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A Primer On Real Estate Joint Ventures: Part 1

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This two-part article discusses the reasons parties enter into real estate joint ventures for the development of commercial real property, how to form a real estate joint venture, the importance of a robust joint venture agreement, key terms of which to be aware and drafting tips related to such terms.

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Initial Steps

Perform Due Diligence on Potential Partner

Given the nature and complexity of developing and managing commercial real estate, it is common for two or more parties to enter into an agreement to allocate and share the associated responsibilities and liabilities. However, a party should not enter into such an arrangement without first performing adequate due diligence and thinking through the eventualities and contingencies related to the venture.

To the extent the potential partners do not have a pre-existing business relationship, each party should conduct diligence necessary to ensure it believes its potential partner is capable of performing its joint venture obligations, whether related to experience with similar real estate projects or ability to provide necessary funds. The parties should also discuss their expectations for the joint venture prior to entering into any formal agreements, including how decisions will be made, profits and losses allocated, and responsibilities shared.

Determine Each Partner's Role

Each partner in a joint venture plays an important role. Though an oversimplification, there usually exists a dollar equity partner and a sweat equity partner. The dollar equity partner typically provides the greater capital contribution amounts and tends to be focused primarily on the real estate project's financial return. The sweat equity partner, on the other hand, is the partner primarily responsible for completing and/or coordinating the development and management of the project. As a result, the sweat equity partner, while also focused on generating a financial return, may additionally be concerned with project viability, brand integrity and ensuring continued access to the dollar equity partner's capital.

Understanding the lens through which each type of partner views the project will help inform the negotiating and drafting of the joint venture agreement and your client's priorities related to the terms of the joint venture agreement.

Prepare a Term Sheet

While many real estate partners prefer to strike an agreement on a joint venture deal with a handshake, the recommended course of action is to first prepare a term sheet outlining the primary joint venture deal terms. Whether the term sheet is binding (entirely or partially) or not at all is up to the parties. The important point is to identify potential sticking points early on in the process to avoid losing time and money later on if the parties are unable to reach an agreement on the primary points. At a minimum, the term sheet should include the following:

- Identity of the project under consideration and the timing expectations for the acquisition/development;
- Relative ownership interests of the various partners;
- Capital contributions, timing, consequences of failure to contribute, and return of capital;
- Management and control;
- Contemplated transactions with affiliate parties (e.g., development, leasing, management agreements);
- Third-party lending considerations (e.g., how to choose a lender, identity of guarantor(s), compensation of guarantor(s));
- Dispute resolution and/or terms of any parties' exit from the venture; and
- Any other unique aspects of the deal.

Determine Joint Venture Entity Structure and Jurisdiction

When the parties are confident they have a deal, the parties should begin the process of creating the joint venture entity and preparing the joint venture agreement. Although there is no legal requirement to do so, best practice is to create a separate legal entity for the joint venture to reduce complications, allow greater ease in pooling resources, and help isolate potential liabilities relating to the project.

When creating a new legal entity for the joint venture, the potential partners must first determine what type of entity to create. Limited liability companies are the most common entity type used for real estate joint ventures due to their ease of formation, flexibility in determining management structure, and limited liability for all members. However, there is no one optimal entity type for all real estate joint ventures. Depending on the location of the project and the parties' intended relationship, there may be tax consequences that necessitate use of a corporation, general partnership, limited partnership or other type of business entity. You should discuss the anticipated joint venture and possible real estate joint venture entity types with a tax attorney and/or qualified CPA prior to forming the business entity to ensure you select the best entity type for the particular circumstances.

Once the type of entity is chosen, the next step is determining where the entity will be created. Rather than simply choosing the state where one or more of the partners are located, the parties should consider the location of the real estate project and any requirements that a lender may have. For example, it is customary in retail real estate for permanent loan lenders to require a borrower, or its managing member, to be organized in the state of Delaware. As a result, it may be easier and more cost-effective to initially organize in that state, rather than having to effectuate a property transfer, conversion or merger prior to entering into a loan agreement.

Joint Venture Entity Creation and Documentation

Once the parties agree on the location and type of entity, the joint venture entity is ready to be created. The first step is to file the applicable organization document with the chosen state's Secretary of State (e.g., Articles of Organization or Certificate of Formation for a limited liability company, Articles of Incorporation for a corporation, etc.).

If the state of organization of the joint venture is different than the state(s) in which it will conduct business, the joint venture must qualify as a foreign entity in order to conduct business in such other states. State requirements for information and forms for such registration vary, but the typical filing is referred to as a foreign registration or qualification.

Following organization, the new joint venture entity should also complete and file a Form SS-4 with the Internal Revenue Service in order to obtain a federal employer identification number that can be used to open bank accounts, file and pay taxes and obtain a loan. One of the few exceptions to this rule is when the joint venture entity will be wholly owned by a single entity that has its own federal employer identification number. In that event, assuming the joint venture entity elects to remain being treated as a disregarded entity for tax purposes, the federal employer identification number of the sole member of the joint venture entity may be used instead of obtaining a separate federal employer identification number for the joint venture entity.

Finally, the parties must prepare the main governing document to administer the joint venture — the joint venture agreement itself. The joint venture agreement is typically the primary governing document for the applicable joint venture entity, such as an operating agreement for a limited liability company or a partnership agreement for a general or limited partnership.

If, as is often the case, the partners that are coming together to form the joint venture intend to effectuate multiple projects together using a similar structure, it is a good idea to draft a base form joint venture agreement that can easily be conformed for each specific deal. By creating a base form, you will ease some of the administrative burden of drafting joint venture agreements for future deals between these same partners, because each deal-specific joint venture agreement can be marked against the form to highlight any deal-specific changes. This is user-friendly to both attorney and client and will help reduce legal expenses for future transactions.

In the event a joint venture involves three or more parties, simultaneously with the preparation of the joint venture agreement or at any time during the joint venture's existence, two or more parties can enter into separate agreements and terms, typically through documents referred to as member agreements, stockholder agreements or partner agreements based on the joint venture entity type. These kinds of agreements are particularly useful for terms governing the relationship among only certain partners (e.g., buy-sell terms for different membership classes, obligations between two or more sweat equity partners, etc.) or for terms that are likely to change frequently, as this type of agreement may be easier to amend than the formal joint venture agreement.

Key Provisions in the Joint Venture Agreement

Purpose

Seemingly innocuous, the statement of the joint venture purpose is a key provision in joint venture agreements and is typically required to be included under various states' laws. While a typical single-member operating agreement may contain a purpose statement that allows the company to engage in any lawful business and activity permitted under existing law, the joint venture members will want assurances that the joint venture will not pursue activities beyond that contemplated by the parties. At the same time, the joint venture will also practically need its purpose language to be broad enough to cover the myriad of activities required to develop real property.

Set out below is a sample purpose provision for a joint venture agreement that is broad but also limits activities to those pertaining to specific real property:

> The Company is organized for the purpose of (i) acquiring, purchasing, selling, exchanging, constructing, developing, operating, leasing, assigning, transferring, financing, encumbering and otherwise dealing in or with the [real property, including the land that is the subject of the proposed development], personal property, equipment, supplies and other items in relation to the purposes stated herein, and (ii) doing any and all things permitted by law incidental to the foregoing, including but not limited to, borrowing of funds, pledging of Company assets, and dealing with tangible and intangible property of all kinds.

Budget

When drafting a joint venture agreement for a development project, the provisions dealing with the budget are of particular importance. The sweat equity partner must ensure that the budget provides for all of the expected and some unexpected costs that may arise during the development process. The money or equity partner will likely seek to limit any requirements for funding in excess of the budget agreed to at the time the joint venture agreement is entered into. Both parties must ensure that the budget is both realistic and flexible enough to ensure the timely completion of the project. The real estate budget development process can be broken down into three parts for this discussion: (1) predevelopment budget, (2) pro forma construction budget and (3) development budget.

The predevelopment budget sets forth the proposed capital outlay for land acquisition costs. These costs will vary by project, and the line-items will generally include feasibility studies and entitlements, engineering, architectural, legal and costs incidental to contracting for the acquisition of land (e.g., tax payments, earnest money deposits, etc.). The parties should add a "Miscellaneous" line-item to account for the unknown but inevitable costs that will arise at this predevelopment stage. By establishing the predevelopment budget, you ensure that the party incurring the expense (if not the joint venture entity) will be reimbursed by the joint venture for its property pursuit and planning costs.

The pro forma development budget is a preliminary budget that will provide the joint venture partners with a detailed outline of projected total costs and, perhaps more importantly, equity requirements. Because the joint venture partners generally must inject equity prior to using loan funds, the pro forma development budget allows the joint venture partners to plan for the upcoming equity requirements. In addition, the pro forma development budget creates the foundation for the development budget that is ultimately submitted to the lender and used for construction.

It is unlikely a development budget will be available at the time of signing the joint venture agreement, but if it is, there is no need to prepare the pro forma budget. If it's not available, you must create a procedure for the parties to convert the pro forma budget into the development budget. This procedure can be simple or complex and is wholly dependent upon the negotiating strength of the parties and the predetermined division of labor among the parties. One option is for the development budget to be approved so long as the figures are consistent with those outlined in the pro forma budget, and any deviations require the consent of a manager, the majority member, a certain percentage of the members or any other approval method that suits the parties.

In considering whether the total budget number is consistent with the pro forma budget, you may also want to consider deviations within certain budget categories. For example, if costs of one budget category increase, the party managing the budget process may keep things on budget by reallocating funds from a different budget category.

The joint venture parties may wish to limit budget reallocations. This is commonly done by inserting a provision similar to the below in the joint venture agreement:

> [Party controlling the budget] (the "Control Party") shall not reallocate line items within the Budget from how such items were presented in the pro forma budget, unless (i) the Control Party obtains [consenting party's] prior written consent to any reallocation which exceeds [$_______] on a per occurrence basis, and (ii) Control Party can demonstrate to [consenting party's] satisfaction that (a) such reallocation constitutes final cost savings in said line item, such that sufficient funds remain in the line item from which the amount is to be reallocated to pay all Project Costs which may be paid from that line item; and (b) no line items in the Budget (other than the line item to which the reallocation is sought) are required, in [consenting party's] judgment, to be increased.

Additionally, you should consider whether there are any items that will not be subject to reallocation, such as payments to affiliates of a joint venture party.

The joint venture majority member, if not the sweat equity partner, may be concerned that budget overages will disproportionately affect the majority member if budget overages are incurred in proportion to each member's respective ownership percentage. One way to balance that concern is for the sweat equity partner to absorb a fixed amount or a higher percentage of the overage.

Below is sample language providing for the sweat equity partner to absorb an initial threshold amount of budget overage:

> If the Company's actual costs of the property and services, in the aggregate, contemplated by the Development Budget exceed the amounts, in the aggregate, specified and budgeted in the Development Budget, the [sweat equity member] shall make an Additional Capital Contribution to the Company in an amount equal to said excess (the "Over Budget Amount"), but not more than $[dollar amount] (the "Overage Contribution") for purposes of this Section; provided, however, this limitation shall not apply to any of the [sweat equity member's] obligations in any other Section of this Agreement. The parties agree that no additional equity in the Company shall be issued to the [sweat equity member] in consideration for, or as a result of, the Additional Capital Contributions made by the [sweat equity member] pursuant to this Section. The Company has the right to offset any distribution or other payment due or otherwise payable to the [sweat equity member] against any amount that the [sweat equity member] owes to the Company with respect to the Overage

Contribution, and such offset amount, if any, will be allocated to the Member and accounted for as a Overage Contribution in the amount of such offset.

Depending on the nature and relationship of the joint venture parties, you should consider providing a means of ensuring the sweat equity partner performs its overage contribution obligation. Joint venture parties often accomplish this by requiring the stakeholders in the sweat equity member to guaranty the performance of the sweat equity entity member's obligations and liabilities.

Third-Party Loans

Although the joint venture parties will inject their own equity into a project, the joint venture parties typically seek third-party financing to fund the majority of the project costs, which may include both acquisition and construction financing. For purposes of this discussion, the term "loan" will mean any type of third-party loan obtained by the joint venture. A construction loan is used to draw funds to develop and construct a property, and a permanent loan is longer-term financing typically obtained once a property is completed and has established an operating history. Note that while there may be variation on these two main types of financing, most (if not all) loans will have the characteristics of a construction loan and/or a permanent loan.

The loan is an important component of any project, because it is a primary economic driver of project costs and returns. Consequently, the joint venture partners should contemplate the loan process in the joint venture agreement.

Important aspects of financing that should be agreed on prior to entering into the joint venture, and that may need to be documented in the joint venture agreement, include the following:

- Responsibility for obtaining the loan. Establish which party is responsible for arranging financing.

- Loan type, amount and term. Depending on the nature of the project and certain circumstances, such as if one of the parties has already acquired the property or if the joint venture will be acquiring and developing the property at the same time, the type of loan will vary as discussed above. Typical acquisition loans are for a fixed dollar amount, whereas the amount of a construction loan may be calculated as a percentage of the as-stabilized appraised value of the proposed project, or a percentage of total project costs. A construction loan term typically ranges between 18 months and three years, whereas a permanent loan is usually between five and 10 years. The joint venture parties may also wish to include a mini perm component, which is a short-term loan that bridges the gap between construction completion and permanent financing.

- Joint venture equity requirements. The High Volatility Commercial Real Estate, or HVCRE, rules established under the Basel III international banking standards will dictate minimum initial equity requirements for the joint venture and will further govern how and when the joint venture can return equity to its investors. The HVCRE rules are important to understand, but are beyond the scope of this article.

- Guarantors and indemnitors. Nearly all construction loans will require a guaranty of payment and construction completion by a nonborrower party(ies), and the lender will also likely require the guarantor(s) and joint venture borrower to enter into an environmental indemnity agreement. In this way, the loan documents will expose the guarantor — which is most often

> the joint venture equity partner or the direct or indirect owner of such joint venture equity partner — to greater financial risk than the sweat equity partners. The guarantor will often require compensation for the increased financial risk, and the joint venture agreement is the appropriate place to address how, when and who pays that additional compensation.

There are two prevalent ways of compensating the guarantor for the increased financial risk it is undertaking. The first is through the payment of a flat fee (the "fee option"). This fee is often a percentage of the total loan amount (typically, between 0.5 percent and 1 percent) and may be paid once at the time of loan inception or on a regular basis (e.g., annually). The second prevalent manner of compensating a guarantor for its increased financial risk is through granting that guaranty party additional equity in the joint venture at no additional cost (the "equity option"). One potential downside of the equity option is that it establishes a permanent arrangement (i.e., the additional equity) for a temporary issue (i.e., the loan). For example, if the construction loan is refinanced into a nonrecourse or limited-recourse loan, the guaranty party may have significantly reduced financial exposure but will still reap the benefits of the no-cost equity it acquired in the joint venture.

The fee option is often thought to be the more fair and flexible approach. The joint venture parties can tailor the fee option terms to the loan at hand. Regardless of whether you choose the fee option, the equity option, a hybrid of the two, or another approach chosen by the parties, the joint venture agreement should require the guarantor party to agree to be the guarantor and/or indemnitor, as applicable, if the proposed loan meets the predetermined terms established in the joint venture agreement. Without that affirmative obligation, the guarantor can use as leverage its participation as the guarantor of the loan and extract additional consideration for agreeing to be the guarantor and indemnitor under the loan.

To confirm the guarantor's obligation to enter into the applicable loan documents, the guarantor should either sign the joint venture agreement or a side letter agreement to memorialize its agreement in this regard. If you do elect the fee option, you must include the anticipated fee in your budget, and you should disclose this to any potential lender at the outset of any loan negotiations. Lenders dislike payments by the joint venture to its affiliate parties, and the amount and timing of the payments should be approved by the lender in advance to ensure compliance with the lender's expectations and its underwriting guidelines.

The parties may desire to establish preapproved terms for a permanent loan in the joint venture agreement, but this may be a futile task. The time horizon of a permanent loan is at least one to three years after completion of the construction of a project. During that time, loan underwriting standards may change, and what seems reasonable and feasible at the time of signing the joint venture agreement may not be so at the time the completed project is ripe for permanent financing. If you do wish to establish preapproved loan terms, the most practical option is to grant financing discretion to one party (typically, the joint venture equity partner) within certain parameters.

Sample language granting financing discretion to one party is below:

> The Equity Member shall be responsible for obtaining the Permanent Loan within [time period] following Stabilization of the Project, and thereafter, upon the maturity of any then-existing Permanent Loan. The terms of the Permanent Loan shall be those which are satisfactory to the Equity Member in its reasonable discretion; provided, however, that the terms of the Permanent Loan shall be as good or better than loans made by commercial and institutional lenders in the [define applicable market] that are secured by projects similar to the Project.

As an addendum to the foregoing suggested language, you may wish to add language establishing which party bears the burden of proving that the permanent loan arranged by the applicable joint venture party does or does not satisfy the standard(s) set forth in the joint venture agreement.

If there are multiple guarantors and/or indemnitors, those parties ought to consider the scenario where one guarantor or indemnitor incurs liability related to the joint venture that, proportionally, is in excess to its ownership percentage in the joint venture. This issue is typically addressed in a contribution agreement where the parties allocate liability among themselves for guaranty/indemnity obligations and further agree that if any one of them incurs liability in excess of its interest in the joint venture, the other party(ies) will reimburse the party that incurred the cost for the nonincurring party's proportionate share of the expense.

Returns

If all goes well, the joint venture will begin to generate net revenue. It is important to detail in the joint venture agreement how such revenue will be used, as well as the timing and priorities for any distributions or dividends. As the ultimate goal of the joint venture is to create a financial benefit for the partners, the provisions governing returns are generally the most important terms to the partners.

The joint venture agreement should first and foremost provide for the distribution of money and property from the entity to the owners upon certain occurrences, subject in all cases to the entity retaining enough money to pay all of its debts. These occurrences can be upon the approval of the owners and/or the entity's management, upon the occurrence of certain event(s), at regularly scheduled intervals or a combination of those occurrences. Distributions based on the happening of certain events may be tied to property or other asset sales or upon the entity's cash flow exceeding the estimated budget by a set amount. Additionally, distributions may be automatically approved for payment of certain obligations, such as tax liabilities, any guaranty fees and developer equity borrowing fees, among others.

After providing for the ability to make distributions, the joint venture agreement should include what is typically referred to as a waterfall provision, which specifies the priorities and timing of distributions. These priorities can be structured however the partners wish, but typically payment of obligations — such as third-party loans and member loans — receives first priority, followed by distributions to the owners of the joint venture entity as further described below. The joint venture partners should decide in advance whether distributions will be made in equal amounts to the partners, or whether certain partner(s) will receive a greater percentage of distributions/revenue than other partner(s) at different levels of the waterfall.

Waterfall provisions can be customized in any number of ways to adapt to the party's expectations. For instance, the money equity partner may wish to recoup its investment first before granting the sweat equity partner distributions, or to receive a greater portion of the distributions. Another option would be specifying that net profits up to a certain dollar amount will go to one partner and net profits over that amount will go to the other partner or be split between the partners. The key to these provisions is for the partners to reach a clear understanding of how they believe distributions should be allocated once the joint venture begins turning a profit.

Management and Authority

Another major consideration for the joint venture agreement is who should have authority over what actions. Although limited liability companies can be structured so that they are managed by their members, typically joint venture entities have two groups with varying decision-making authority — the owners (i.e., members in a limited liability company, stockholders in a corporation, partners in a partnership) and the management (i.e., managers in a limited liability company, directors in a corporation and general partners in a partnership). Management may also be authorized to appoint, and delegate certain responsibilities to, officers of the joint venture entity.

The joint venture partners will need to determine a variety of issues that relate to the management of the joint venture entity, including the following:

- What will be the voting percentages/breakdown among the owners?

- How many managers/directors will be elected or appointed, and how will the owners select the management team? For instance, the parties can mutually agree to one manager, mutually agree to a board of managers or board of directors, and/or allow each party to select a certain number of managers based on their capital contributions or voting percentages.

- What decisions will management be able to make, and what decisions require consent of the owners? Typically, management is responsible for day-to-day actions and authority, and owners' consent is required for major decisions. Major decisions are usually defined to include items that the law requires owners to approve, as well as items that the owners want additional input over, and may require a simple majority in interest (50 percent), a super majority in interest (usually 60 percent to 70 percent), or unanimous (100 percent) consent from the owners. Some examples of the major decisions that owners like to retain control over include but are not limited to:

- Amending the joint venture agreement;

- Merger or consolidation of the joint venture entity with another entity;

- Transfer of all, or substantially all, of the joint venture entity's assets;

- The taking of any action that is outside of the joint venture entity's stated purpose;

- Making any loan;

- Borrowing money or guaranteeing indebtedness on behalf of the joint venture entity;

- Agreeing to material terms for the lease of joint venture property in excess of a set number of square feet;

- Making any expenditure in excess of the budgeted amounts or a set dollar amount;

- Executing any material contract in excess of a set dollar amount relating to construction of the joint venture project;

- Making any assignment for the benefit of the joint venture entity's creditors;

- Admitting a new owner/member to the joint venture;

- Changing or modifying site plans previously approved;
- Approving the construction and/or operating budgets for the joint venture project; and/or
- Requiring additional capital contributions or capital loans by the owners.

- What percentage of management and/or owners is required to authorize an action? Another way of customizing how decisions are made is to assign different approval thresholds to different actions. For instance, on more minor approvals the joint venture agreement can specify that only a majority of the management and/or ownership is required to approve an action. On more major decisions, the joint venture agreement can require a super-majority approval (typically approval by two-thirds of management and/or ownership) or unanimous approval to authorize such actions.

- What happens in the event of a deadlock? If there is an even number of managers/directors, or an even 50/50 split between voting rights for the partners, a deadlock among management and/or ownership could result. In such instance, the deadlock could be treated as a rejection, which may ultimately lead to a partner asking a court to intervene, or the parties could agree on a process for breaking a deadlock. For breaking occasional deadlocks or deadlocks over more minor decisions, the parties can agree to have rotating vote mechanism where the parties alternate between who has the tie-breaking vote, or the parties can come up with internal or external tie breaking mechanisms. An example of an external tie-breaking mechanism is to appoint a mutually approved mediator or professional adviser to weigh in on the best course of action. An example of an internal tie breaking mechanism is to provide that a panel of the owners (if the deadlock is at the management level) be designated as the tie breakers.

Part 2 of this article will discuss equity interest transfers and exit strategies.

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