# KEY TERMS OF REAL ESTATE JOINT VENTURE AGREEMENTS

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The real estate joint venture (JV) is a distinct but common way for two or more private parties to form a legal entity.[1] These JVs are often used for the purpose of buying, developing, leasing, operating, managing, and, ultimately, selling for a profit real estate assets. JVs are typically governed by a written JV agreement that establishes the duties, obligations, responsibilities, and expectations for the parties to the agreement. Entering into a JV agreement should be done with care, however, because it is not uncommon for conflicts to arise between the partners during the development or operation of the project. This article reviews a number of issues that commonly arise between partners in forming, operating, and exiting the JV.

## What is a real estate JV?

A JV is commonly defined as a combination of two or more parties (people or entities) that acquire or develop and own, lease, manage, or sell one or more real estate assets. The JV typically has two categories of partners: the "operating partner" and one or more "capital partners." JVs are frequently used by experienced real estate developers to obtain the capital they need for their projects.

The capital partner is typically a passive investor who provides the bulk of the equity capital that the JV needs. In most cases, the capital partner is not involved in the JV's day-to-day management or operations, although the capital partner is likely to insist on having approval or control rights over "major decisions." The JV will typically raise about 20 to 50 percent of the total amount of the equity capital needed for the project and then obtain debt financing from a bank or other lender for the remaining capital needs.

As discussed below, the JV agreement details the specific initial financial contributions that each partner is required to provide. Further, the JV agreement should specify what happens when additional contributions are required and, in that regard, if the additional contributions are not made, how the ownership interests of the various participants will become diluted.

## Management of the JV

The JV agreement should address the management and voting rights of each of the JV partners as well as formal meeting requirements. The operating partner will typically serve as the "managing member" or "manager" with the authority to bind the JV to contracts with third parties, but these decisions may be subject to specific approval rights granted to the capital partner. The major decisions that the capital partner has the right to veto generally include all loans or financing arrangements, the acquisition of additional real property, the sale of JV assets, property management agreements, major leases, deals with affiliates, oversight of lawsuits, filing for bankruptcy, granting liens on JV assets, mergers, spending the JV's funds above certain approved limits, and granting easements. In some cases, the capital partner can force the major decision to happen (i.e., the operating partner cannot block it), and in other cases, the capital partner has only veto or blocking rights. Voting rights should clearly establish a decision-making hierarchy and clarify who holds decision-making authority over the JV.

The major decisions provision of the JV agreement is not boilerplate and is subject to negotiation. From the perspective of the operating partner, the right of control may be the difference between success or failure of the JV (e.g., the capital partner may be in position to veto action that the operating partner considers essential for the JV's success). Therefore, the operating partner should be firm in securing enough autonomy in the JV agreement to ensure that the capital partner cannot derail the most important decisions that the operating partner needs to be make for the JV to achieve and maintain success.

## Goals of the partners

While the goals of the two different JV partners are aligned, they are nonetheless different. The capital partner joined the JV to obtain a robust return on its capital investment. To obtain this desired economic outcome, the capital partner will require approval rights over major decisions which the capital partner views as placing its investment at undue risk. These control rights will therefore include the right to veto: (i) requests for additional capital; (ii) large increases in the JV's debt; (iii) the terms for sale of the JV assets; and (iv) the manner for winding down or selling the JV.

By contrast, the operating partner seeks a strong financial return by minimizing its capital investment. More specifically, the operating partner wants to secure a disproportionate share of the profits from the JV through what is commonly referred to as "carried interest." The operating partner will have the day-to-day control of the JV, and it will want to limit the approval (veto) rights that are granted to the capital partner, block the capital partner from removing the operating partner from its position, and generate fees for providing services to the JV, which include property management, leasing, development, acquisition, and disposition services.

Thus, the JV partners share the goal of securing favorable financial returns from the business, but the operating partner wants to preserve the freedom to make decisions regarding the manner in which the business will be run to meet those goals. By contrast, the capital partner wants to protect its investment and will therefore be unwilling to completely turn over the reins of running the business to the operating partner. The checks and balances at issue should be hammered out at the beginning so that each partner understands the motivation of the other partner, and so that they have a clear understanding of their respective roles, rights, and obligations.

## The role of capital contributions

The JV agreement sets forth the amount each partner is required to contribute to the JV as the "initial capital contribution." Some or all of this initial capital contribution is often mandatory, and remedies will apply if there is a failure to fund, including dilution or forfeiture of interest in the JV. Usually there is a cap on the amount of initial capital contributions and a date after which these contributions cannot be drawn.

A JV agreement also will include provisions for additional capital contributions requested by the operating partner that may be used for discretionary expenses, as well as to fund additional acquisitions,

development costs, unanticipated costs, or operating expenses. These additional capital contributions may also be for "necessary" expenses, which if not paid will cause material loss to the JV (i.e., property taxes, debt service, insurance, expenses necessary to prevent immediate threat to health, safety, welfare of public). The JV agreement will set forth whether the additional capital contribution is mandatory, and if not, the remedies for failure to fund are less severe than for the initial capital contribution and would not include a lawsuit for non-payment or forfeiture of the partner's interest in the JV.

## Distributions to partners

The terms of the JV agreement that dictate the manner in which distributions are allocated among the JV partners are known as the waterfall provisions. Contrary to what may be expected, it is common for distributions to vary from the amount of capital invested. For example, JV agreements used in real estate ventures and by private equity funds often provide incentives to operating partners that allow them to contribute a smaller share of the initial capital contributions, while providing them returns that far exceed their equity investment.

In a financially successful JV, the order of payment will be as follows:

- The JV will pay all debt and operating expenses that are owed to lenders and other third parties;
- The JV will then repay the additional capital contributions and the initial capital contributions that the JV received from partners; and
- The distributable cash proceeds arising from operations or from the sale of the underlying asset will then be paid through distributions to partners in accordance with the waterfall distribution provision in the JV agreement. The operating partner usually determines the amount of cash available for distribution after deducting expenses to be paid and making deposits to reserve accounts for future liabilities.

A common JV agreement scenario may include up to four tiers in the distribution structure, although this can be customized by the parties. The tiers will dictate what steps each dollar will take before becoming fully disbursed, with the four common components being: (i) a return of the capital contribution; (ii) a return of preferred capital contributions (commonly called a preferred return, the "pref," or the "hurdle rate"); (iii) the catch-up provision; and (iv) the carried interest.

In the first tier—the return of the capital contribution—all proceeds have to first repay the investors' full capital investment amounts. Then, the preferred return must be met. Typically, this is an amount in the range of six to eight percent of the investment, but this rate increases in higher interest rate environments. Next is a catch-up provision, which usually serves the interests of the operating partner and allows the operating partner to collect a substantial portion of the JV's profits. Last, the remaining profits are shared among the JV partners on a pro-rata basis. A carried interest usually qualifies for capital gain tax treatment that makes it more favorable than payment in the form of a fee that would be taxable at ordinary income tax rates.

The waterfall distribution provision of the JV agreement addresses who gets paid and in what amount, so the interpretation and implementation of this provision is a common source of dispute. Thus, operating and capital partners should pay close attention in negotiating this provision, and make sure to fully understand how it will operate in practice. To illustrate, "return of capital" can be defined as: (i) the total amount of capital contributed just for investment; (ii) the capital contributed to those investments that are realized; or (iii) the total amount of capital contributed for investments, as well as for investment expenses, and for operational expenses. Each of these different definitions will have a substantial impact on the amount that is distributed, as well as the timetable for distribution.

## Exit considerations

A critical component of a JV agreement is the exit provision, which sets forth the terms for when, how, and for what amount a capital partner is permitted

to leave the JV. Some of the most common exit terms utilized by capital partners in JV agreements are listed below:

- A "forced sale" provision that permits the capital partner to sell its interest in the JV asset without obtaining the consent of the operating partner;
- A "permitted transfer" provision allowing the capital partner the right to transfer its interest after making its full contribution of capital to the JV;
- A "buy-sell" provision, which allows either of the JV parties to send a notice to the other partner specifying a cash purchase price at which the offeror partner would be willing to purchase all the assets of the JV entity. After this offer is submitted, the receiving partner must elect to buy or sell its interest at this price;
- A right of first offer, which is a first right to buy the property or a JV interest before the triggering party offers it for sale to a third party;
- A right of first refusal to buy the property or the JV interest after the triggering party has first located a buyer who is willing to purchase it on the same terms as the third-party offer;
- A "drag along" clause, which gives the majority partner the authority to force a minority partner to join in the sale of a JV;
- A "tag along" clause, which enables a minority partner to force a majority partner to join in the sale of a JV;
- A put/call option clause that enables one partner to require the other partner to purchase its interest (a "put") or to purchase the other partner's interest in the JV (a "call") at an agreed value or at an appraised value;
- A redemption clause that allows a JV partner to redeem the interest of another JV member's interest at fair market value; and
- A dissolution clause that provides for the occurrence of events that cause the JV to dissolve in the future. These "exit" clauses are often included in JV agreements to avoid future disputes between the partners.

One or more of these exit provisions should be included within a JV agreement. Well-drafted exit provisions reduce or prevent disputes between JV partners by setting forth when, how, and for what amount a capital partner is permitted to depart the JV.

## Conclusion

JVs provide a flexible, established way to develop, maintain, and govern substantial real estate projects. But JV agreements are not "cookie cutter" types of documents, and both capital partners and operating partners need to focus closely when negotiating and adopting the key terms of these agreements. In particular, they should carefully negotiate the provisions in the JV agreement that concern: (i) major decisions; (ii) capital contributions (both initial and additional); (iii) distributions of cash according to the waterfall; and (iv) exiting the JV agreement. The allocation of profits and losses between the partners and exit from the JV agreement can lead to protracted and expensive conflicts if the terms are not spelled out in careful detail so there is no misunderstanding between the parties.

As a final note, we suggest using specific examples that include actual amounts in the drafting of JV agreements. Providing specific examples in the JV agreement of how distributions are determined by the operating partner and what amounts will be issued at various levels of distributable cash is a good way to head off at least some of the disputes that might otherwise take place between the partners. Finally, the partners may also want to consider having disputes about distributions be subject to a fast-track arbitration that will allow a prompt resolution of conflicts of this nature rather than allowing these claims to become embroiled in years of litigation.

Notes

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