

A Primer On Real Estate Joint Ventures: Part 2

By J. Andrew Crossett and Samantha Maerz (January 25, 2019, 1:21 PM EST)

This is the second part of this article on real estate joint ventures.

Equity Interest Transfers and Exit Strategies

Permitted Equity Interest Transfers

The joint venture partners will also need to determine whether the partners will be permitted to transfer their ownership interests in the joint venture, and the extent to which the other partner(s)'s approval will be required for admission of any new members. Buy-sell provisions are discussed in further detail below in the context of separation, but joint venture agreements can also permit certain types of transfers (such as transfers to a family member or trust), no transfers at all, or require management or all other owners to approve admission of any new member into the joint venture entity.

A permitted transfer clause is provided below:

Subject to Sections [sections of the joint venture agreement with relevant transfer obligations/restrictions], at all times, a Member shall have the right, in its sole discretion, to transfer all or any part of its membership interest in the Company to another Member, to another entity owned and controlled by the Member, or to the Member's spouse, parent, child, brother, sister, grandchild, or trust for the benefit of one or more such individuals, without offering to transfer such membership interest to the Company and/or any other Member, and without obtaining the approval of the other Members.

Separation

At some point, a partner may wish to separate from the joint venture, and the joint venture agreement should provide for at least one method of doing so. While an ownership interest in a joint venture entity is typically treated as personal property of the owner, joint venture agreements may still prohibit or restrict an owner's separation from the entity or transfer of interest. Regardless of whether any separation is anticipated, the joint venture agreement should still include one or more mechanism(s) by which parties may voluntarily separate to avoid costly litigation or dispute resolution issues down the line.



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Member Withdrawal

The joint venture agreement should address the ability and terms of any membership withdrawal. While the laws of the joint venture entity's state of creation likely include default rules, such rules typically allow the joint venture agreement to change or modify the default rules. For instance, in California, a member in a limited liability company may withdraw at any time by giving written notice, regardless of the terms of the operating agreement, but such withdrawal does not entitle the withdrawing member to payment for its interest unless the operating agreement provides otherwise. On the other end, the default rule under Delaware law is that a member of a limited liability company may not resign unless the terms of the operating agreement authorize a member to do so. If the operating agreement does allow a member to resign, but does not specify the rights of such withdrawing member with respect to payment for the member's interest, Delaware law states that the member is entitled to receive the fair value of such member's interest in the limited liability company.

Another consideration is whether a third-party lender will be involved. In such cases, the terms of the loan documents may prohibit members from withdrawing while the debt is outstanding.

Put and Call Rights

"Put" and "call" mechanisms are a common form of resolving deadlocks and granting one or more partners an exit strategy. A put mechanism grants an owner the right to require that the other owner(s) acquire the putting owner's interest and a call mechanism grants an owner the right to require that the other owner(s) sell its interest to the calling member. Put and call mechanisms are typically designed to be triggered upon the occurrence of certain events and should provide a method for determining the purchase price for the ownership interest being sold. Typically, this purchase price is the fair market value of the membership interest as determined by a third-party appraisal. The appraisal will typically take into account all of the joint venture entity's assets, as well as the joint venture entity's unpaid liabilities, but the joint venture agreement may provide for different criteria that the third-party appraisers are required to use to calculate the fair market value.

An example of language that may be used to define the fair market value of the membership interest is below:

Except as otherwise set forth herein, the fair market value ("Net Equity") of a Member's Interest in the Company, as of any day, shall be the amount that would be paid or distributed to such Member in liquidation of the Company if: (1) all of the Company's assets were sold for their fair market values, (2) the Company paid its accrued, but unpaid, liabilities and established reserves for the payment of reasonably anticipated contingent or unknown liabilities, and (3) the Company distributed the remaining proceeds to the Members in liquidation, all as of such day; provided, that, in determining such Net Equity, no reserve for contingent or unknown liabilities shall be taken into account if such Member agrees to indemnify the Company and all other Members for that portion of any such reserve as would be treated as having been withheld from the distribution such Member would have received if no such reserve were established.

Triggering events for put and call rights can be heavily negotiated. They can be triggered upon the completion of certain stages of the project or upon a party's failure to perform its obligations. As mentioned above, they are also commonly triggered in the event of a deadlock between the owners.

Russian Roulette/Texas Shootout

Apart from put and call rights, there are other types of buy-sell rights that involve a third-party appraisal to set the purchase price. However, requiring a third-party appraisal can be a costly and lengthy process. To avoid having to appraise ownership interest using such methods, some real estate joint ventures may instead wish to include shotgun style buy-sell provisions, as further discussed below.

The two most common styles of such shotgun buy-sell provisions are commonly referred to as Russian roulette and Texas shootout provisions. Under a Russian roulette provision, an initiating owner will send notice to the other owner(s) stating the price per ownership unit at which the initiating owner is willing to either buy the other owner(s) interest or sell all of its interest to the other owner. Under a Texas shootout provision, each owner will prepare a sealed bid for the other owner(s)'s interest. Both bids are then opened at the same time, and the owner with the highest bid is permitted to purchase the interest of the other owner at such price.

An example of the key terms for a Russian roulette provision (not including any provisions related to closing timing or penalties for failure to perform) is below:

Any Member may initiate the buy-sell procedure hereinafter described ("Buy-Sell Right") at any time. Such procedure shall be initiated by the Member wishing to initiate it ("Initiating Partner") giving written notice ("Initiation Notice") thereof to the other Member (the "Non-Initiating Partner"). The Initiation Notice shall state a purchase price ("Unit Purchase Price") that the Initiating Partner designates for one (1) share or percentage interest in the Company ("Unit") and shall state that the Initiating Partner is prepared either to purchase the entire ownership interest of the Non-Initiating Partner for the Purchase Price (as calculated below) or to sell the entire ownership interest held by the Initiating Partner to the Non-Initiating Partner for the Purchase Price. The "Purchase Price" for the applicable ownership interest shall be calculated by multiplying the Unit Purchase Price by the number of Units in such ownership interest. The Non-Initiating Partner shall have thirty (30) days after the date of such notice from the Initiating Partner to elect to either sell its ownership interest or buy the ownership interest of the Initiating Partner on the above terms. If the Non-Initiating Partner does not make any election within said period, it shall be deemed to have elected to sell its ownership interest in the Company on such terms.

These types of buy-sell provisions avoid third-party appraisals by forcing the owners to establish the price of ownership units. While there are possibilities for one party to unfairly benefit from such provisions depending on the position of each party, for the most part these provisions are intended to produce a fair valuation. In a Russian roulette provision, for example, if an owner undervalued the interest, then it would risk its interest being purchased for less than what it was worth. If an owner overvalued the interest, then it would risk having to pay more for the other owner's interest than it was worth.

Drag-Along/Tag-Along Rights

Drag-along and tag-along rights are used in situations where there is a clear minority owner and majority owner. A drag-along right allows a majority owner to drag along a minority owner in the event the majority owner wishes to sell all of its interest to a third party. Such provisions require that the minority owner receive the same price and terms as the majority owner. If a sale of the joint venture entity is anticipated at some stage in the real estate joint venture, this provision can assist in such a sale by guaranteeing the sale of 100 percent of the ownership interest. Without such a provision, the

majority owner would only be able to offer to sell the ownership interest that it controls.

A tag-along right grants a minority owner an option to tag along with a majority owner in the event the majority owner wishes to sell all of its interest to a third party. The purpose of this provision is to protect minority owners by allowing them to receive the same price and terms as the majority owner, and to allow the minority owner to exit if it does not wish to continue the real estate joint venture with a third party.

Drag-along rights and tag-along rights are not mutually exclusive. An example of language that allows for both options is as follows:

The Member (“Exercising Member”) shall have the right, in its sole discretion, to transfer all or any part of its membership interests (“Interests”) in the Company to any one or more persons if so long as all other Members are given the opportunity to participate (“Tag-Along Right”) in the proposed transaction on financial terms equal to the financial terms offered to the Exercising Member, as adjusted to reflect each Member’s respective Percentage Interest, and, if the transfer is to an unrelated third party on an arms-length basis, at the option of the Exercising Member, all other Members shall so participate (“Drag-Along Right”) in the proposed transaction and transfer their respective Interests. The Exercising Member shall provide the other Members (“Continuing Members”) with written notice (“Transfer Notice”) of its intention to transfer all or part of its Interest in the Company, specifying in the Transfer Notice the identity of the proposed transferee, the purchase price therefor (the “Purchase Price”), and the terms of the proposed sale (the “Transfer Terms”). Thereafter, each Continuing Member shall have a period of fifteen (15) days (“Exercise Period”) to elect by written notice to the Exercising Member to exercise its Tag-Along Right.

If a Continuing Member does not exercise its Tag-Along Right, then following the expiration of the Exercise Period, the Exercising Member shall have a period of fifteen (15) days to elect by written notice to the Continuing Members to require the Continuing Members to join in the sale by selling to the Exercising Member's proposed transferee that portion of the Continuing Members' Interest which is identical to the portion, on a percentage basis, of the Exercising Member's Interest which is being transferred (it being expressly understood that the Exercising Member has no obligation to exercise its Drag-Along Right). If the Class A Member elects to exercise his Drag-Along Right, then the sale of the Continuing Member's Interest shall be at a price and on terms that are no less favorable to the Continuing Member than the Purchase Price and Transfer Terms, as adjusted to reflect each Member's respective Percentage Interest.

Right of First Refusal

Another common buy-sell provision is a right of first refusal. This type of provision is used when the parties want to allow each other flexibility to seek out third party purchasers, while still providing an option for the non-selling owners to acquire the selling owner’s interest on equal or better terms than the selling owner would receive from a third-party purchaser. However, rights of first refusal are not as useful for resolving issues of deadlock or forcing separation. Such provisions generally provide that the right will kick in upon receipt of a third-party offer. While it is possible for one owner to receive such an offer, it is more common that a third party would seek to purchase the underlying real estate rather than investing in only a percentage of the controlling joint venture entity.

Entity Termination

While one exit strategy is for an owner to transfer its interest or otherwise remove itself from the entity, another option is dissolution of the entity. An entity can be dissolved upon the happening of certain events specified in the joint venture agreement (e.g., filing for bankruptcy, sale of all or substantially all of the entity's assets, etc.) or upon written consent of all of the members, though the joint venture may be restricted by contract (such as under the joint venture loan documents) from dissolving.

To effectuate an entity termination, the joint venture entity must file notice with the applicable state(s)'s secretary(ies) of state. The joint venture entity will then proceed to wind up its business by paying off outstanding liabilities and obligations, disposing of property that will not be distributed to the owners in kind, and distributing the assets of the company among the owners. The specific details are largely guided by the applicable state law, but the terms (including how assets are distributed) may be specified in the joint venture agreement.

While this article provides details on many of the common issues surrounding real estate joint ventures, all joint ventures will be different. Partners looking to enter into a joint venture should make sure that they are knowledgeable about the other partners and exercise their due diligence before entering into a real estate joint venture. Once the parties are comfortable proceeding with each other, they should determine the key terms related to the joint venture entity's purpose, budget, capitalization, management, distributions, third party loans, exit strategies and any other project-specific or partner-specific terms desired by the partners. Completing this legwork up front will assist the partners in efficiently creating and maintaining a successful joint venture.

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