

Real Estate JVs: Structuring Capital Call Provisions and Contribution Default Remedies

Strategies for Mitigating Legal, Operational and Tax Risks

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Today's faculty features:

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Real Estate JVs

“Real Estate Joint Ventures:
Structuring Capital Call Provisions
and Contribution Default Remedies”

April 23, 2015

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CAPITAL CALL PROVISIONS: WHICH PARTNERS MAY CALL FOR CAPITAL?

- ◆ Operator only
- ◆ Investor only
- ◆ Any Partner

Note: The presentation and materials generally assume that there are only two partners, an operator and an investor, and use partnership and LLC terminology interchangeably because the concepts and issues generally apply equally to either form of entity.

CAPITAL CALL PROVISIONS: WHEN ARE CONTRIBUTIONS REQUIRED OR PERMITTED?

- ◆ Timing
- ◆ Circumstances
- ◆ Limitations
- ◆ Conditions

CAPITAL CALL PROVISIONS: TAX ISSUES WITH NON-CASH CONTRIBUTIONS

- ◆ Disguised Sales
- ◆ 704(c) Allocations
- ◆ Transfer Tax and Property Tax Reassessment

CAPITAL CALL PROVISIONS: DIFFERENCES VERSUS FUNDS AND OTHER GP-LP STRUCTURES

- ◆ Can LPs Ever Call for Capital?
- ◆ Different Priority for Post-Closing Contributions?
- ◆ Different Tranches for Different Assets?

CAPITAL CALL PROVISIONS: MULTI-TIER CONSIDERATIONS

- ◆ Sponsor/Operator Syndications
 - ◆ Co-Investment Fund vs. Single-Asset

- ◆ Additional Capital Provisions
 - ◆ Target Raise
 - ◆ Commitment vs. Fully-funded
 - ◆ Mandatory vs. Voluntary

- ◆ Contribution Provisions
 - ◆ Timing
 - ◆ Circumstances
 - ◆ Limitations

CAPITAL CALL PROVISIONS: ENFORCEMENT BY CREDITORS

- ◆ Did creditor reasonably rely on contribution obligation?
- ◆ Are there unsatisfied conditions to contribution obligation?
- ◆ Equitable considerations?

CAPITAL CALL PROVISIONS: OTHER CONSIDERATIONS

- ◆ Limited Time for Drafting or Negotiating
- ◆ Transaction Cost Constraints
- ◆ Each Partner's Creditworthiness and Ongoing Access to Funds

CONTRIBUTION DEFAULT REMEDIES: PRIORITY TREATMENT

- ◆ Preferred Contribution to JV
- ◆ Loan to JV
- ◆ Loan to Defaulting Partner

CONTRIBUTION DEFAULT REMEDIES: DILUTION

- ◆ Non-Punitive vs Punitive with Capital Shift vs Punitive with Deemed Bonus
- ◆ Gross Contributions vs Capital Account vs FMV
- ◆ Right Away? Ongoing Right? Only after Cure Period?
- ◆ Capital, or Profits, or Both?
- ◆ Promote Too?
- ◆ And Contributions?
- ◆ Automatic withdrawal at 0%

CONTRIBUTION DEFAULT REMEDIES: OTHER REMEDIES

- ◆ Damages/Indemnification
- ◆ Removal
- ◆ Loss of Voting Rights
- ◆ Call Right
- ◆ Dissolution
- ◆ Specific Performance

CONTRIBUTION DEFAULT REMEDIES: OPTIONAL COMPLICATIONS

- ◆ Partial Contributions
- ◆ Refunds
- ◆ Different Priority or Rate Depending upon Purpose?
- ◆ Equity Multiple Too?
- ◆ Funding for Others Prior to Funding Deadline

CONTRIBUTION DEFAULT REMEDIES: EXAMPLE #1

- ◆ Contributing to JV = Loaning to JV = Loaning to Partner
- ◆ Assumptions:
 - ◆ Initial Contributions are \$90 (I) / \$10 (O), then \$50 (I) / \$0 (O) (“deficiency” is \$5)
 - ◆ Default contributions are recouped with priority plus 10%/annum
- ◆ Distributable cash necessary to repay in full after 1 year:
 - ◆ \$50 priority contribution to JV = \$55 (otherwise would have gone \$49.50 / \$5.50)
 - ◆ \$50 loan to JV = \$55 (again, otherwise would have gone \$49.50 / \$5.50)
In either case, I is paying itself the interest on its \$45 share of the capital call.
 - ◆ \$5 loan to partner repaid from its distributions = \$55 (equates to \$5.50 to repay)

CONTRIBUTION DEFAULT REMEDIES: EXAMPLE #2

- ◆ Dilution: Non-Punitive vs Capital Shift vs Deemed Bonus
- ◆ Assumptions:
 - ◆ Initial Contributions are \$90 (I) / \$10 (O), then \$50 (I) / \$0 (O) (“deficiency” is \$5)
 - ◆ Punitive dilution is based on 1.5x on deficiency (\$7.50 credit for covering \$5)
- ◆ Variations:
 - ◆ Non-Punitive: I = 93.33% (\$140.00 / \$150.00), O = 6.67% (\$10.00 / \$150.00)
 - ◆ Capital Shift: I = 95% (\$142.50.00 / \$150.00), O = 5% (\$7.50 / \$150.00)
 - ◆ Deemed Bonus: I = 93.44% (\$142.50 / \$152.50), O = 6.56% (\$10.00 / \$152.50)

CONTRIBUTION DEFAULT REMEDIES: EXAMPLE #3

- ◆ Dilution: Capital vs Profits vs Capital and Profits

- ◆ Assumptions:
 - ◆ \$90 / \$10, then \$50 / \$0 one year later with 1.5x capital shift on deficiency
 - ◆ There is \$300 available for distribution one year after the dilution
 - ◆ Waterfall is 90/10 until I gets 10% IRR (\$164), then O gets 20% as promote

- ◆ Variations (what has switched from 90/10 to 95/5?):
 - ◆ Capital: 95/5 until \$164 / \$9, then 76/24 until \$97 / \$30 = \$261 / \$39
 - ◆ Profits: 90/10 until \$164 / \$18, then 81/19 until \$96 / \$22 = \$260 / \$40
 - ◆ Both: 95/5 until \$164 / \$9, then 85.5/14.5 until \$109 / \$18 = \$273 / \$27

CONTRIBUTION DEFAULT REMEDIES: TAX ISSUES

- ◆ Ordinary Income or Capital Gain
- ◆ Fractions Rule
- ◆ REIT Considerations
- ◆ Liquidating Distributions
- ◆ Transfer Tax and Property Tax Reassessment

CONTRIBUTION DEFAULT REMEDIES: DIFFERENCES VERSUS FUNDS AND OTHER GP-LP STRUCTURES

- ◆ Who is permitted to cover deficiency, in what order and in what manner?
- ◆ Are the logistics manageable (including dispute resolution)?
- ◆ Can anyone be required to cover shortfalls?
- ◆ Different priority or rate depending upon purpose?

CONTRIBUTION DEFAULT REMEDIES: MULTI-TIER CONSIDERATIONS

- ◆ Sponsor/Operator Syndication
 - ◆ Co-Investment Fund vs. Single-Asset

- ◆ Punitive vs. Non-Punitive

- ◆ Investor Relations

CONTRIBUTION DEFAULT REMEDIES: LEGAL CONSIDERATIONS

- ◆ Enforceability
- ◆ Bankruptcy of Partner
- ◆ Equitable Subordination or Recharacterization of Loans
- ◆ Fiduciary Duties
- ◆ Usury / Lender Licensing

CONTRIBUTION DEFAULT REMEDIES: OTHER CONSIDERATIONS

- ◆ Limited Time for Drafting or Negotiating
- ◆ Transaction Cost Constraints
- ◆ Are additional contributions anticipated, or only if there's a problem?
- ◆ SPE and other Lender Restrictions
- ◆ Has property increased or decreased in value?

CONTRIBUTION DEFAULT REMEDIES: DELAWARE LP/LLC ACTS

- ◆ Except as otherwise provided in the partnership agreement:
 - ◆ All available remedies for breach of contract
(See 6 Del. C. §§ 17-502(a); 18-502(a))
 - ◆ Distributions/Allocations are pro rata based on each partner's contributions
(See 6 Del. C. §§ 17-503, 504; 18-503, 504)
 - ◆ Silence regarding ability or obligations to make contributions

- ◆ (Nearly) Limitless options under the partnership agreement
 - ◆ “shall be subject to specified penalties…”
 - ◆ Long list of examples
(See 6 Del. C. §§ 17-306, 406, 502(c); 18-306, 405, 502(c))

ADDITIONAL INFORMATION

For additional information about capital calls and contribution default remedies in real estate joint ventures, please see: Carey, Guggenheim, and Soejoto, “Contribution Default Remedies in a Real Estate Venture,” *Business Entities* (November/December 2013), available at http://www.pircher.com/media/publication/53_business%20entity%20article.pdf

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