership). In other words, if a capital call were funded by pro rata capital contributions, there would be an additional net worth cushion as a result of the additional contributions, and this benefit is preserved with a loan to the non-contributing partner (which results in pro rata additional contributions), but is lost with a loan to the partnership (which results in no additional contributions).

- Sometimes tax and accounting goals conflict. For example, current earnings recognition may be important enough to motivate decisions, even if contrary to short-term or long-term goals, including minimizing taxes. Might a lending partner who is a public corporation opt for a loan to the other partner so it can report higher profits by not increasing the losses allocated to it (even though that increased loss allocation might reduce the lending partner’s income taxes, as discussed earlier)?

- Might a lending partner choose a loan to the other partner to avoid acquiring control (with more than 50% of the debt and equity investment of the partners in the partnership) for fear of being forced to consolidate?

Before reaching a final conclusion, it may be worthwhile to check with an accounting expert.

**ECONOMICS**

What about the economics? Does one loan type provide more or less cash to the lending partner than the other type does? It may. To appreciate the potential differences, consider two types of partnerships between an investor and an operator:

- first, a straight-up partnership (where all contributions and distributions are made in the same fixed percentages); and
second, a partnership with a promote structure (where for simplicity, it will be assumed that each distribution is made first in accordance with partnership percentages until all capital contributions have been recouped together with a return at a specified “Hurdle Rate”, and then after that “hurdle”30 is achieved, the balance is distributed in a different ratio because a portion of it is paid to the operator as a promote).

The question is whether the net cash received by a partner under the partnership agreement is different depending on whether the lending partner makes a loan to the non-contributing partner (of the non-contributing partner’s share of a capital call) or makes a loan to the partnership (of the entire capital call). To put this question in a manageable and easily understandable context, some definitions and assumptions may help.

**Assumptions.** Unless otherwise stated, it will be assumed that: (a) there is a partnership between two partners (the investor and the operator); (b) they are to make contributions in accordance with their “Partnership Percentages” (which are fixed percentages set forth in the partnership agreement); (c) the partnership agreement provides that if one partner fails to contribute its share of a capital call, then the other partner may advance the non-contributing partner’s share and either (i) treat the entire amount advanced as a loan to the partnership earning a specified “Loan Rate” (which is a simple annual interest rate)31 and payable prior to any distributions, or (ii) treat the non-contributing partner’s share as a loan to the non-contributing partner which is used by the non-contributing partner to fund its share (with the understanding that such loan earns simple annual interest at the Loan Rate and is payable out of the first distributions to the non-contributing partner), and (d) there are no partner loans other than as described in the preceding clause.

**Source of Repayment.** Also, for simplicity and to make sure we are comparing apples to apples, it is assumed in this Article that either loan type is repaid as and when cash is available to the partnership to make distributions and repay partner loans to the partnership (“Available Cash”). More specifically, it is assumed that a loan to the partnership would be repaid only from Available Cash before any distributions, and that a loan to a partner would be repaid only from the next distributions of Available Cash to the borrowing partner.

**Net Cash Receipts (or “NCR”).** The net cash received by a partner under the partnership agreement which is to be compared under the two loan alternatives will be called “Net Cash Receipts,” or “NCR,” and will be defined as the amounts received by a partner as (x) distributions from the partnership (after deducting the payments, if any, such partner makes under any loan made to it by the other partner), (y) loan repayments, if any, from the partnership, and (z) loan repayments, if any, from the other partner (paid out of the other partner’s distributions).

**STRAIGHT-UP PARTNERSHIP**

In a “straight-up” partnership (i.e., where all contributions and distributions are to be made in the same fixed proportions), each partner’s Net Cash Receipts should be the same under the two loan alternatives:

- with a loan to the partnership, the lending partner is bearing its Partnership Percentage of the loan and is effectively paying itself (from what it would otherwise have received as distributions) all loan payments other than the principal and interest attributable to the
non-contributing partner's share of the loan. As a consequence, the loan payments attributable to the lending partner's share of the capital call simply replace and offset an equal amount of distributions and therefore the only additional Net Cash Receipts received by the lending partner (and the only Net Cash Receipts no longer received and retained by the non-contributing partner) are the loan payments attributable to the non-contributing partner's share of the loan; and

- this is the same increase in Net Cash Receipts to the lending partner (and the same decrease in Net Cash Receipts to the non-contributing partner) that occurs when the lending partner simply makes a loan to the non-contributing partner for the non-contributing partner's share of the capital call. See Appendices A and B for more details.

Both options may nonetheless be offered because there may be other reasons (e.g., bankruptcy concerns) to prefer one alternative over the other.

**PROMOTE STRUCTURE**

Life is not so simple when there is a promote, which is often the case. In this context, the two loan alternatives may yield different amounts of Net Cash Receipts for each partner. As a result, a loan to the partnership may be borne disproportionately by one of the partners. The issue revolves around the promote. Through the promote, the operator typically receives a disproportionately greater share of the upside after capital contributions have been recouped together with a return at some Hurdle Rate. It should therefore come as no surprise that a loan to the partnership that replaces capital (which would otherwise accrue a return at the Hurdle Rate) will usually benefit the operator if the Loan Rate is less than the Hurdle Rate and will usually benefit the investor if the Loan Rate is greater than the Hurdle Rate. This result holds regardless of who the lending partner is.

Appendices C and D provide examples using a 50/50 partnership, a 10% Hurdle Rate, a 20% promote, and a $200 capital call that is funded entirely by one of the partners as a loan to the partnership and repaid one year later.

- When the loan is made with a 5% Loan Rate, the additional Net Cash Receipts resulting from the loan are $104 if the investor makes the loan and $106 if the operator makes the loan. Thus, in this example, it is as though (from an economic standpoint) the investor made a $100 loan to the operator using a 4% Loan Rate, but the operator made a $100 loan to the investor using a 6% loan rate! Regardless of who makes the loan, the operator comes out 1% ahead: in effect, it is a lender at 1% more than the stated rate and a borrower at 1% less than the stated rate. See Appendix C for more details.

- When the loan is made with a 15% Loan Rate, the additional Net Cash Receipts resulting from the loan are $116 if the investor makes the loan and $114 if the operator makes the loan. Thus, in this example, it is as though (from an economic standpoint) the investor made a $100 loan to the operator using a 16% Loan Rate, but the operator made a $100 loan to the investor using a 14% loan rate! Regardless of who makes the loan, the investor comes out 1% ahead: in effect, the operator is a lender at 1% more than the stated rate and a borrower at 1% less than the stated rate. See Appendix D for more details.
See Appendix E for a more in-depth discussion of the impact on Net Cash Receipts of a loan to the partnership in a partnership with a promote structure.

**LOAN ALTERNATIVES**

The disparities described above are arguably nothing more than a reflection of the inherent disproportionality of a promote structure:

- the operator is getting a disproportionately larger amount of the surplus distributions (i.e., distributions in excess of what is required to achieve the hurdle) due to its promote;
- in terms of whole dollars, less surplus distributions means less promote and more surplus distributions means more promote; and
- given the priority of financing, if a loan replaces capital contributions, then a Loan Rate that is less than the Hurdle Rate translates to more surplus distributions and therefore more promote and a Loan Rate that is more than the Hurdle Rate translates to less surplus distributions and therefore less promote.

This impact on the promote holds regardless of whether the financing is provided by a third party or a partner; and it may come into play whenever the partnership requires capital. For example, some partnership agreements provide that when additional capital is required, the partnership will seek third party financing, and may go on to provide that if acceptable third party financing is not available and only one of the partners is able and willing to contribute its share, then that partner may provide the requisite financing to the partnership at a pre-agreed Loan Rate. From the operator’s perspective, if the Loan Rate is less than the Hurdle Rate, then the loan will provide a welcome benefit regardless of which partner provides it; but if the Loan Rate is more than the Hurdle Rate, then the operator will not welcome the impact on its promote, especially if it is the lending partner. If the operator is the lending partner, it may prefer, from an economic standpoint, to lend only the investor’s share to the investor in order to leave its promote unaffected. Making sure the lending partner has either loan alternative as an option may be an acceptable solution to the operator (assuming it is comfortable that it can avoid a loan to the partnership by the investor by simply not defaulting). But what if there are non-economic reasons why the operator would prefer to make a loan to the partnership? Is it possible to use a loan to a partnership that results in the same Net Cash Receipts (assuming payment) to each partner as a loan to a partner? Such a solution may be available, under certain circumstances, by modifying the hurdle calculation, as described below.

**THE HURDLE CALCULATION**

In the discussion of promote structures above, the partner loan (whether to the partnership or the other partner) is not taken into account in the hurdle calculation. In other words, partner loans (whether to the partnership or the other partner) may have a Loan Rate that is higher or lower than the Hurdle Rate and there is no compensating credit for a lower Loan Rate and no compensating debit for a higher Loan Rate that would ensure that all capital, including amounts advanced as loans, have received a return equal to (but no more and no less than) the Hurdle Rate before promote distributions are made. Many, if not most, partnership agreements reviewed by the author have been drafted in a manner that is consistent with that assumption: the hurdle has been based on
contributions and distributions and does not address other cash flows, like loan advances and loan payments. But as indicated in a prior article, the investor on occasion may want to include some loans (when the Loan Rate is less than the Hurdle Rate) in the hurdle calculation to avoid diluting its return. By the same token, the operator might want to include some loans (when the Loan Rate is greater than the Hurdle Rate) in the hurdle calculation to avoid inflating the investor’s return. What is appropriate will depend on the transaction.

Loan to a Partner. In the case of a loan to a partner, the borrowing partner is receiving matching distributions alongside the lending partner before the promote distributions, which (under the promote structure described above) include a return equal to the Hurdle Rate on (in addition to the return of) the amounts borrowed from the investor. If the lending partner wants to earn no less than the Hurdle Rate on the money it loans, it would be easiest to make sure the Loan Rate is no less than the Hurdle Rate. Similarly, if the borrowing partner does not want the lending partner to earn more than the Hurdle Rate on the money it borrows, it should simply make sure the Loan Rate is no greater than the Hurdle Rate. However, Loan Rates for default loans may be expected to exceed the Hurdle Rate.

Loan to the Partnership. A simple adjustment to the Loan Rate doesn’t work so well for a loan to the partnership because it may affect the timing and amount of the promote. Is there a way to structure a loan to the partnership without changing the promote? In fact, it may be possible, in many deals, to do so by replicating the hurdle calculation used for a loan to a partner. Basically, for purposes of the hurdle calculation, treat each partner’s Partnership Percentage of the loan advance (regardless of who made it) in the same way as a contribution by that partner and each partner’s Partnership Percentage of the loan payments in the same way as distributions to that partner. If the hurdle calculation is based solely on the investor’s contributions and distributions, then treat the investor’s Partnership Percentage of the loan advance (regardless of who made it) the same as a contribution by the investor and the investor’s Partnership Percentage of the loan payments the same as distributions to the investor. In other words, even though a partner elects to make a loan to the partnership, the partners are treated, solely for purposes of the hurdle calculation, as though the lending partner elected to make a loan to the other partner. See Appendices C and D for examples of the proposed solution.

**CONCLUSION**

Partner loans to a partnership or the other partner may be a useful way to provide capital to a partnership that the other partner is unwilling or unable to fund. By making a loan rather than a contribution, it is easy for the partners to keep the partners’ respective shares of contributions consistent and also allow for preferential treatment of the loan advance. Some thought should go into the decision of whether to include one or both of these loan alternatives in the partnership agreement and when to use them. This Article has focused on some of the considerations to be taken into account in choosing one alternative over the other under certain circumstances.
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<tr>
<th>Credit/BK</th>
<th>Loan to Partner</th>
<th>Loan to Partnership</th>
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<td></td>
<td>Harder to prevent BK of borrower; BK remoteness not bulletproof; if SPE, no credit beyond deal.</td>
<td>Easier to prevent bankruptcy of borrower; no credit beyond deal; if amount is large enough and no other debt, mortgage could be considered.</td>
</tr>
<tr>
<td>Enforcement</td>
<td>Charging order issues for unsecured lending partner; even with security interest, UCC foreclosure may be challenging.</td>
<td>Cumbersome to draft because of dual role of lending partner.</td>
</tr>
<tr>
<td>Contractual Restrictions</td>
<td>Transfer/encumbrance restrictions in partnership mortgage loan or other documents may prohibit loan to partner (especially if there is grant or foreclosure of security interest) unless carve-out is negotiated.</td>
<td>Indebtedness restrictions in partnership mortgage loan documents likely to prohibit loan to partnership unless carve-out is negotiated or subsidiary structure used.</td>
</tr>
<tr>
<td>Tax</td>
<td>Interest is ordinary income (which could be a concern to taxable partners if it replaces distributions that would otherwise be capital gain); lending partner gets no basis from loan to partner; for partners with special tax issues (e.g., REITs) there may be other concerns.</td>
<td>More debt so ordinary income issue may be magnified if interest expense is not currently deductible; lending partner may get basis from loan to partnership; and it may be easier to get exemption for REIT 10% single issuer limitation.</td>
</tr>
<tr>
<td>Accounting</td>
<td>Liability on borrowing partner’s balance sheet; partnership’s net worth is increased by amounts advanced (as contributions) pursuant to capital call; avoid increasing allocation of losses? avoid consolidation issues?</td>
<td>Liability on partnership’s balance sheet; partnership’s net worth is not increased by amounts advanced (as loan) pursuant to capital call; increase allocation of losses? consolidation issues?</td>
</tr>
<tr>
<td>Economics</td>
<td>Promote not changed.</td>
<td>In many partnership agreements, promote may be deferred or accelerated if Loan Rate is more or less than Hurdle Rate.</td>
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</table>

The best outcome for any particular partnership and partner will depend on the facts. In the author’s experience, some partners would prefer to use a partner loan to the non-contributing partner because they don’t want to defer (and decrease) or accelerate (and increase) the promote distributions. However, assuming the partnership’s lenders permit it, some partners prefer a loan to the partnership for other reasons (e.g., because it may mitigate issues a contributing partner might otherwise have with the non-contributing partner’s creditors, and in particular, problems arising from the non-contributing partner’s bankruptcy). This Article has explained how these conflicting concerns may both be addressed, under certain circumstances (if both partners are willing to accept the economic results of a loan to a partner), by using a hybrid: using a loan to the partnership but altering the hurdle calculation so that it operates in the same manner as it would for a loan to the non-contributing partner. 38

WORD COUNT: 14,471
APPENDICES

Appendix A  – Straight-Up Partnership – Specific Example
Appendix B  – Straight-Up Partnership – More Generalized Fact Pattern
Appendix C  – Illustration of Promote Impact on NCR (Loan Rate < Hurdle Rate)
Appendix D  – Illustration of Promote Impact on NCR (Loan Rate > Hurdle Rate)
Appendix E  – Promote Impact on NCR
Appendix F  – Sample Available Cash Allocation Provisions
Appendix G  – Change in Promote and in Operator NCR
Appendix H  – Issue 2: Loan Required Available Cash
Appendix I  – Change in Net Cash Receipts from Base Case
APPENDIX A

STRAIGHT-UP PARTNERSHIP – SPECIFIC EXAMPLE

This Appendix will provide an example to illustrate that a partner’s Net Cash Receipts are the same whether there is a loan to the non-contributing partner of the non-contributing partner’s share of the capital call or a loan to the partnership of the entire capital call.

HYPOTHETICAL FACTS FOR ALL APPENDICES

Unless otherwise stated, the examples in the Appendices to this Article will be based on the following hypothetical facts (which will later be expanded in Hypothetical Y to add a promote structure) and the assumptions stated in the body of this Article:

Hypothetical X. Assume the following facts: (a) there are only two capital calls, one at the outset and a subsequent capital call on the first anniversary; (b) there is only one distribution (or repayment of partner loans to the partnership) and it occurs on the second anniversary; and (c) the partners contribute the amount covered by the first capital call in accordance with Partnership Percentages and the second capital call is funded entirely by one of the partners.

EXAMPLE

Consider the specific facts of the following example:

Example A-1. Assume (a) the facts of Hypothetical X; (b) the two capital calls (which occur at the outset and on the first anniversary) are for $200 million each; (c) partner loans to the partnership are repaid, and distributions are made, only on the second anniversary, at which time there is at least $220 million of Available Cash; (d) Partnership Percentages are 50% for the investor and 50% for the operator; (e) distributions are to be made in accordance with Partnership Percentages; and (f) the Loan Rate is 10% per annum.

Under these facts, the amount of Net Cash Receipts the lending partner receives (after the other partner turns over any distributions it is required to turn over to repay a partner loan to it) is the same under either alternative:

<table>
<thead>
<tr>
<th>Loan of $100MM to Non-Contributing Partner</th>
<th>Loan of $200MM to Partnership</th>
</tr>
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<tbody>
<tr>
<td>Lending Partner</td>
<td>Lending Partner</td>
</tr>
<tr>
<td>Repayment of Partner Loan to Partnership</td>
<td>Other Partner</td>
</tr>
<tr>
<td>Distributions</td>
<td>$110</td>
</tr>
<tr>
<td>Repayment of Partner Loan to Other Partner</td>
<td>$110</td>
</tr>
<tr>
<td>Total Net Cash Receipts</td>
<td>$220</td>
</tr>
</tbody>
</table>
In either case, the first $220 million of Available Cash would ultimately end up with the lending partner so that it gets $220 million of Net Cash Receipts. The lending partner either gets 100% of the $220 million directly from the partnership or it gets 50% of it from its own distributions and 50% of it from the other partner’s distributions.

Did it matter that the Partnership Percentages were 50/50? No. The result would be the same for any Partnership Percentages. For a more generalized fact pattern, see Appendix B.

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APPENDIX B

STRAIGHT-UP PARTNERSHIP – MORE GENERALIZED FACT PATTERN

This Appendix will expand the analysis in Appendix A of Example A-1 to cover the more general facts of Hypothetical X. If the partnership contemplated by Hypothetical X is straight-up (so that distributions are also made in accordance with Partnership Percentages), then a partner’s Net Cash Receipts should be the same regardless of whether the loan is to the partnership or the other partner.

NOTATION

The following notation will be helpful in showing the allocation:

A. the aggregate amount of the first capital call
B. the aggregate amount of the second capital call
D. the amount of Available Cash as of the second anniversary
q. the lending partner’s Partnership Percentage
r. the Loan Rate
LRAC. the Loan Required Available Cash, which is explained in Appendix E

ALLOCATION

In light of the fact that all distributions are made in accordance with Partnership Percentages, the only portion of the Available Cash where the allocation might vary is the Loan Required Available Cash. But as indicated below, the amount and allocation of the Loan Required Available Cash (after taking into account the payment by a borrowing partner of any distributions to repay its partner loans) doesn’t vary under the two loan alternatives:

<table>
<thead>
<tr>
<th>Loan of B(1 - q) to Non-Contributing Partner</th>
<th>Loan of B to Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lending Partner</td>
<td>Other Partner</td>
</tr>
<tr>
<td>Repayment of Partner Loan to Partnership</td>
<td></td>
</tr>
<tr>
<td>Distributions</td>
<td>Bq(1 + r)</td>
</tr>
<tr>
<td>Repayment of Partner Loan to Other Partner</td>
<td>B(1 - q)(1 + r)</td>
</tr>
<tr>
<td>Net Cash Receipts</td>
<td>B(1 + r)</td>
</tr>
</tbody>
</table>

In either case, the lending partner ultimately receives the first B(1 + r) of Available Cash: in the case of the partner loan to the partnership, the lending partner receives 100% of this amount directly from the partnership; and in the case of the partner loan to the other partner, the lending partner receives q of this amount from its share of the distribution of B(1 + r) and (1 - q) of this amount from the other partner’s share of the distribution of B(1 + r).
OBSERVATION

Thus, in Hypothetical X, regardless of whether the loan is to the partnership or the other partner: \( LRAC = B(1 + r) \) and always goes entirely to the lending partner; and the balance of the Available Cash is distributed in accordance with Partnership Percentages.

* * *

15
APPENDIX C

ILLUSTRATION OF PROMOTE IMPACT ON NCR

Loan Rate < Hurdle Rate

This Appendix will show how the investor may bear a disproportionate burden of a loan to the partnership if the Loan Rate is less than the Hurdle Rate.

BACKGROUND

There may be a disparity in the treatment of the partners when there is an option to make a loan to the partnership for the entire capital call: the increase in Net Cash Receipts to the lending partner resulting from the Loan may vary depending on who made the Loan (even if the partners have equal Partnership Percentages). If the Loan Rate is less than the Hurdle Rate, then a loan to the partnership may cost the investor more than it costs the operator because of the operator’s promote. (Of course, if the Loan Rate is more than the Hurdle Rate, then a loan to the partnership may cost the operator more than it costs the investor, but that is another story which is illustrated in Appendix D.)

EXAMPLE

To see the discrepancy, consider the following example.

Example C-1. Assume (a) the facts of Hypothetical X in Appendix A, (b) each Partner’s Partnership Percentage is 50%, (c) any Available Cash is to be used first, to pay partner loans to the partnership, which have a simple annual loan rate of 5%, second, to make a 50/50 distribution to the partnership until investor has recouped its capital contributions and received a 10% simple annual return from these 50/50 distributions, and third, 20% to Operator as a promote with the remaining 80% being split equally, (d) there is a $200 million capital call at the outset that is funded by pro rata contributions, a $200 million capital call on the first anniversary, and no other contributions, and (e) there is $560 million of Available Cash on the second anniversary (but none before that).

BASE CASE – PRO RATA CONTRIBUTIONS (NO LOAN)

What happens to the $560 million of Available Cash if the second capital call is funded by pro rata contributions? Under the first level, there would be nothing to pay because there would be no loan to the partnership. Under the second level, $460 million would be distributed 50/50 (each partner getting 100 + 20 + 100 + 10 = 230). Of the $100 balance to be distributed under the third level, $20 million would be distributed as a promote, and the remaining $80 million would be split equally.

In sum:

Investor would get 230 + 40 + 0 = $270
Operator would get 230 + 40 + 20 = $290
Total $560
LOAN TO THE PARTNERSHIP

Now, what happens when the second capital call is funded 100% by one of the partners as a loan to the partnership?

If there is a loan to the partnership for the entire second capital call, then the lending partner gets $210 million under the first level. The investor's hurdle is $120 million so $240 million would be distributed under the second level; and of the $110 million balance, $22 million is paid under the third level as a promote and the $88 million balance is split equally. Thus,

- If investor were the lending partner:
  
  Investor would get: $210 + $120 + $44 + 0 = $374
  
  Operator would get: $0 + $120 + $44 + $22 = $186
  
  Total: $560

- If operator were the lending partner:
  
  Investor would get: $0 + $120 + $44 + 0 = $164
  
  Operator would get: $210 + $120 + $44 + $22 = $396
  
  Total: $560

Now, comparing these figures to the Base Case, we see the following skewed results:

<table>
<thead>
<tr>
<th></th>
<th>Investor</th>
<th>Operator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lending Partner</td>
<td>$374</td>
<td>$396</td>
</tr>
<tr>
<td>Base Case (no loan)</td>
<td>$270</td>
<td>$290</td>
</tr>
<tr>
<td>Additional Cash</td>
<td>$104</td>
<td>$106</td>
</tr>
</tbody>
</table>

Contrast these results with a loan to the non-contributing partner: the loan by the investor yields results that are similar to those resulting from a loan to the other partner with a simple annual interest rate of 4%, but the loan by operator yields results that are similar to those resulting from a loan to the other partner with a simple interest rate of 6%.

PROPOSED SOLUTION

What happens when a partner funds the entire capital call as a loan to the partnership under the proposed structure (under which the second level takes each partner's Partnership Percentage of the loan into account in the hurdle calculation in the same way it would if such partner had funded such amount as a capital contribution, but the lending partner still gets all the first-level payments and each partner is treated as having received a distribution equal to its Partnership Percentage of the first-level payments for purposes of the second-level hurdle calculation)?

The lending partner would get $210 million under the first level. Under the second level, the investor's hurdle would be $230 million less $105 million (its share of the $210 million) for a net hurdle of $125 million, so $250 million would be distributed under the second level; and of the remaining $100 million, $20 million would be distributed under the third level as a promote and the $80 million balance would be split equally so that:
If investor were the lending partner:

Investor would get 210 + 125 + 40 + 0 = $375
Operator would get 0 + 125 + 40 + 20 = $185
Total $560

And if operator were the lending partner:

Investor would get 0 + 125 + 40 + 0 = $165
Operator would get 210 + 125 + 40 + 20 = $395
Total $560

Here are the results:

<table>
<thead>
<tr>
<th></th>
<th>Investor</th>
<th>Operator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lending Partner</td>
<td>$375</td>
<td>$395</td>
</tr>
<tr>
<td>Base Case (no loan)</td>
<td>$270</td>
<td>$290</td>
</tr>
<tr>
<td>Additional Cash</td>
<td>$105</td>
<td>$105</td>
</tr>
</tbody>
</table>

In either case, the lending partner gets $105 million of additional distributions, which reflects the sum of a $100 million advance and $5 million of interest. These are the same economic results one achieves with a loan to the non-contributing partner.40

* * *
APPENDIX D

ILLUSTRATION OF PROMOTE IMPACT ON NCR

Loan Rate > Hurdle Rate

Appendix C showed how the operator may bear a disproportionate burden of a loan to the partnership when the Loan Rate is less than the Hurdle Rate. This Appendix will explain how a loan to the partnership may be borne disproportionately by the operator when the Loan Rate is greater than the Hurdle Rate.

EXAMPLE

To see the discrepancy when the Loan Rate is less than the Hurdle Rate, consider the following example.

Example D-1. Assume the same facts as Exhibit C-1, except that the Loan Rate is a 15% simple annual rate.

BASE CASE – PRO RATA CONTRIBUTIONS (NO LOAN)

The Base Case is the same as the Base Case under Appendix C because it doesn’t involve a loan.

LOAN TO THE PARTNERSHIP

What happens when the second capital call is funded 100% by one of the partners as a loan to the partnership?

If there is a loan to the partnership for the entire second capital call, then the lending partner gets $230 million under the first level. The investor’s hurdle is $120 million so $240 million would be distributed under the second level; and of the $90 million balance, $18 million is paid under the third level as a promote and the $72 million balance is split equally. Thus,

- If investor were the lending partner:

  Investor would get 230 + 120 + 36 + 0 = $386
  Operator would get 0 + 120 + 36 + 18 = $174
  Total $560

- And if operator were the lending partner:

  Investor would get 0 + 120 + 36 + 0 = $156
  Operator would get 230 + 120 + 36 + 18 = $404
  Total $560

Now, comparing these figures to the Base Case, we see the following skewed results:
Contrast these results with a loan to the non-contributing partner: the loan by investor yields results that are similar to those resulting from a loan to the other partner with a simple annual interest rate of 16%, but the loan by operator yields results that are similar to those resulting from a loan to the other partner with a simple interest rate of 14%.

**PROPOSED SOLUTION**

What happens when a partner funds the entire capital call as a loan to the partnership under the proposed structure (under which the second level takes each partner’s partnership percentage of the loan into account in the hurdle calculation in the same way it would if such partner had funded such amount as a capital contribution, but the lending partner still gets all the first-level payments and each partner is treated as having received a distribution equal to its partnership percentage of the first-level payments for purposes of the second-level hurdle calculation)?

The lending partner would get $230 million under the first level. Under the second level, the investor’s hurdle would be $230 million less $115 million (its share of the $230 million) for a net hurdle of $115 million, so $230 million would be distributed under the second level; and of the remaining $100 million, $20 million would be distributed under the third level as a promote and the $80 million balance would be split equally so that:

- **If investor were the lending partner:**
  
  Investor would get \(230 + 115 + 40 + 0\) = $385
  Operator would get \(0 + 115 + 40 + 20\) = $175
  Total $560

- **And if operator were the lending partner:**
  
  Investor would get \(0 + 115 + 40 + 0\) = $155
  Operator would get \(230 + 115 + 40 + 20\) = $405
  Total $560

Here are the results:

<table>
<thead>
<tr>
<th></th>
<th>Investor</th>
<th>Operator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lending Partner</td>
<td>$385</td>
<td>$405</td>
</tr>
<tr>
<td>Base Case (no loan)</td>
<td>$270</td>
<td>$290</td>
</tr>
<tr>
<td>Additional Cash</td>
<td>$115</td>
<td>$115</td>
</tr>
</tbody>
</table>
In either case, the lending partner gets $115 million of additional distributions, which reflects the sum of a $100 million advance and $15 million of interest. These are the same economic results one achieves with a loan to the non-contributing partner.
APPENDIX E

PROMOTE IMPACT ON NCR

This Appendix will further examine the potential disparities that may occur in a promote structure when there is a loan to the partnership. For purposes of the following discussion, the facts of Hypothetical X will be supplemented slightly to add a promote structure and to assume that the Available Cash is sufficiently large to reach the promote level (regardless of whether there is a loan to the partnership or a loan to the non-contributing partner, although Appendix I will provide some explanation of what happens when the Available Cash is not sufficient):

Hypothetical Y. Assume (a) the facts of Hypothetical X; (b) the Available Cash as of the second anniversary exceeds the amount required to repay all partner loans to the partnership and to make distributions sufficient to achieve the hurdle; and (c) Available Cash will be allocated in accordance with the cash allocation waterfall set forth as Alternative 1 of Appendix F, based on a specified “Hurdle Rate” and a specified “Promote Percentage”, which may be summarized as follows:

first, to repay all loans, if any, to the partnership by a partner, together with interest at the Loan Rate;

second, in accordance with their Partnership Percentages until the investor receives its contributions and a simple annual return thereon equal to the Hurdle Rate; and

third, the Promote Percentage to the operator as a promote and the balance to the Partners in accordance with their Partnership Percentages.

To be clear, in this cash allocation waterfall, partner loans are not taken into account in determining the hurdle balance (i.e., the partner loan advances are not treated in the same way as contributions so that, among other matters, promote distributions are not conditioned on there being any minimum return on loan advances under the second level).

Available Cash Required for Hurdle and Loan. To appreciate the differences between the two loan alternatives, it may be helpful to keep track of the following amounts:

- The “Hurdle Required Available Cash” (or “HRAC”) is the total amount of Available Cash that must be allocated to the partners (i.e., used to repay partner loans to the partnership and to make distributions) in order to achieve the hurdle as of a particular time (which is assumed in this Article to be the second anniversary).

- The “Loan Required Available Cash” (or “LRAC”) is the total amount of Available Cash that must be allocated to the partners (i.e., used to repay partner loans to the partnership or to make distributions) in order to repay all partner loans (either directly in the case of loans to the partnership or indirectly in the case of loans to a partner) as of a particular time (which is assumed in this Article to be the second anniversary).

Notation. To save space, the following notation (some of which was introduced in Appendix B) may be used:
A ................ the aggregate amount of the first capital call
B ................ the aggregate amount of the second capital call
D ................ the amount of Available Cash as of the second anniversary
h ............... the Hurdle Rate
p ............... the Promote Percentage
q ............... the investor’s Partnership Percentage
r ............... the Loan Rate
HRAC .......... the Hurdle Required Available Cash as of the second anniversary
LRAC .......... the Loan Required Available Cash as of the second anniversary

Issue 1: How Much Must Be Distributed/Paid Before Reaching Hurdle? The key difference between the two types of loans under Hypothetical Y (where there is a promote structure) is what happens to the amount of Hurdle Required Available Cash when the Loan Rate changes:

• with a loan to a partner, HRAC is constant regardless of the Loan Rate; but

• with a loan to the partnership, HRAC (and consequently the promote) varies as the Loan Rate varies.

As will be illustrated, when the Loan Rate exceeds the Hurdle Rate (i.e., when \( r > h \)) under the facts of Hypothetical Y, then HRAC is larger for a loan to the partnership, \( A(1 + 2h) + B(1 + r) \), than for a loan to a partner, \( A(1 + 2h) + B(1 + h) \). The increase is \( B(r - h) \). As a result, the promote is deferred and reduced in the distribution waterfall.43 Assuming distributions are sufficiently large, the reduction in the promote (when shifting from a loan to a partner to a loan to the partnership) equals the portion of the promote (when there is a loan to a partner) attributable to the increase in the Hurdle Required Available Cash, namely \( B(r - h)p \), and the operator’s net loss in distributions equals the investor’s Partnership Percentage of this promote loss, namely \( B(r - h)pq \). See Appendix G for more details.

Issue 2: How Much Must Be Distributed/Paid Before Loan Is Satisfied? Under the facts of Hypothetical X: LRAC = \( B(1 + r) \) for a straight-up partnership regardless of whether the loan is to the partnership or to the other partner, but when there is a promote structure as in Hypothetical Y, then LRAC may not always equal \( B(1 + r) \). LRAC differs from \( B(1 + r) \) only when there is a loan to a partner and only when \( r > h \) and \( B(1 + r) > HRAC \); in other words, the difference occurs only when the hurdle can be reached before the loan is repaid. Once the hurdle has been reached, the borrowing partner has more or less than its Partnership Percentage of the remaining distribution (due to the promote) to repay the loan. If distributions are sufficiently large, the reduction in the promote is again \( B(r - h)p \) (i.e., there is no additional promote loss from that described in the discussion of Issue 1 above). However, the solution suggested in this Article to address Issue 1 does not address Issue 2 and therefore Issue 2 might still be relevant. The good news is that, in many if not most deals, the likelihood is small (based on relative amounts that are likely to occur in practice) that LRAC does not equal \( B(1 + r) \). See Appendix H for further discussion of this issue. The remaining discussion in this Appendix will focus on Issue 1.

Illustrative Facts. To illustrate Issue 1 with more specifics, the following facts will be used:
Example E-1. Assume: (a) the facts of Hypothetical Y; (b) the two capital calls (which occur at the outset and on the first anniversary) are for $200 million each; (c) the sole distribution (which occurs on the second anniversary) is $560 million; (d) Partnership Percentages are 50% for the investor and 50% for the operator; and (e) the Hurdle Rate is 10% and the Promote Percentage is 20%, and consequently, the allocation of Available Cash may be summarized as follows:

*first*, to repay all loans, if any, to the partnership by a partner, together with interest at the Loan Rate;

*second*, 50/50 until the Investor receives its contributions and a 10% simple annual return thereon; and

*third*, 20% to the operator as a promote and the balance 50/50 (i.e., 40% to the investor and 60% to the operator).

**Loan to Partner**

What happens if there is a loan to a partner for its share of the second capital call?

Example E-2. Assume the facts in Example E-1 and the following: (a) the second capital call is funded entirely by the investor; and (b) the operator’s share of the second capital call is funded as a loan to the operator.

As indicated in the following charts, for Loan Rates of 0%, 10% and 20%, the Hurdle Required Available Cash will always be $460 million but the allocation of that amount will change.

<table>
<thead>
<tr>
<th>Interest-Free Loan to Operator (HRAC = 460)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
</tr>
<tr>
<td>$100</td>
</tr>
<tr>
<td>$100</td>
</tr>
<tr>
<td>$130</td>
</tr>
<tr>
<td>$40</td>
</tr>
<tr>
<td>$370</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>10% p.a. Loan to Operator (HRAC = 460)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
</tr>
<tr>
<td>$110</td>
</tr>
<tr>
<td>$110</td>
</tr>
<tr>
<td>$120</td>
</tr>
<tr>
<td>$40</td>
</tr>
<tr>
<td>$380</td>
</tr>
</tbody>
</table>
20% p.a. Loan to Operator (HRAC = 460)

<table>
<thead>
<tr>
<th>Investor</th>
<th>Operator</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$120</td>
<td>$120</td>
<td>$240</td>
</tr>
<tr>
<td>$120</td>
<td>-$120</td>
<td>$0</td>
</tr>
<tr>
<td>$110</td>
<td>$110</td>
<td>$220</td>
</tr>
<tr>
<td>$.40</td>
<td>$.60</td>
<td>$100</td>
</tr>
<tr>
<td>$390</td>
<td>$170</td>
<td>$560</td>
</tr>
</tbody>
</table>

To summarize:

$100 Million Loan to Partner
(with aggregate fundings of $300MM by investor and $100MM by operator, but aggregate contributions of $200MM by each of them)

<table>
<thead>
<tr>
<th>Simple Interest Rate</th>
<th>NCR to Investor</th>
<th>NCR to Operator</th>
<th>NCR to Partners</th>
<th>HRAC</th>
<th>LRAC</th>
<th>Promote*</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>$370</td>
<td>$190</td>
<td>$560</td>
<td>$460</td>
<td>$200</td>
<td>$20</td>
</tr>
<tr>
<td>10%</td>
<td>$380</td>
<td>$180</td>
<td>$560</td>
<td>$460</td>
<td>$220</td>
<td>$20</td>
</tr>
<tr>
<td>20%</td>
<td>$390</td>
<td>$170</td>
<td>$560</td>
<td>$460</td>
<td>$240</td>
<td>$20</td>
</tr>
</tbody>
</table>

*Promote = 20% ($560 million - HRAC)

Under the more generalized facts of Hypothetical Y, if the loan is made to the non-contributing partner, then all funds advanced by the contributing partner are ultimately contributed (the loan proceeds being used by the non-contributing partner to contribute its share of the second capital call), the loan is a matter between the partners, and the Hurdle Required Available Cash is determined without reference to the loan. Indeed, as the definition indicates, the Hurdle Required Available Cash takes into account repayment of partner loans to the partnership, but does NOT take into account partner loans to a partner. Thus, if the loan is made to the other partner, then the amount of Hurdle Required Available Cash should always be as follows: HRAC = A(1 + 2h) + B(1 + h), which is independent of the Loan Rate (r). This amount may be shared differently depending on the Loan Rate: a higher Loan Rate will result in a larger share of Available Cash for the lending partner (because more distributions to the borrowing partner will be diverted to the lending partner to pay the loan). However, because the hurdle is independent of the loan and the Loan Rate, the promote will remain constant and equal p(D - HRAC), which, of course, has nothing to do with the Loan Rate (r).

**LOAN TO PARTNERSHIP**

To repeat, when there is a loan to a partner under the facts of Example E-1, different Loan Rates may impact the allocation of Hurdle Required Available Cash; but the amount of Hurdle Required Available Cash, and hence the timing and amount of the promote distributions, is not affected. By contrast, a loan to the partnership under the facts of Example E-1 may impact the amount of Hurdle Required Available Cash and therefore the timing and amount of the promote distributions: a loan to the partnership may accelerate or defer the promote depending on whether the Loan Rate is less or more than the Hurdle Rate, respectively.
**Example E-3.** Assume the facts in Example E-1 and the following: (a) the second capital call is funded entirely by the investor, and (b) the entire amount of the second capital call is funded as a loan from the investor to the partnership.

The consequences of 0%, 10% and 20% Loan Rates under Example E-3 are indicated in the following charts.

<table>
<thead>
<tr>
<th>Interest-Free Loan to Partnership (HRAC = 440)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
</tr>
<tr>
<td>$200</td>
</tr>
<tr>
<td>$120</td>
</tr>
<tr>
<td>$ 48</td>
</tr>
<tr>
<td>$368</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>10% p.a. Loan to Partnership (HRAC = 460)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
</tr>
<tr>
<td>$220</td>
</tr>
<tr>
<td>$120</td>
</tr>
<tr>
<td>$ 40</td>
</tr>
<tr>
<td>$380</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>20% p.a. Loan to Partnership (HRAC = 480)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
</tr>
<tr>
<td>$240</td>
</tr>
<tr>
<td>$120</td>
</tr>
<tr>
<td>$ 32</td>
</tr>
<tr>
<td>$392</td>
</tr>
</tbody>
</table>

To summarize:

<table>
<thead>
<tr>
<th>$200 Million Loan to Partnership</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(with aggregate fundings of $300MM by investor and $100MM by operator, but aggregate contributions of $100MM by each of them)</td>
<td></td>
</tr>
<tr>
<td>Simple Interest Rate</td>
<td>NCR to Investor</td>
</tr>
<tr>
<td>----------------------</td>
<td>----------------</td>
</tr>
<tr>
<td>0%</td>
<td>$368</td>
</tr>
<tr>
<td>10%</td>
<td>$380</td>
</tr>
<tr>
<td>20%</td>
<td>$392</td>
</tr>
</tbody>
</table>

*Promote = 20% ($560 million - HRAC)

Under the more generalized facts of Hypothetical Y, if the loan is made to the partnership, then

\[
HRAC = A(1 + 2h) + B(1 + r),
\]

which is dependent on the Loan Rate \((r)\). Consequently, the promote, \(p(D - HRAC)\), will also be dependent on the Loan Rate \((r)\).
THE DIFFERENCE

Under Example E-2, the loan to the partner did not change the promote (regardless of the Loan Rate), which was $20 million in all cases considered. However, under Example E-3, the loan to the partnership did change the promote: the interest savings or additional interest cost (when compared to the 10% Loan Rate) resulted in a shift of an equal amount between the 50/50 second level distributions and the third-level distributions where the promote is paid, so that the promotes for 0%, 10% and 20% simple annual interest rates would be $24, $20 and $16 million, respectively, and the net whole dollar gain or loss to the operator would be $2, $0 or -$2 million, respectively.

Under the more generalized facts of Hypothetical Y, the promotes compare as follows:

**Loan to Partner Promote:**

\[ p(D - HRAC) = \frac{p(D - [A(1 + 2h) + B(1 + h)])}{p(D - [A(1 + 2h) + B(1 + h)])}, \]

which is independent of the Loan Rate \(r\).

**Loan to Partnership Promote:**

\[ p(D - HRAC) = [p(D - [A(1 + 2h) + B(1 + r)])], \]

which is dependent on the Loan Rate \(r\).

The difference in promote when a loan to the partnership is used instead of a loan to the non-contributing partner is

\[ pB(r - h) \]

which may be positive or negative depending on whether the Loan Rate \(r\) is more or less than the Hurdle Rate \(h\).

See Appendix G for further detail.

* * *

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APPENDIX F

SAMPLE AVAILABLE CASH ALLOCATION PROVISIONS

This Appendix will set forth two sample (rather than model) partnership agreement Available Cash allocation provisions for the facts of Hypothetical Y using a preferred return/return of capital hurdle. For purposes of these provisions, "Available Cash" is defined to mean cash available to the Partnership, after all third-party expenses have been paid and reasonably adequate reserves have been set aside, to repay loans by a Partner to the Partnership or to make distributions to the Partners.

1. HURDLE NOT INCLUDING LOANS

Available Cash. All Available Cash shall be allocated as follows:

first, to repay all loans to the Partnership by a Partner, together with interest at the Loan Rate (it being understood that if there is more than one such loan outstanding, the loans will be repaid pro rata in accordance with the relative balances of outstanding principal and interest);

second, pro rata to the Partners in accordance with their Partnership Percentages until Investor has received under this second level an amount equal to all of its contributions to the Partnership and a simple annual return thereon equal to the Hurdle Rate; and

third, the Promote Percentage to Operator as a promote and the balance to the Partners in accordance with their Partnership Percentages.

2. HURDLE INCLUDING INVESTOR'S CONTRIBUTION SHARE OF INVESTOR LOANS TO PARTNERSHIP

The following formulation differs from the first alternative above where indicated (underscoring indicates additions and strike-through indicates deletions):

Available Cash. All Available Cash shall be allocated as follows:

first, to repay all loans to the Partnership by a Partner, together with interest at the Loan Rate (it being understood that if there is more than one such loan outstanding, the loans will be repaid pro rata in accordance with the relative balances of outstanding principal and interest);

second, pro rata to the Partners in accordance with their Partnership Percentages until Investor has received an amount under this second level an amount equal to which, when added to Investor's Partnership Percentage of the allocation under the first level above, equals the sum of all of its contributions by Investor and Investor's Partnership Percentage of all partner loans to the Partnership and a simple annual return thereon equal to the Hurdle Rate; and

28
third, the Promote Percentage to Operator as a promote and the balance to the Partners in accordance with their Partnership Percentages.

* * *

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APPENDIX G

CHANGE IN PROMOTE AND IN OPERATOR NCR

This Appendix will show that under the facts of Hypothetical Y, when Available Cash is sufficiently large to reach the hurdle regardless of whether there is a loan to the partnership or a loan to a partner, then the loss or gain in promote (as a result of shifting from a loan to a partner to a loan to the partnership) is $B(r - h)p$, and the net loss or net gain in Net Cash Receipts to the operator is $B(r - h)pq$.

PRELIMINARY OBSERVATIONS

The difference in promote is relatively obvious when one considers the amount of Available Cash under Hypothetical Y required to reach the hurdle, which is $B(1 + r) + A(1 + 2h)$ for a loan to the partnership and $B(1 + h) + A(1 + 2h)$ for a loan to a partner. The difference between these amounts of Available Cash is


Thus, there is $B(r - h)$ more (if $r > h$) or less (if $r < h$) Available Cash to be distributed after the hurdle when there is a loan to the partner under the facts of Hypothetical Y. This translates to a promote differential of $B(r - h)p$. It may also be obvious that the loss or gain in Net Cash Receipts to the operator is the investor's share of this promote differential, but this will be spelled out in detail below.

NOTATION

To do this, let $ONCR_{0i}$ and $ONCR_{1o}$ represent the total Net Cash Receipts to the operator under Hypothetical Y when there is a loan to a partner ($ONCR_{0i}$ for a loan from the operator to the investor and $ONCR_{1o}$ for a loan from the investor to the operator) and let $ONCR_{0p}$ and $ONCR_{1p}$ represent the total distributions to the operator under Hypothetical Y when there is a loan to the partnership ($ONCR_{0p}$ for a loan from the operator to the partnership and $ONCR_{1p}$ for a loan from the investor to the partnership). The cases where the operator is the lending partner and where the investor is the lending partner will be considered separately.
OPERATOR IS LENDING PARTNER

If \( D \geq A(1 + 2h) + B(1 + r) > B(1 + r) \) and \( D \geq A(1 + 2h) + B(1 + h) \)

\[
\text{Loan Repayment} + \text{Share of Hurdle} + \text{Share of Residual}
\]

\[
\begin{align*}
\text{ONCR}_{\text{OP}} &= B(1 + r) + (A[1 + 2h] + B[1 + h])(1 - q) + (D - [A(1 + 2h) + B(1 + h)])(p + [1 - p][1 - q]) \\
\text{ONCR}_{\text{OR}} &= B(1 + r) + A(1 + 2h)(1 - q) + (D - [A(1 + 2h) + B(1 + r)])(p + [1 - p][1 - q]) \\
\text{ONCR}_{\text{OR}} - \text{ONCR}_{\text{OP}} &= B(1 + r)(q - 1) + B[1 + h](1 - q) - B(1 + h) \cdot [1 + r](p + [1 - p][1 - q]) \\
&= B(h - r)(1 - q) + B(r - h)(p + [1 - p][1 - q]) \\
&= B(r - h)(p + [1 - p][1 - q]) \\
&= B(r - h)(1 - q) \\
&= B(r - h)p
\end{align*}
\]

INVESTOR IS LENDING PARTNER

If \( D \geq A(1 + 2h) + B(1 + r) > B(1 + r) \) and \( D \geq A(1 + 2h) + B(1 + h) \)

\[
\begin{align*}
\text{Share of Hurdle} + \text{Share of Residual} - \text{Loan Repayment}
\end{align*}
\]

\[
\begin{align*}
\text{ONCR}_{\text{IO}} &= (A[1 + 2h] + B[1 + h])(1 - q) + (D - [A(1 + 2h) + B(1 + h)])(p + [1 - p][1 - q]) - B(1 + r)(1 - q) \\
\text{ONCR}_{\text{IP}} &= A(1 + 2h)(1 - q) + (D - [A(1 + 2h) + B(1 + r)])(p + [1 - p][1 - q]) - 0^V \\
\text{ONCR}_{\text{IO}} - \text{ONCR}_{\text{IP}} &= B(1 + h)(1 - q) - B(1 + r)(1 - q) - [B(1 + h) - B(1 + r)](p + [1 - p][1 - q]) \\
&= B(h - r)(1 - q) + B(r - h)(p + [1 - p][1 - q]) \\
&= B(r - h)(p + [1 - p][1 - q]) \\
&= B(r - h)(1 - q) \\
&= B(r - h)p
\end{align*}
\]

\[
\text{ONCR}_{\text{IO}} - \text{ONCR}_{\text{IP}} = B(1 + h)(1 - q) - B(1 + r)(1 - q) - [B(1 + h) - B(1 + r)](p + [1 - p][1 - q]) \\
= B(h - r)(1 - q) + B(r - h)(p + [1 - p][1 - q]) \\
= B(r - h)(p + [1 - p][1 - q]) \\
= B(r - h)(1 - q) \\
= B(r - h)p
\]

\[
1/ \text{Loan is repaid directly by the partnership.}
\]

\*[ 
\* 
\* 
\* 

31
APPENDIX H

ISSUE 2: LOAN REQUIRED AVAILABLE CASH

Assuming the facts of Hypothetical Y, this Appendix will discuss when the LRAC for a loan to the partnership, namely \( B(1 + r) \), might differ from the LRAC for a loan to a partner (i.e., when LRAC does not equal \( B(1 + r) \)).

OVERVIEW

It will be seen that LRAC differs from \( B(1 + r) \) under Hypothetical Y only when the loan is to a partner (rather than the partnership) and the Loan Rate exceeds the Hurdle Rate (i.e., \( r > h \)). In fact, it is not enough for \( r > h \) to ensure that LRAC will not equal \( B(1 + r) \). The following stronger inequality must hold: \( B(1 + r) > HRAC \). In fact, it will be clear that (assuming there is a loan to the partner):

\[
LRAC \neq B(1 + r) \iff B(1 + r) > HRAC
\]

It will be shown that if this stronger inequality (i.e., \( B(1 + r) > HRAC \)) holds, then \( B(1 + r) \) will be more than or less than LRAC depending on whether the loan is to the operator or the investor, respectively. The conclusion that will be reached may be summarized as follows:

<table>
<thead>
<tr>
<th>( B(1 + r) &gt; HRAC )</th>
<th>( \Rightarrow )</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan to Operator</td>
<td>( B(1 + r) &gt; LRAC &gt; HRAC )</td>
</tr>
<tr>
<td>Loan to Investor</td>
<td>( LRAC &gt; B(1 + r) &gt; HRAC )</td>
</tr>
</tbody>
</table>

To show the relationships in the above chart, it will be assumed that \( B(1 + r) > HRAC \), and the formulations that will be derived below for LRAC (based on this assumption) will make it obvious that \( LRAC > HRAC \), so it will be apparent that HRAC will be the smallest of the three quantities (regardless of the recipient of the loan), which leaves only the question of the relative order of \( B(1 + r) \) and LRAC. The discussion below will make clear that under these facts, \( B(1 + r) \) is more than LRAC for a loan to the operator and less than LRAC for a loan to the investor.

SOME PRELIMINARY OBSERVATIONS

HRAC. Remember that HRAC is the cash needed to pay off partner loans to the partnership and to make the distributions needed to achieve the hurdle. It does not take into account partner loans to a partner. Thus, HRAC is easy to determine under the facts of Hypothetical Y regardless of whether the loan is to the partnership or the other partner:

<table>
<thead>
<tr>
<th>Loan to Partnership</th>
<th>Loan to Partner</th>
</tr>
</thead>
<tbody>
<tr>
<td>HRAC</td>
<td>( A(1 + 2h) + B(1 + r) )</td>
</tr>
<tr>
<td></td>
<td>( A(1 + 2h) + B(1 + h) )</td>
</tr>
</tbody>
</table>
Loan to Partnership. Both LRAC and HRAC are easy to determine when there is a loan to the partnership under the facts of Hypothetical Y:

<table>
<thead>
<tr>
<th>Loan to Partnership</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>LRAC</td>
<td>B(1 + r)</td>
</tr>
<tr>
<td>HRAC</td>
<td>A(1 + 2h) + B(1 + r)</td>
</tr>
</tbody>
</table>

LRAC for Loan to Partner. It is more difficult, however, to describe LRAC succinctly if there is a loan to a partner. If one assumes a typical range of loan rates, then LRAC is likely to be the same as it is for a loan to the partnership, namely B(1 + r). In fact, this equality holds whenever B(1 + r) is less than or equal to HRAC. To see this, recall that, as long as there are pro rata distributions (in accordance with the partners’ Partnership Percentages), it was shown in Appendix A that under the facts of Hypothetical X, LRAC = B(1 + r). It follows that if B(1 + r) ≤ HRAC under the facts of Hypothetical Y, then (there will be pro rata distributions of B(1 + r), which will clearly result in the payoff of the loan so) LRAC = B(1 + r). However, if B(1 + r) > HRAC, then a loan to a partner will not be repaid before there are promote distributions and a description of LRAC will therefore depend on whether the loan is made to the operator or to the investor. The balance of this Appendix will examine both cases. Note that B(1 + r) > HRAC only when r > h and the loan is to a partner, so the discussion below will focus on situations where the Loan Rate exceeds the Hurdle Rate (i.e., r > h) and the loan is to a partner.

Promote Structure – When r > h

When the Loan Rate is greater than the Hurdle Rate (i.e., r > h), then LRAC = B(1 + r) for a loan to the partnership, but it could be equal to, less or more than B(1 + r) for a loan to a partner, depending on whether B(1 + r) > HRAC and which partner is the borrowing partner:

- If B(1 + r) ≤ HRAC, then as noted above, LRAC = B(1 + r).
- If the hurdle were reached before the loan were repaid (i.e., if B(1 + r) > HRAC) and the operator were the borrowing partner, then the remaining portion of the loan would be repaid from more than the operator’s Partnership Percentage of the distributions (because of the promote) in which event the total cash required to pay off the loan would be less (i.e., LRAC < B(1 + r));
- Similarly, if the hurdle were reached before the loan were repaid (i.e., if B(1 + r) > HRAC) and the investor were the borrowing partner, then the investor’s share of remaining distributions would be smaller than its Partnership Percentage (because of the promote), so a lesser amount of every dollar distributed would be applied against the loan and therefore LRAC would exceed B(1 + r) (i.e., LRAC > B(1 + r)).

Next, a formulation for LRAC in each of the last two cases will be determined.

Loan to Operator – When B(1 + r) > HRAC

If r > h and either r is large enough or B is large enough relative to A, or both, then a loan to the operator may not be repaid when the hurdle is achieved. In other words, B(1 + r) may exceed
HRAC = A(1 + 2h) + B(1 + h). In that event, the operator will start getting its promote before the loan is repaid and will then have a larger proportion of the cash to repay the balance of the loan (so that it will repay the loan before B(1 + r) has been distributed). Instead of its (1 - q) Partnership Percentage, its share will be increased by reason of the promote (p) to p + (1 - q)(1 - p). At this point, the loan balance immediately before the allocation of Available Cash, (1 - q)B(1 + r), has been paid down by (1 - q)HRAC, so that the remaining balance is (1 - q)(B[1 + r] - HRAC), and the following amount must be distributed to the partners to enable the operator to pay that amount: (1 - q)(B(1 + r) - HRAC)/[p + (1 - q)(1 - p)]).

Thus,

$$LRAC = HRAC + (1 - q)(B(1 + r) - HRAC)/[p + (1 - q)(1 - p)] < B(1 + r)$$

**Loan to Investor – When B(1 + r) > HRAC**

If r > h and either r is large enough relative to h or B is large enough relative to A, or both, then a loan to the investor may also not be repaid when the hurdle is achieved. In other words, B(1 + r) may exceed HRAC = A(1 + 2h) + B(1 + h). In that event, the operator will start getting its promote before the loan is repaid and the investor will then have a smaller proportion of the cash to repay the balance of the loan (so that it will repay the loan after B(1 + r) has been distributed). Instead of its q Partnership Percentage, its share will be decreased by reason of the promote (p) to q(1 - p). At this point, the loan balance immediately before the allocation of Available Cash, qB(1 + r), has been paid down by qHRAC, so that the remaining balance is qB[1 + r] - HRAC), and the following amount must be distributed to the partners to enable the investor to pay that amount: (B(1 + r) - HRAC)/(1 - p) = (B[1 + r] - HRAC)/(1 - p).

Thus,

$$LRAC = HRAC + (B[1 + r] - HRAC)/(1 - p) > B(1 + r)$$

**Observation**

The deferral of the promote from a loan to the partnership does not occur only when B(1 + r) > HRAC for a loan to a partner. Even when B(1 + r) is the same as or is less than HRAC for both loan types (as it is in Examples E-2 and E-3 in Appendix E), the HRAC (and accordingly the promote) may differ. See Issue 1 in Appendix E. In fact, it is not the cause of any additional promote disparity. Moreover, as indicated below, it is unlikely that B(1 + r) > HRAC.

**Likelihood of B(1 + r) > HRAC**

The discussion above indicates how to calculate LRAC for a loan to a partner when B(1 + r) > HRAC (i.e., when a loan to a partner will not be repaid until after the hurdle is achieved). How likely is this event (under the assumed facts of Hypothetical Y)? As noted earlier, it is impossible for the hurdle to be achieved before the loan is repaid unless r > h. If r > h, then it is unlikely that B and r would be large enough so that B(1 + r) > HRAC. To see this, observe that B(1 + r) > HRAC $$\iff r > h + (1 + 2h)A/B.$$ Now, assume for the sake of argument and simplicity that h = 0, recognizing that this will make the floor for r smaller. Then r > A/B. In many, if not most, deals seen by the author, subsequent contributions are dwarfed by the initial acquisition contribution, representing only a small fraction of the initial contribution. But again, for the sake of argument,
assume that B can be up to two times as large as A: B ≤ 2A so that A/B ≥ 1/2. Then r > A/B ≥ 50%, which is much higher than any loan rate the author has seen. It therefore would appear that the premise, B(1 + r) > HRAC, is also unlikely.57

**ILLUSTRATION**

**Example H.1.** Assume the facts of Example E-2, except that the loan rate is 160%58 (so that the outstanding balance of the $100 million loan to the non-contributing partner is $260 million after one year). Then B(1 + r) = 260% of $200 million = $520 million. As illustrated below, LRAC is $10 million less than $520 million ($510 million) if the loan is to the operator and $15 million more than $520 million ($535 million) if the loan is to the investor.

<table>
<thead>
<tr>
<th>160% p.a. Loan to Operator</th>
<th>(B(1 + r) = 520; LRAC = 510; HRAC = 460)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
<td>Operator</td>
</tr>
<tr>
<td>$230</td>
<td>$230</td>
</tr>
<tr>
<td>$230</td>
<td>-$230</td>
</tr>
<tr>
<td>$ 20</td>
<td>$ 30</td>
</tr>
<tr>
<td>$ 30</td>
<td>-$ 30</td>
</tr>
<tr>
<td>$ 20</td>
<td>$ 30</td>
</tr>
<tr>
<td>$530</td>
<td>$ 30</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>160% p.a. Loan to Investor</th>
<th>(LRAC = 535; B(1 + r) = 520; HRAC = 460)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
<td>Operator</td>
</tr>
<tr>
<td>$230</td>
<td>$230</td>
</tr>
<tr>
<td>-$230</td>
<td>$230</td>
</tr>
<tr>
<td>$ 30</td>
<td>$ 45</td>
</tr>
<tr>
<td>-$ 30</td>
<td>$ 30</td>
</tr>
<tr>
<td>$ 10</td>
<td>$ 15</td>
</tr>
<tr>
<td>$ 10</td>
<td>$550</td>
</tr>
</tbody>
</table>

Had there been a loan to the partnership, $520 million would have been distributed to pay the loan, the remaining $40 million would have been divided equally and the promote would have been $0. Regardless of whether one compares this result to a loan to the other partner made by the investor or the operator, the loan to the partnership results in a promote loss of $20 million (20%[D - HRAC]) and the reduction in the operator’s Net Cash Receipts is the investor’s share of the lost promote, namely $10 million (50% of $20 million): if the loan is to the operator, the operator receives $20 million instead of $30 million; and if the loan is to the investor, then the operator receives $540 million ($520 million plus $20 million) instead of $550 million.
The chart below summarizes the alternative possible amounts of LRAC under Hypothetical Y along with the amounts for HRAC:

<table>
<thead>
<tr>
<th>LRAC and HRAC under Hypothetical Y</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Loan to Partnership</strong></td>
</tr>
<tr>
<td>B(1 + r) ≤ HRAC</td>
</tr>
<tr>
<td><strong>LRAC</strong></td>
</tr>
<tr>
<td>B(1 + r)</td>
</tr>
<tr>
<td><strong>HRAC</strong></td>
</tr>
<tr>
<td>A(1 + 2h) + B(1 + r)</td>
</tr>
</tbody>
</table>

1/ Note that \( r \leq h \Rightarrow B(1 + r) \leq HRAC \), and that this inequality holds whenever \( r \leq h \). Even if \( r \) is greater than \( h \), this inequality may still (and for typical values of \( r \), and a typical ratio of \( B \) to \( A \), is likely to) hold.

2/ This amount is less than \( B(1 + r) \).

3/ This amount is more than \( B(1 + r) \).

* * *
APPENDIX I

CHANGE IN NET CASH RECEIPTS FROM BASE CASE

This Appendix will summarize (under the facts of Hypothetical Y) the difference between the NCR to each partner with a loan to the partnership or a loan to one of the partners, on the one hand, and the NCR to that partner when there is no loan (i.e., when each partner contributes its share of the second capital call), on the other hand. First, it will be assumed that \( r \leq h \) and then it will be assumed that \( h \leq r \). For each of these alternatives, the results for various amounts of total distributions are outlined and then there is a chart showing the difference between the amount of NCR each partner receives with a loan to the partnership, on the one hand, and the amount of NCR such partner receives when there is a loan to one of the partners. As will be seen, the difference (denoted as \( \Delta \)) is the same regardless of which partner is the lending partner.

\[
\begin{align*}
\text{Case 1.1 Assumption: } D &\leq B(1+r) (\leq B(1+h)) \\
\text{Case 1.2 Assumption: } B(1+r) &< D \leq A(1+2h) + B(1+r) (\leq A(1+2h) + B(1+h)) \\
\text{Case 1.3 Assumption: } A(1+2h) + B(1+r) &< D \leq A(1+2h) + B(1+h) \\
\text{Case 1.4 Assumption: } (A(1+2h) + B(1+r)) &\leq A(1+2h) + B(1+h) < D
\end{align*}
\]

\[\Delta\] Between Loan to Partnership vs. Loan to Partner

<table>
<thead>
<tr>
<th>As Borrower or Lender</th>
<th>Case 1.1/Case 1.2</th>
<th>Case 1.3</th>
<th>Case 1.4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
<td>0</td>
<td>- ((D - [A(1+2h) + B(1+r)])pq)</td>
<td>- ((B(h - r)pq))</td>
</tr>
<tr>
<td>Operator</td>
<td>0</td>
<td>((D - [A(1+2h) + B(1+r)])pq)</td>
<td>((B(h - r)pq))</td>
</tr>
</tbody>
</table>
\( h \leq r \)

**Case 2.1** Assumption: \( D \leq \min(B(1+r), A(1+2h) + B(1+h)) \)

<table>
<thead>
<tr>
<th>Investor Loan to Operator</th>
<th>Investor Loan to Partnership</th>
<th>Operator Loan to Investor</th>
<th>Operator Loan to Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
<td>( D(1 - q) )</td>
<td>- ( D )</td>
<td>- ( D )</td>
</tr>
<tr>
<td>Operator</td>
<td>- ( D(1 - q) )</td>
<td>( D )</td>
<td>( D )</td>
</tr>
</tbody>
</table>

**Case 2.2** Assumption: \( B(1+r) < D \leq A(1+2h) + B(1+h) \)

<table>
<thead>
<tr>
<th>Investor Loan to Operator</th>
<th>Investor Loan to Partnership</th>
<th>Operator Loan to Investor</th>
<th>Operator Loan to Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
<td>( B(1+r)(1-q) )</td>
<td>- ( B(1+r)q )</td>
<td>- ( B(1+r)q )</td>
</tr>
<tr>
<td>Operator</td>
<td>- ( B(1+r)(1-q) )</td>
<td>( B(1+r)q )</td>
<td>( B(1+r)q )</td>
</tr>
</tbody>
</table>

**Case 2.3** Assumption: \( A(1+2h) + B(1+h) < D \leq B(1+r) \)

<table>
<thead>
<tr>
<th>Investor Loan to Operator</th>
<th>Investor Loan to Partnership</th>
<th>Operator Loan to Investor</th>
<th>Operator Loan to Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
<td>( D(1 - q) )</td>
<td>- ( Dq )</td>
<td>- ( Dq )</td>
</tr>
<tr>
<td></td>
<td>( (D - [A(1+2h)+B(1+h)])pq )</td>
<td>( Dq )</td>
<td>( (D - [A(1+2h)+B(1+h)])pq )</td>
</tr>
<tr>
<td>Operator</td>
<td>- ( D(1 - q) )</td>
<td>( Dq )</td>
<td>( (D - [A(1+2h)+B(1+h)])pq )</td>
</tr>
</tbody>
</table>

**Case 2.4** Assumption: \( \max(B(1+r), A(1+2h) + B(1+h)) < D \leq A(1+2h) + B(1+r) \)

<table>
<thead>
<tr>
<th>Investor Loan to Operator</th>
<th>Investor Loan to Partnership</th>
<th>Operator Loan to Investor</th>
<th>Operator Loan to Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
<td>( B(1+r)(1-q) )</td>
<td>- ( B(1+r)q )</td>
<td>- ( B(1+r)q )</td>
</tr>
<tr>
<td></td>
<td>( (D - [A(1+2h)+B(1+h)])pq )</td>
<td></td>
<td>( (D - [A(1+2h)+B(1+h)])pq )</td>
</tr>
<tr>
<td>Operator</td>
<td>- ( B(1+r)(1-q) )</td>
<td>( B(1+r)q )</td>
<td>( B(1+r)q )</td>
</tr>
</tbody>
</table>

**Case 2.5** Assumption: \( (A(1+2h)+B(1+h)) \leq A(1+2h) + B(1+r) < D \)

<table>
<thead>
<tr>
<th>Investor Loan to Operator</th>
<th>Investor Loan to Partnership</th>
<th>Operator Loan to Investor</th>
<th>Operator Loan to Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
<td>( B(1+r)(1-q) )</td>
<td>- ( B(1+r)q )</td>
<td>- ( B(1+r)q )</td>
</tr>
<tr>
<td></td>
<td>( (B(r-h))pq )</td>
<td></td>
<td>( (B(r-h))pq )</td>
</tr>
<tr>
<td>Operator</td>
<td>- ( B(1+r)(1-q) )</td>
<td>( B(1+r)q )</td>
<td>( B(1+r)q )</td>
</tr>
<tr>
<td></td>
<td>- ( (B(r-h))pq )</td>
<td></td>
<td>( (B(r-h))pq )</td>
</tr>
</tbody>
</table>

\( \Delta \) Between Loan to Partnership vs. Loan to Partner

<table>
<thead>
<tr>
<th>As Borrower or Lender</th>
<th>Case 1.1/Case 1.2</th>
<th>Case 2.3/Case 2.4</th>
<th>Case 2.5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
<td>0 ( (D - [A(1+2h)+B(1+h)])pq )</td>
<td>( B(r-h)pq )</td>
<td></td>
</tr>
<tr>
<td>Operator</td>
<td>0 ( - (D - [A(1+2h)+B(1+h)])pq )</td>
<td>( - B(r-h)pq )</td>
<td></td>
</tr>
</tbody>
</table>

* * *
This Article applies equally to limited liability companies, but for convenience partnership terminology will be used. Also, some of the concepts will apply to ventures involving more than two parties but such ventures are more complicated; for simplicity, this Article will assume, unless otherwise stated, that there are only two parties.

In the author’s experience, partnership agreements typically provide that the contributing partner’s advance of the non-contributing partner’s share will be treated in one of the following ways (and when more than one option is provided, the contributing partner usually may choose): (1) as a loan to the partnership, as described in the body of this Article, (2) as a loan to the non-contributing partner, as described in the body of this Article, or (3) as a contribution to the partnership, in which event either (a) the entire amount advanced by the contributing partner is treated as a special preferred contribution (which earns a preferred return) so the partners’ respective shares of regular contributions stay in sync or (b) there is some adjustment of the partnership percentages. There are obviously many similarities between the loan to the partnership alternative and the special preferred contribution alternative, but there are also differences. The special preferred contribution and dilution alternatives will be addressed in a subsequent article.

Of course, if there has previously been dilution, then the originally contemplated contribution sharing percentages may have changed and if the dilution is punitive, then the new sharing percentages may no longer match the ratio of actual contributions (and even if there is pro rata dilution, the sharing percentages may not match the ratio of outstanding capital and accrued return).

See immediately preceding endnote. Also, note that it is possible to loan only the non-contributing partner’s share to the partnership, but then the lending partner will have made a disproportionate amount of contributions (as a result of the contribution of its share of the capital call without a matching contribution by the other partner). This additional contribution may be addressed in a number of ways (as an alternative to treating it as a loan to the partnership) including (1) making it a preferred contribution that is recouped (possibly with a return) before other contributions, or (2) implementing a dilution formula that adjusts the allocations for some or all distributions (e.g., providing that all contributions, possibly with a return, are returned proportionately based on the relative shares of outstanding capital, and any accrued and unpaid return, before other distributions are made). The first alternative is generally not as attractive as a loan to the partnership because it is simpler to treat both portions of the capital call the same way. The second alternative is also more complicated than a loan to the partnership and is undesirable when the contributing partner does not want to implement a dilution remedy (e.g., because there is a risk the partnership won’t have the money to repay all contributions).

The amount of the loan to the non-contributing partner might not always equal the non-contributing partner’s share of the capital call if the partnership agreement allows the non-contributing partner to make a partial contribution and then allows the contributing partner to contribute only the remaining deficiency: if a partner contributes some but not all of its share of a capital call, then the amount of a deficiency loan to that partner will obviously be less than the non-contributing partner’s full share of the capital call. For simplicity, it is assumed in this Article that partial contributions are not allowed.

It is possible to include bankruptcy-remote requirements in the partnership agreement, but these are not as common in partnership agreements as they are in loan agreements; moreover, a veto power in a partnership agreement that limits the authority of the partnership to file bankruptcy may be more reliable and easier to obtain than effective contractual bankruptcy-remote requirements, which may be violated (e.g., a springing recourse guaranty may not be helpful if the guarantor runs into financial difficulties and the non-contributing partner files bankruptcy) and may be subject to coercion and other defenses. See, for example, Paul J. Pascuzzi & Christopher D. Crowell, Just Say No to Bankruptcy: Courts Enforce Provisions in Organizational Documents Restricting Ability to Seek Bankruptcy Protection, BUSINESS LAW NEWS (State Bar of CA, Issue 1, 2012), at 25, 25–28, which, although it addresses certain bankruptcy-remote (organizational document) requirements imposed by lenders, provides useful background. It is possible, of course, that the non-contributing partner makes or orchestrates an involuntary filing in an attempt to get around the authority limits on a voluntary filing. See 11 U.S.C. § 303(b) (2012). However, such circumvention may be suggestive of bad faith and has been the basis for dismissal in at least one case (where the partnership apparently had no equity). See In re Global Ship Systems, LLC, 391 B.R. 193 (Bankr. S.D. Ga. 2007).

See, e.g., Limited Liability Company Agreement of NTE Mobility Partners Holding LLC (Draft dated Nov. 25, 2008) § 3.3(c), available at http://ftp.dot.state.tx.us/pub/txdot-info/ftw/nte/34.pdf (“To the extent permitted under any Financing Documents, if a Lending Member makes a Default Loan, the Defaulting Member shall be deemed to have... granted to such Lending Member a continuing first priority security interest in, all of the Defaulting Member’s Membership Interest to secure... such Default Loan...”).
A mortgage in favor of a partner may not be practical unless the partnership does not have or anticipate third-party financing; if it does, third-party lenders may not be willing to permit such a mortgage (and if they do, the lender is likely to require a subordination agreement). Moreover, although the partnership and LLC Acts may permit loans by members or partners to the limited liability company or partnership, that doesn’t mean they are free from risk (e.g., recharacterization or equitable subordination claims), so priority over partnership creditors is by no means assured. See, e.g., Joe Basile, Ron Landen & Rose Constance, Equitable (In)subordination — Considerations for Sponsors Lending to Portfolio Companies, VC EXPERTS (Feb. 2010) § 10.11.3.d, available at http://www.weil.com/files/upload/VCExperts.pdf. Subject to the equitable subordination and recharacterization risks, the lending partner would be ahead of unsecured partnership creditors and subordinate secured partnership creditors. However, if there are other secured partnership creditors, then it may be difficult for a lending partner to obtain a mortgage.

Del. Code tit. 6, § 17-107 (2012) (DRULPA); Del. Code tit. 6, § 18-107 (2012) (DLLCA). These statutes don’t eliminate all issues posed by the conflict of interest, but they are a good start. The right to make a capital deficit loan to the partnership is typically an express right set forth in the partnership agreement, which is also helpful. Such a provision may “help to protect a general partner from a claim that its participation . . . involved a conflict of interest. . . . Further, to the extent that a general partner owes a fiduciary duty, such a provision affords the general partner additional protection to the extent that the general partner relies in good faith on such authorizing provisions and acts in accordance with such provisions.” Martin I. Lubaroff & Paul M. Altman, Lubaroff & Altman on Delaware Limited Partnerships (Aspen Publishers/Wolters Kluwer, Supp. 2012) § 4.26, at 4-37. Note that the limitation “subject to other applicable law” also appears in Section 107 of the Revised Uniform Limited Partnership Act (RULPA) but not in Section 112 of the Uniform Limited Partnership Act (2001) (ULPA). See also, Revised Uniform Partnership Act (RUPA) § 404(f) (1997); Uniform Limited Liability Company Act (ULLCA) § 409(f) (2006). At least two authors suggest that “other applicable law” in RULPA (1985) refers to “nonpartnership law restrictions.” Larry E. Ribstein & Robert R. Keatinge, Ribstein and Keatinge on Limited Liability Companies (2nd ed., West/Thomson Reuter, June 2012), Vol. 1, § 5.9 at 255. In discussing the corresponding LLC statutes, the same authors indicate that the effect of these statutes “is unclear. They probably do not deal with partners’ duties among themselves, but rather clarify that members and managers are treated like other firm creditors from the standpoint of debtor-creditor law.” Id. § 9.8 at 503. The comment to Section 112 of ULPA (2001) states that “[i]t has no impact on a general partner’s . . . duty of loyalty [including] refraining from acting as or for an adverse party[] and means rather that this Act does not discriminate against a creditor . . . that happens also to be a partner.” The “other applicable law” may also include the RULPA “prohibition on distributions that leave the partnership insolvent.” ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP (Wolters Kluwer), Vol. IV, § 15.16(e), n. 58 at 15:194 (Release No. 4 — 1998-1 Supp.)

See, e.g., BROMBERG & RIBSTEIN, supra note 8, Vol. 1, § 3.05(d)(i) at 3:97 (Release No. 30 – 2011-1 Supp.) (“Although the U.P.A. nowhere says that a charging order is the exclusive process for a partner’s individual creditor, the courts have generally so interpreted it.”); Id. Vol. IV, § 13.07(d) at 13:48–13:49 (Release No. 7 – 1992-2 Supp.) (“First, U.L.P.A. §22(3) explicitly states that the charging order remedy ‘shall not be deemed exclusive’ . . . . But despite the explicit nonexclusive language, some courts (as in general partnerships) construe the charging order as the exclusive remedy of a creditor of a limited partner against the partner’s interest.”); RIBSTEIN AND KEATINGE, supra note 8, Vol. 1, § 7:8 at 322–323 (“Most LLC statutes make clear that unsecured judgment creditors of a member can obtain from a court a charging order, against an LLC member’s interest. . . . [I]t is not clear under LLC statutes whether other remedies, including garnishment, are also available, or whether the charging order is the exclusive remedy . . . .”) (footnotes omitted); Lubaroff & Altman, supra note 8, § 6.11 at 6-28 (“Most important, Section 17-703(d) states that the entry of a charging order is the exclusive remedy by which a judgment creditor of a partner or of a partner’s assignee may satisfy a judgment out of the judgment debtor’s partnership interest.”); William S. Forberg, Asset Protection and the Limited Liability Company: Not the Panacea of Creditor Protection That You Might Think!, PROBATE & PROPERTY (Nov./Dec. 2009) at 39, 39 (“The general rule under most state LLC statutes is that if a judgment creditor of an LLC member attempts to seize the LLC member’s membership interest, or the LLC assets, the judgment creditor’s only remedy is a ‘charging order.’ The charging order limits a judgment creditor’s remedies against the LLC member by prohibiting the creditor from seizing or selling the LLC member’s membership interest and also—and equally as important—from seizing or selling the LLC’s assets. The judgment creditor simply becomes an ‘assignee’ of the LLC. The charging order remedy is therefore a significant collection roadblock to the judgment creditor.”); Christopher M. Riser, Asset Protection Basics: Using Partnerships and LLCs, THE PRACTICAL REAL ESTATE LAWYER (Vol. 24, No. 1, Jan. 2008) at 27, 28 (“A creditor of a member of an LLC is entitled only to a charging order, rather than being entitled to execute
directly against LLC assets."); Thomas E. Rutledge, Foreclosure and Dissolution Rights of a Member's Creditors: No Cause for Alarm, PROBATE & PROPERTY (May/June 2007) at 35, 40 ("[T]he assets of the business organization . . . generally are not available to satisfy the creditors of the owners.").

11 The charging order may be less of a concern for a lending partner than an outside creditor, particularly if there are only two partners, as has been assumed in this Article; among other matters, the lending partner may already have control over the partnership or the partnership agreement may strip the borrowing partner of its control rights in the event of a failure to make the relevant contribution that gave rise to the partner loan.

See, e.g., James D. Prendergast, Real Estate Mezzanine Lending Collateral Foreclosure, THE PRACTICAL REAL ESTATE LAWYER (Vol. 27, No. 6, Nov. 2011) at 11, 26 ("[T]he legal standard for a personal property foreclosure is not set forth in the U.C.C. with much specificity, but is based on the amorphous standard of "commercial; reasonableness," whatever that may mean from time to time.").

13 Another possible consideration might be whether it would be easier to avoid usury and other local state law issues by using one form of loan instead of the other. For example, it may not make much difference when using a Delaware limited partnership or limited liability company in California (unless in the context of an LLC, "internal affairs" are not construed to cover a loan by a member to the LLC which, according to § 18-107 of the Delaware LLC Act quoted earlier in the body of this Article, is to be treated like a loan from a third party (see Del. Code tit. 6, § 18-107 (2012) (DLLCA)): “The laws of the state . . . under which a foreign limited partnership is organized govern relations among . . . and between the partners and the . . . partnership . . . .” (Cal. Corp. Code Ann. § 15909.01(a) (2012)); "Subject to . . . Section 17453: (a) The laws of the state . . . under which a foreign limited liability company is organized shall govern its organization and internal affairs . . . ." (Cal. Corp. Code Ann. § 17450 (2012)). Query whether the internal affairs statutes would preclude a borrowing partner from asserting that the lending partner failed to comply with lender licensing statutes?

14 See, e.g., John N. Oest, Negotiating the Loan Commitment: The Borrower’s Perspective, BUSINESS LAW TODAY (ABA, Jan./Feb. 2010) at 61, 63 ("Lenders never want to compete with other creditors. Accordingly, loan agreements typically forbid other indebtedness (anti-debt restrictions) . . . [subject to negotiated exceptions]."); Joseph Philip Forte, Topsy-Turvy: The World of Commercial Real Estate Finance Turned Upside Down, REAL ESTATE LAW & INDUSTRY REPORT (BNA, Mar. 2012) at 180, 183 ("All of the rating agencies define an SPE by the same simple formulation as an entity that engages in no other business . . . , owns no other property . . . , and incurs no debt other than the mortgage loan and the entity covenants to those three continuing for the life of the loan. . . . SPE covenants provide that the owner of the financed asset . . . cannot incur debt or other liabilities (other than customary property-related trade credits) that could result in a lien or claim against the asset . . . .") (emphasis added); see also id. at 183, nn. 17 & 19 (citing Fitch and S&P criteria); Michael T. Madison, Jeffrey R. Dwyer & Steven W. Bender, THE LAW OF REAL ESTATE FINANCING, Vol. 2 (Thomson Reuters/West, rev. ed. 2012) § 13:38 at 13-70 ("Bankruptcy-remote structures . . . [include] the use of covenants to preserve the borrower as a single asset, single purpose borrower . . . [which, in turn,] often include those that prohibit the borrower from incurring other debt (with exceptions of ordinary course trade payables and equipment financing) . . . ."); Michael T. Andrew, et al., CALIFORNIA REAL ESTATE FINANCE PRACTICE: STRATEGIES AND FORMS, Vol. 2 (CEB, Janis LaRoche Blanchet, Bonnie C. Maly & Donald R. Briggs, eds., as updated Mar. 2012), § 10.19 at 827.7 ("Most securitizing mortgage lenders allow the SPE borrowers . . . to incur only three kinds of debt: (1) senior debt owed to that lender; (2) liabilities owed to known tenants under their approved leases; and (3) trade debt incurred in the ordinary course operation of the leveraged property."); id. § 10.29 at 874, clause g (providing sample negative SPE covenants).

15 Query whether even an unsecured loan to a partner would violate the transfer restrictions in a mortgage loan because there is arguably a transfer of the borrowing partner’s distributions (assuming all distributions to the borrowing partner must be paid to the lending partner until the loan is repaid, as is typically the case)?

16 For example, it may be necessary to capitalize construction-period interest under the Internal Revenue Code. See 26 U.S.C. §§ 263A(f) & 460(c)(3) (2012); see also Dominick L. Daher & Salvador D. Aceves, Interest Expense Deductions, 536-3RD TAX MGMT. PORTFOLIOS (2007) § VIB. However, although partnership loan interest might, under certain circumstances, be capitalized as construction-period interest, this seems less likely with a loan to a partner. There is also the possibility of limits to deductibility for investment interest in either case. See 26 U.S.C. § 163(d)(1). But even if the interest expense is deductible, it is possible that the lending partner’s share of the deduction may be less than the lending partner’s share of the income attributable to the increase in the loan amount to cover the lending partner’s share of the capital call in a loan made to the partnership.

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See Treas. Reg. § 1.752-1(a)(1) to -1(a)(2) (1991). For example, if a 5% partner funds 100% of the amount necessary to pay off a matured nonrecourse mortgage loan and 95% is treated as a loan to the 95% partner, then the 95/5 allocation of liability (and corresponding basis in their partnership interests) previously associated with the debt may not change, whereas a loan to the partnership may shift to the 5% partner all the liability (and basis) previously attributable to the partnership’s debt. If the 5% partner must bring in other capital to pay off the mortgage loan, that capital source may insist on getting the basis associated with the money it funds, especially if that basis is necessary to be able to take associated depreciation deductions with respect to the mortgage collateral.

UBTI is an acronym for “unrelated business taxable income.” See 26 U.S.C. § 511 et seq.


See Treas. Reg. § 1.704-2(i). Note that it is assumed that the partners do not want a capital account deficit funding obligation to shift the economic risk of loss.

Most partner loans to advance another partner’s share of capital do not have a minimum pay rate. It is therefore important to have other indices of debt if the debt is to be respected. A key requirement is an outside date for repayment in any and all events. Query whether a partner loan would be respected when the borrower has no net worth (e.g., because the partnership has no equity and either the borrower is the partnership or the borrowing partner is an SPE) without a guaranty or some other credit enhancement?

Unlike an excessive allocation of losses due to partner nonrecourse debt, which does not result in a fractions rule violation unless and until it occurs (see Treas. Reg. § 1.514(c)-2(j)(1) (1994)), allocations in respect of a preferred contribution are tested prospectively, as is generally the case under fractions rule. See Treas. Reg. § 1.514(c)-2(b)(2).

And unlike the partner nonrecourse debt issue, a preferred contribution can create a fractions rule violation regardless of who the lending partner is: if the lending partner is the operator, then the possibility of an allocation to the operator of 100% of the losses attributable to that contribution may result in a fractions rule violation; and if the lending partner is the investor, then the possibility of an allocation to the investor of 100% of the profits attributable to the return on that contribution may result in a fractions rule violation (assuming that the return is not a “reasonable preferred return” under Treas. Reg. § 1.514(c)-2(d), which provides for a safe harbor rate that is unlikely to be helpful). The safe harbor annual rate for Nov. 2012 was 6.4%, compounded annually, 6.39%, compounded semiannually, 6.38%, compounded quarterly, and 6.38%, compounded monthly. See Rev. Rul. 2012-24 I.R.B. 329, available at http://apps.irs.gov/app/picklist/list/federalRates.html; Treas. Reg. § 1.514(c)-2(d)(4)(ii).

REIT is an acronym for “real estate investment trust.” See 26 U.S.C. § 856 et seq.

See id. § 856(c)(4)(B).

See id. § 856(m).

If the partnership meets the 75% income test (which many REIT partners would require in any partnership in which they invest), then a partnership loan may not be considered a security for purposes of the value prong of this limitation under 26 U.S.C. § 856(c)(4)(B)(III).

Does net worth matter? It might. It is possible, for example, that the partnership is a master entity that owns several subsidiaries for which it obtains separate financing and provides carve-out, environmental and other guaranties under which a lender requires a net worth covenant from the partnership.


Often, the “hurdle” refers only to the distributions the investor must receive before there are promote distributions (which is consistent with the sample cash allocation provisions in Appendix F). However, all capital is typically treated the same so that when the investor has achieved its hurdle, the operator has received the same hurdle on its cash investment, assuming all the distributions up to that point have been made in fixed partnership percentages and the contributions have been made by the partners at the same times in the same fixed partnership percentages. Those fixed partnership percentages will hold in the examples that follow, and therefore references to the hurdle in this Article may sometimes refer to the hurdle on the contributions from both partners and may sometimes refer to the hurdle only on the contributions from the investor, but the intended meaning should be clear in each context. The latter formulation (investor only) is often preferred to avoid potential confusion associated with promote distributions and refunds of promote distributions which may be outside the hurdle calculation.
In the author's experience, compound interest is typically used, but simple interest is used in this Article to make the calculations easier to follow. The possibility that a loan to the partnership would be recharacterized as a loan to the non-contributing partner (because they would be so similar economically) is beyond the scope of this Article. But keep in mind that in a straight-up partnership, the two loan alternatives result in the same amount of Net Cash Receipts, so one alternative is chosen over the other (in a straight-up partnership) for other reasons. Those other reasons are equally meaningful in a promote structure and the form of the transaction and intent of the parties should be relevant. A claim for recharacterization would likely be made by another creditor and other creditors would most likely exist if the non-contributing partner were not an SPE. But if the non-contributing partner were not an SPE, then it would likely have other assets and the lending partner may have recourse to those assets for repayment of the debt. That may be an important distinction that should be considered in response to any claim for recharacterization. Of course, making the loan nonrecourse may eliminate this particular argument.

It is important to recognize that there is no single solution for every transaction. For example, an investor who plays the primary role in obtaining financing might argue that it should get the benefit of any increase in the promote attributable to that financing.

Stevens A. Carey, Real Estate JV Promote Calculations: Basic Concepts and Issues, REAL ESTATE FINANCE JOURNAL (Spring 2003). If the non-contributing partner is unwilling to give a priority to the higher return (i.e., to have preferred interest payments for more than the stated loan rate), then the partner loans may be included in the hurdle calculation if that is consistent with the deal (e.g., if the parties have agreed that no promote is payable until all cash invested earns a return equal to the Hurdle Rate): treat the loan advances in the same way as capital contributions; and treat loan payments in the same way as distributions. But this approach is subject to two caveats: (1) the investor may not want to include default loans with a penalty rate that exceeds the hurdle (because their inclusion would take the sting out of the default rate and dilute the return on the other capital); and (2) if a loan from a partner to the other partner is included in the hurdle calculation, then the partners' cash outflows would no longer be in accordance with their Partnership Percentages. One may wonder why not include 100% of the partner loans to the partnership (as discussed in the previous endnote with respect to loans to a partner): treat the loan advances in the same way as capital contributions; and treat loan payments in the same way as distributions? However, this may accomplish more than was intended, and partially eliminate the benefit of the difference between the Loan Rate and the Hurdle Rate even for the portion of the loan to the partnership that is attributable to the non-contributing partner’s share. Also, when treating loan advances and loan payments in the same manner as contributions and distributions, it may be advisable to refer to cash inflows and cash outflows to help avoid any argument that the parties intended the loans to be equity in substance.

As observed in endnote 30, this is a common approach when contributions stay in sync (i.e., when contributions are always made in accordance with fixed percentages). This is the approach that is used in the Appendices to this Article.

There have been many simplifications and assumptions utilized in this Article, which is not intended to provide a proof or complete analysis, for the myriad other cases that may occur in practice, of any of the conclusions that have been reached in this Article for the particular facts assumed. The interested reader is encouraged to consider the more general cases.

See Appendix E.

There may also be issues associated with paying a promote after a 10% hurdle is reached when a portion of the investor’s investment is earning only 5%.

Alternative distribution provisions are set forth on Appendix F, which will be considered later.

However, there is an independent requirement that partnership loans must be repaid together with interest at the Loan Rate before there are any distributions, let alone promote distributions.

When the Loan Rate is less than the Hurdle Rate (i.e., when \( r < h \)), there is a similar problem for the investor because the promote is in effect accelerated and increased.

It will be assumed that the investor is the partner that makes the loan. The reader is encouraged to consider the case in which the loan is made by the operator.

Interest-free loans are used in this Article for illustrative purposes to make the math simple. If an interest-free loan occurs in practice, there would of course be imputed income issues. See, e.g., I.R.C. §§ 1272, 7872.
When the loan is to the non-contributing partner, there are $400 million of contributions and the Hurdle Required Available Cash equals $400 million plus $40 million (a 10% simple annual return on the initial $200 million contribution for two years) plus $20 million (a 10% simple annual return on the second $200 million contribution for one year).

Note that if the amount of the Hurdle Required Available Cash changes, then at least one of the partners must get a different amount so that the allocation changes as well.

The initial allocation by the partnership of Available Cash is not affected by partner loans to a partner: if there are no loans to the partnership, then each capital call is deemed to have been satisfied by contributions in accordance with Partnership Percentages and distributions are initially made (before diversion to pay partner loans) and accounted for as though there were no partner loans. Thus, it should be no surprise that the Hurdle Required Available Cash does not change. It is only after the distributions are deemed received by the non-contributing partner and then diverted to repay the partner loans to it, that the allocation of the Available Cash changes.

A loan to the partnership may also wreak havoc with whole dollar hurdles. For example, if the hurdle required payment of a multiple (e.g., 150%) of the contributions to deal with the possibility of an early sale, the loan to the partnership could eliminate much of the whole dollar protection for the amount advanced as a loan to the partnership (unless it were somehow built into the Loan Rate). The solution suggested at the end of this Article may address this concern.

Of course, it may be necessary to use a portion of the promote to pay the loan and in that sense the promote is affected, but viewing the promote and loan separately, the amount of the promote is not changed.

In other words, $D \geq HRAC$ regardless of whether there is a loan to a partner or to the partnership. Thus $D \geq \max(A[1 + 2h] + B[1 + h], A[1 + 2h] + B[1 + q])$.

LRAC $\neq B(1 + r) \Rightarrow B(1 + r) > HRAC$ is easily proven by contradiction because we will show that $B(1 + r) \leq HRAC$ $\Rightarrow LRAC = B(1 + r)$, and $B(1 + r) > HRAC \Rightarrow LRAC \neq B(1 + r)$ follows from the more detailed conclusion summarized next.

This is equivalent to saying that $r \leq h \Rightarrow B(1 + r) \leq HRAC$, which should be obvious: if the loan is to the partnership, then $r \leq h \Rightarrow B(1 + r) < A(1 + 2h) + B(1 + r) = HRAC$; and if the loan is to a partner, then $r \leq h \Rightarrow B(1 + r) \leq B(1 + h) < A(1 + 2h) + B(1 + h) = HRAC$.

The operator will get its promote, $p$, plus its Partnership Percentage $(1 - q)$ of the balance $(1 - p)$:

$p + (1 - q)(1 - p)$.

If Available Cash exceeds HRAC (regardless of whether there is a loan to a partner or a loan to the partnership), we have already shown that the reduction in the operator’s Net Cash Receipts is the investor’s share of the reduction in the promote, namely $B(1 + r)pq$. See Appendices E and G. As indicated in Appendix 1 (cases 2.3 and 2.4), the reduction in the operator’s Net Cash Receipts is also the investor’s share of the reduction in the promote, namely $(D - [A(1 + 2h) + B(1 + h)p]q)$, when Available Cash does not exceed HRAC (for either a loan to a partner or a loan to the partnership), including when $B(1 + r) > HRAC$ for a loan to a partner (case 2.3). But Issue 2 is mentioned because the solution offered in the body of this Article to Issue 1 may not address Issue 2. For this reason, the likelihood of Issue 2 may be important: if Issue 1 is solved and Issue 2 does not occur, then there may be a complete solution.

The likelihood of Issue 2 occurring in practice is much greater of course when a capital call is made at a time when the hurdle has been achieved (with respect to prior capital). However, in the author’s experience, the likelihood is usually low that there will be a capital call after all capital has been returned and the requisite return paid, let alone that there will be a contribution default (which is also the exception rather than the rule).

Clearly, the rate must exceed 130% to achieve the hurdle before loan repayment. 160% was chosen to avoid fractional millions.

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