Real Estate
Joint Ventures

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I. Economics of Real Estate Joint Ventures

Introduction

• The more an investor has at stake financially, the greater the returns they will expect (development deals)
• The greater an owner’s risk, the greater the returns they will expect
• The greater an owner’s contractually guaranteed returns, the smaller an “at risk” profits return they should expect
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Guaranteed Payments and Fees

- Examples: management and leasing fees and commissions; asset management fees, construction management/owner’s representative fees; development fees
- Establishing market fees
- Typically the Joint Venture retains an affiliate of the Developer Member to handle initially the development work and later property or asset management
- Opportunity for Developer Member to earn an additional development or management fee
- Fee amounts and quality of work must be comparable to that of an unaffiliated third party
- Investor Member makes sole election to allege an event of default by the affiliate developer
- May be cross defaults under JV agreement
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Capital Calls

• Owners should consider addressing the potential need to “feed” the project either (a) at the outset, in the JV agreement, or (b) in the future once a problem arises

• Specific drafting considerations: required approvals to issue capital calls; limitations on amount/frequency of capital calls; required form of capital calls (e.g., cash vs. credit enhancement guaranties of 3rd party debt); mandatory vs. voluntary participation; allocation of responsibility among owners for meeting capital calls; consequences of failure to meet capital calls

• Dealing with cost overruns; parri passu responsibility or should Developer Member be responsible for initial overruns up to a cap?
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Guaranty Obligations

• To what extent are owners obligated to provide personal guaranties of JV obligations (to project lenders)? Will owners receive separate compensation for providing guaranties and, if so, how is that compensation determined (e.g., percentage of guaranteed amount)? Or is the guaranteeing owner’s guaranty compensation already “baked into” the overall distribution “waterfall” for the JV?

• Allocation of guaranty payment obligations amongst the members

• Treatment of Guaranty Payments
  • Capital to the Joint Venture
  • Priority Capital

• Guaranty called due to the bad act of one Member

• Back–Stop Indemnities

• Release if Developer Member removed as managing member or buy/sell triggered

• Affect on major decisions
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Return of Capital, Preferred Returns and Promote Interests

• Cash distribution waterfall generally: guaranteed payments; return of capital; preferred returns; and finally profits/promote interest distributions

• Establishing and documenting an owner’s capital account: cash capital contributions vs. in-kind capital contributions (e.g., contributions of real property or services)
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• Return of capital and preferred returns to capital providers:
  • Any preference in priority of return of capital distributions? Are all capital contributions created equal? Do return of capital priority distributions apply to subsequent capital contributions (e.g., following a future capital call)?
  • Priority for funded cost overruns or development projects.
  • How are any preferred returns determined? Simple interest on outstanding capital or a more complicated IRR threshold? Always have client review and approve calculation methodology. Are preferred returns cumulative and compounding? Are they applicable to initial and all future capital contributions?
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• Promote Interests
  • Can range from single digits to 40-50% (or more)
  • Can be tiered… Two, Three… or more
  • Typically will vary by property type and size; identity/nature of the capital providers; experience/track record of the promoter; amount of guaranteed fees to promoter; the promoter’s overall risk (e.g., has a creditworthy promoter provided a loan or construction guaranty?); the risk inherent in the project (e.g., purchase of stabilized property with anchor tenant for market cap rate vs. development or turn-around/distressed project). What is the promoter’s value-add and risk/exposure?
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• A joint venture waterfall is a complex way to answer the simple question:
  • When does the JV manager begin receiving distributions of promote and how quickly is such promote (and how much of such promote is) paid?
  • A distinction is drawn between JV “money” partners and JV manager

• “Whole fund” waterfall:
  • Provides for the return of all capital invested in the JV to a “money” partner (including with respect to multiple investments, in multiple investment JVs), plus a preferred return on such capital, prior to any distributions being made to the manager with respect to its promote

• “Deal by deal” waterfall for multiple investment JVs:
  • Allocates capital (plus potentially other items) on a deal by deal basis and provides for the distribution of promote to the manager after such capital, plus a preferred return thereon, is returned to the “money” partner
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Clawback Introduction

• Purpose is to maintain the appropriate sharing ratio between the money partners and the manager, in light of the fact that the promote is paid out deal by deal

• Underperforming investments can be among the last to be disposed of

• Unless they were already written down when the promote was calculated on prior profitable dispositions, the manager may receive over-distributions of promote, based on the JV’s entire portfolio, in the case of a deal-by-deal calculation

• Some JV agreements permit the manager to defer promote distributions to avoid getting into a clawback situation
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Clawback Mechanics

• A typical clawback will require the manager to contribute to the JV, to be distributed to each affected money partner, the sum of the amounts determined for each money partner equal to the greater of either:
  
  • (a) the excess of promote distributions attributable to a money partner’s interest over 20% (or other promote percentage) of profits attributable to a money partner’s interest, or
  
  • (b) the amount by which the sum of a money partner’s capital contributions and preferred return exceeded total distributions received by it

• Less commonly, a “reverse waterfall” giveback obligation

• After-Tax Calculation:
  
  • The aggregate clawback payments typically do not exceed the aggregate clawback distributions, reduced by tax distributions, plus tax attributed to built-in gains on assets distributed in-kind (based on the value on the date of distribution)
  
  • The reduction for taxes on built-in gains reflects the fact that the gain resulting in the tax will be recognized outside the fund and would not have given rise to a tax distribution, and thus will not be picked up by the tax distribution reference
Interim Clawback

• Some JVs provide for an interim clawback, which require the clawback calculations (and any resulting clawback distributions) to be made periodically.

• Distributions to money partners are treated as flowing through the waterfall; the “catch-up” layer of distributions must be adjusted to back out distributions that are recontributed by the manager pursuant to the interim clawback.
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**Escrow, Clawback Guaranty**

- Because JV manager entities are typically special purpose entities with no assets other than their interest in the JV, steps must be taken to secure the payment of the clawback.

- Some JVs require a portion of the promote to be escrowed by the JV and clawback payments are then first made from the escrow.
  - The escrow usually has a formula-based cap.

- Alternatively, JV agreements may require the manager to secure guaranties of the clawback obligation from its members or partners.
  - Such guaranties are typically several and not joint.
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Capital Accounts and Tax Allocations

• Capital accounts reflect each partner’s ownership interest in the assets of a partnership
  • The sum of the partners’ capital accounts represents the partnership’s total equity
  • Capital accounts are not the same as tax basis, though tax accounting principles apply

• Capital accounts act like partners’ ownership interests in a partnership in a parallel universe where:
  • The value at which an asset is carried on the partnership’s books represents fair market value; and
  • Adjustments to those values represent real economic gain or loss that is reflected in the capital accounts of the partners who are entitled to that gain or who bear that loss
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**Capital Accounting Rules**

- Each partner’s capital account is **increased** by:
  - Its capital contributions, with in-kind contributions reflected at net fair market value, and
  - Its share of the partnership’s income

- Each partner’s capital account is **decreased** by:
  - Distributions to it, and
  - Its share of the partnership’s losses

- Practice Tips: Make sure you have a tax specialist look at the “allocations” section of every JV agreement
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Function of Capital Accounts

• Except for special circumstances (e.g., “fractions rule” partnerships), capital accounts are typically not used to determine a partner’s economic entitlements
  • Economic entitlements are generally determined by the distribution waterfall

• Capital accounts typically are used as a benchmark for tax profit and loss allocations:
  • Capital account allocations begin with taxable income, with certain adjustments to align with the principles of the parallel universe
  • “Tax follows book”
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Capital Account Allocations

• Under a “targeted” or “forced” allocation arrangement, partnership profit and loss is allocated so that at year end, each partner has a capital account balance equal to the amount such partner would receive if the partnership sold its assets at the value reflected in the capital accounts and liquidated.

• More traditional “tiered” allocation provisions use a different methodology, but are designed to reach the same result.
II. Management and Governance of Real Estate Joint Ventures

- Granting and limiting management authority:
  - Clear delegations of authority for day to day management
  - Clear limitations of authority for fundamental actions/decisions (e.g., incurring secured debt or unsecured debt in excess of threshold amount/outside ordinary course of business; sale of property or leases in excess of threshold amount/outside ordinary course of business; not distributing all available cash flow; terminating/engaging/changing managers/leasing agents/franchisors; capital expenditures or constructing improvements in excess of threshold amount/outside ordinary course of business; deviating from minimum required insurance standards; mergers, conversions, share exchanges or other entity reorganizations deviating from approved budget by more than pre-approved tolerances; entering into any agreements with any owner/owner affiliates; acquiring additional property; etc.)
  - Clear accountability for authority exercised and responsibility for third party outside management services providers
  - “Major Decisions” tend to be heavily negotiated
  - Consider loan guarantees – Investor can’t veto major decisions required by lender
  - Practice Tip: Make sure Investor Member has right to propose “Major Decisions”, not just veto
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• Budgets
  • Include mechanism for operating partner to periodically prepare and update project budget
  • Avoiding unpleasant surprises through pre-approved budgets
  • Tolerated deviations from pre-approved budgets
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• Replacing nonperforming managers/managing members

  • Termination with cause:
    • Definition of “cause”
    • Required approvals to terminate for cause
    • Forfeiture of promote interest
    • Buy-Sell provisions

  • Termination without cause:
    • Required approvals to terminate without cause
    • Termination fees or liquidated damages
    • Buy-Sell provisions
III. Transfer Rights and Restrictions

- Developer Member - Rights
  - Typically more limited than Investor Member
  - Sometimes allow minority interest transfers
  - Typically allow transfers between individuals within the development company
  - Developer controlled affiliate transfers
  - Family and estate planning
  - Transfers to Investor Member
  - Lender concerns and restrictions
III. Transfer Rights and Restrictions

• Developer Member - Restrictions
  • Investor Member wants tight restrictions given Developer’s role in the project
  • Must maintain a minimum percentage of interest/control
  • Majority interest transfers are prohibited
  • Third party transfers of control will almost always require approval by the Investor Member
  • Affiliate transfers require that notice be given to the Investor Member
III. Transfer Rights and Restrictions

- Investor Member - Rights
  - Often greater flexibility in transferring interest than Developer Member
  - Right to transfer provides Investor Member with liquidity
  - Transfers of minority interest to third parties
  - Transfers of majority interest between members of the Investor company
  - Affiliate transfers of majority interest
  - Sometimes there is a “lockout” period until all capital is funded and/or construction is completed
III. Transfer Rights and Restrictions

- Investor Member - Restrictions
- Developer Member requires some limitations
  - Wants to be certain new Investor Member is creditworthy or “institutional”
  - Business relationship concerns/Prior history
  - Majority interest transfers to third parties
  - Notice of transfer to Developer Member
  - Citizenship Restrictions (must be U.S. “Person”)
  - Limitation of transfers that alter the company structure such as:
    - Publicly Traded Partnership
    - ERISA: “Plan Assets”
IV. Other Transfer Provisions

• Notice Requirement for both Developer and Investor Members

• Right of First Offer (ROFO)
  - Developer Member must receive notice of transfer by Investor Member
  - Developer has a limited period of time to buy the interest before the sale is opened to third parties

• Right of First Refusal (ROFR)
  - Transferor sends notice of the terms of sale of his interest
  - Members are given a limited period of time to accept /reject the offer. If rejected, third parties may purchase the interest for a price greater than or equal to original terms

• Tag Along Rights
  - For transfers of interest above a set percentage the Development Member can require that their interest is sold at the same price as the Investor Member

• Drag Along Provision
  - Investor Member has the right to package the entire JV as one interest if a third party offer is large enough
V. Exit Strategies: Buy-Sell

- Some Buy-Sells have lock-out periods
  - Typically the lockout period lasts until after the substantial completion or “stabilization” of the project
- Some are tied to “trigger events” such as:
  - Major decision deadlock
  - Member default
- Notice must be given to all members and include:
  - Net Enterprise Amount
  - Purchase price of the asset
- Member receiving notice must decide to sell its interest or purchase the other parties interest
- Valuation of property and interests
- Time Frames
  - Offers
  - Closing
- Closing Mechanics
V. Exit Strategies: Forced Sale

• Timing – triggers and lockouts
  • Investor Member is required to give notice to the Developer Member
  • Typically a short period is given for Developer Member to invoke the terms of any Tag-Along provision
  • If Investor Member is selling its entire interest, the Developer Member can be forced to sell his entire interest

• Closing Mechanics
  • Investor Member has a negotiated period of time to execute a contract for the sale of the company
  • Investor and Developer Members pay their respective pro-rata shares of all real property and/or transfer taxes
  • Transfer of all necessary documents between Investor and Developer Members
VI. Dispute Resolution

- Jurisdiction and Venue
- Mediation vs. Binding Arbitration
- Waivers
  - Jury Trial
  - Governing Law (Delaware is typically selected)
  - Forum
- Deadlock
  - Notice of Deadlock
  - Good Faith Negotiations.
  - If not solved, leads to arbitration or Buy/Sell