



Waterfall Engineering: How Sponsors Are Preserving Promote in Down Deals

Insights • May 11, 2026

Across a broad range of asset classes and capital structures, real estate sponsors are revisiting waterfall engineering in commercial real estate as transactions underwritten in a low-rate environment confront refinancing pressure, valuation resets, extended hold periods, and reduced liquidity. In many cases, traditional promote structures that once appeared achievable are now materially impaired or entirely out of reach.

Rather than simply conceding economics, sponsors are increasingly exploring structural modifications designed to preserve some level of promote participation, maintain incentive alignment, and retain operational control through stressed periods. These efforts are taking many forms (including revised hurdle mechanics, partial earn-back structures, recapitalization-driven reallocations, and refinements to waterfall definitions and timing assumptions).

Notably, many of these adjustments are occurring even where sponsors are not contributing substantial new capital. That dynamic has become a growing point of negotiation among sponsors, investors, and lenders, particularly where stakeholders believe the original underwriting failed to adequately anticipate interest rate volatility, refinance risk, or operational stress.

At the same time, many capital providers appear increasingly willing to accept calibrated modifications where the alternatives (including sponsor disengagement, forced transitions, enforcement proceedings, or distressed sales) may produce inferior economic outcomes. As a result, waterfall engineering has emerged as less of a technical drafting exercise and more of a broader negotiation around control, incentives, recovery strategy, and asset preservation.

The “Dead Promote” Problem in Commercial Real Estate

Many pre-2022 transactions were structured around assumptions that no longer hold consistently across the market:

- inexpensive floating-rate debt,
- short-duration business plans,
- cap rate compression,
- stable refinancing availability, and
- predictable exit liquidity.

As rates increased and debt markets tightened, a significant number of transactions effectively fell “out of the promote.” In some situations, projected returns no longer clear preferred return hurdles. In others, extended hold periods have substantially diluted IRR-based economics.

That creates a fundamental tension within the capital structure.

Sponsors often remain responsible for:

- leasing execution,
- lender negotiations,
- construction oversight,
- capital planning,
- tenant relationships, and
- workout management,

while simultaneously facing the prospect of little or no back-end participation.

In many cases, stakeholders are now confronting a practical question that was largely theoretical during the prior cycle:

How does a deal maintain sponsor alignment when the original promote structure no longer functions economically?

How Sponsors Are Re-Engineering Real Estate Waterfalls

The market response has generally not been wholesale abandonment of promote structures. Instead, many transactions are being recalibrated through more targeted modifications.

Time-Based Recalibration of Hurdles

One recurring approach involves revisiting the timing assumptions embedded in preferred returns and IRR thresholds.

Examples include:

- adjustments to compounding mechanics,
- revised accrual periods,
- modified IRR calculations tied to extended hold periods, and
- partial hurdle resets following recapitalizations or major capital events.

These changes can materially affect economics without altering headline promote percentages.

Because IRR calculations are highly sensitive to timing, extending the duration of a business plan without recalibrating hurdles may effectively eliminate sponsor participation even where underlying operational performance remains relatively stable.

Investors, however, often scrutinize whether these changes appropriately allocate the economic consequences of delay and whether the revised structure remains consistent with the original risk allocation.

Incremental Promote and “Earn-Back” Structures

Another emerging theme involves partial or graduated promote participation.

Rather than maintaining an all-or-nothing waterfall, some transactions now incorporate:

- interim hurdles,
- milestone-based distributions,
- phased promote participation,
- refinancing-based triggers, or
- partial catch-up mechanisms.

These structures are often designed to preserve operational incentive alignment while still prioritizing investor capital recovery.

From an investor perspective, these arrangements may be more acceptable where:

- sponsor engagement remains critical to preserving value,
- replacing the sponsor would introduce meaningful disruption, or
- asset stabilization still appears achievable.

At the same time, some investors view these modifications as a re-trade of economics, particularly where they believe the original underwriting reflected avoidable assumptions or inadequate risk management.

Recapitalizations and Capital Stack Reordering

Recapitalizations are also reshaping waterfall dynamics.

As rescue capital, preferred equity, mezzanine capital, and note acquisitions become more prevalent, proceeds often flow through materially revised capital structures.

In many situations:

- new capital is structurally senior,
- legacy common equity is subordinated,
- promote participation becomes contingent on revised hurdles, and
- sponsors negotiate sidecar economics tied to new contributions or operational performance.

These restructurings frequently create tension between:

- existing investors seeking downside protection,
- new money seeking priority economics, and
- sponsors attempting to preserve future upside.

The resulting negotiations are often driven less by theoretical fairness and more by practical assessments of recoverability and control.

Fee-Promote Rebalancing

Another trend involves the reallocation of economics between current compensation and contingent upside.

Some transactions are exploring:

- deferred [asset management](#) fees,
- accrued but contingent development fees,
- fee conversions into promote participation,
- reduced current compensation in exchange for revised back-end economics, or
- enhanced operating compensation paired with reduced promote.

These adjustments may provide sponsors with near-term liquidity while preserving long-term alignment incentives.

However, institutional investors are increasingly attentive to whether fee structures remain appropriately tied to measurable performance and whether revised economics adequately reflect changed risk profiles.

Waterfall Definition Engineering and Distribution Mechanics

In marginal or distressed transactions, seemingly technical definitions can become economically significant.

Negotiations increasingly focus on:

- treatment of refinancing proceeds,
- reserve calculations,
- treatment of insurance recoveries,
- allocation of operating shortfalls,
- treatment of capital event proceeds, and
- expense characterization.

In some cases, relatively modest definitional adjustments may materially affect whether promote hurdles are achieved.

As a result, drafting precision has become increasingly important, particularly where multiple capital providers, layered intercreditor arrangements, or restructuring transactions are involved.

Why Investors and Lenders Are Accepting Waterfall Modifications

One of the more notable features of the current market is that sponsors are, in some cases, preserving economics without contributing substantial new capital.

That outcome can appear counterintuitive, particularly where stakeholders believe the sponsor should have anticipated adverse scenarios (including interest rate volatility, refinance market disruption, delayed absorption, construction inflation, insurance cost escalation, or valuation compression).

In practice, however, these negotiations are often driven by pragmatic economic considerations rather than abstract fault allocation.

The Economics of Replacement Are Often Worse

In many transactions, replacing the sponsor may create additional value deterioration.

Even where performance has disappointed, investors and lenders may conclude that the existing sponsor still possesses:

- critical asset knowledge,
- leasing relationships,
- municipal and regulatory familiarity,
- contractor oversight capability, or
- workout execution experience.

Particularly in development, hospitality, mixed-use, or operationally intensive assets, stakeholders may determine that preserving continuity produces better recovery prospects than forcing a transition.

As a result, partial promote preservation may be viewed less as a reward and more as a retention mechanism designed to maintain operational engagement.

Many Capital Providers Did Not Underwrite to Own

Another practical reality is that many passive investors and lenders are not structured to directly operate distressed real estate assets.

Foreclosure or sponsor removal may create:

- increased carrying costs,
- operational disruption,
- reserve obligations,
- litigation exposure,
- reputational concerns,
- regulatory complications, or

- portfolio concentration issues.

In some situations, stakeholders may determine that a negotiated restructuring with a motivated sponsor presents a more attractive path than formal enforcement remedies.

This is particularly true where the transaction remains salvageable but requires additional time, leasing execution, or operational stabilization.

The Original Assumptions Were Often Shared

Many distressed outcomes are tied to broader market dislocation rather than isolated sponsor conduct.

That does not eliminate scrutiny around underwriting discipline or risk management. Investors are increasingly evaluating whether sponsors:

- adequately hedged floating-rate exposure,
- maintained sufficient contingencies,
- relied on overly aggressive exit assumptions, or
- underestimated refinance risk.

At the same time, many stakeholders recognize that:

- debt markets repriced unusually quickly,
- refinancing liquidity contracted materially,
- insurance and operating costs increased sharply, and
- exit valuations reset across multiple sectors simultaneously.

Where underwriting assumptions were broadly shared across the capital stack, negotiations often become more commercially collaborative than fault-oriented.

Consent Rights Are Often More Limited Than Assumed

Another important dynamic is structural.

Many joint venture and preferred equity arrangements grant sponsors substantial authority over:

- operational budgeting,
- reserve management,
- refinancing strategy,
- affiliate arrangements within negotiated parameters,
- workout negotiations, and
- business plan implementation.

Similarly, some economic shifts occur indirectly through:

- recapitalizations,
- amendments at different entity levels,

- note acquisitions,
- restructuring transactions, or
- intercreditor modifications.

As a result, not every economic recalibration necessarily requires unanimous investor approval.

The practical leverage created by governance structures, amendment thresholds, lender controls, and entity-level decision rights can significantly shape outcomes even where formal consent rights exist.

Sponsors Often Retain Strategic Optionality

Even where sponsor economics appear significantly impaired, sponsors may still control critical strategic decisions.

Depending on the structure, sponsors may influence:

- guaranty exposure,
- cooperation in workouts,
- litigation strategy,
- bankruptcy risk,
- additional capital sourcing,
- timing of enforcement actions, and
- asset-level operational decisions.

In these situations, preserving some measure of sponsor incentive alignment may be viewed as economically rational from both lender and investor perspectives.

The analysis is often less about whether the sponsor “deserves” promote and more about whether aligned incentives improve the probability of preserving value.

The Market Response: Tighter Governance

One consequence of the current cycle is that investors and lenders are becoming more focused on upfront governance protections.

These trends parallel broader [regulatory attention](#) on commercial real estate risk management and workout oversight.

Increasing attention is being paid to:

- promote forfeiture triggers,
- bad-act carveouts,
- mandatory co-invest requirements,
- enhanced reporting obligations,
- stronger removal rights,
- restructuring consent controls,
- capital call enforcement provisions, and

- tighter amendment thresholds.

In many cases, the market response is not rejection of promote structures themselves, but rather more detailed negotiation around how economics may evolve under stress.

Key Takeaways

- Waterfall structures are becoming increasingly dynamic as sponsors and capital providers respond to changing market conditions.
- In many stressed transactions, preserving some level of sponsor economics is being viewed as a practical alignment tool rather than a simple reward mechanism.
- Investors and lenders are increasingly balancing accountability concerns against operational continuity and recovery optimization.
- Small adjustments to timing, definitions, and distribution sequencing can materially alter economic outcomes.
- Governance provisions and amendment mechanics often become as important as the headline economics themselves.
- The current cycle is likely to produce more detailed negotiation around restructuring authority, promote forfeiture, and sponsor alignment in future transactions.

The current market is testing a fundamental question embedded in virtually every real estate joint venture: whether promote is intended solely as a reward for successful outcomes or also as a mechanism to preserve sponsor engagement during periods of distress. Increasingly, stakeholders are confronting the reality that those objectives may diverge precisely when deals become most stressed.

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