Agenda For A Joint Venture Agreement

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It can be a lot like a marriage, so think twice before plunging in.

ANY REAL ESTATE INVESTMENT OR DEVELOPMENT PROJECT may need more than one principal to make it work. One principal might provide local knowledge and expertise. Another might deliver money, land, a project in progress, or some other asset. And any transaction may require specialized expertise, such as construction, hotel management, or the ability to find acquisitions if the joint venture intends, for example, to acquire a series of defaulted or distressed loans from multiple sellers. In cases like these, the parties may decide to set up a joint venture, rather than have just one of the parties undertake the transaction on its own.

Any joint venture for real estate will usually take the form of a limited liability company. But the terms and structure of each limited liability company will vary widely with circumstances. A joint venture can raise a wide range of business, practical, legal, and tax issues. The parties must think through those issues and negotiate them in a way that will meet their needs over the long term. Once the parties have signed their joint venture agreement, the relationship becomes much like a marriage. The parties must live with each other, for better or worse. Extrication can cause great pain and expense, potentially requiring litigation with all its attendant uncertainties, distractions, delays, expense, and surprises. Just as any careful bride or groom should insist on entering into a prenuptial agreement long before the wedding, any party going into a joint venture will want a clear and well-defined roadmap for the relationship and for extrication should it become necessary.

Although this discussion focuses on real estate joint ventures, similar issues arise in joint ventures in any other area. If that area operates under any regulatory or licensing regime, or in a highly political environment, that fact will open a whole new world of additional issues and requirements to consider. Each joint venture will, of course, depend very much on its own facts and circumstances, but the issues discussed here will typically arise in most joint ventures.

A few general points are worth mentioning at the start:

This discussion limits itself to joint ventures formed by a small group of sophisticated real estate players, often with existing relationships. The number of joint venturers will typically be small. This article assumes two venturers. If a transaction includes more, all the same issues arise and can be worked out, but they become more complex.

The discussion in this article assumes the joint venture will start by acquiring some interest in real estate — vacant land, defaulted loans, a building, a long-term leasehold, or some other real estate asset. The joint venture will then probably invest additional money in its business, perhaps to carry or improve the assets (e.g., finish a failed condo project) and in any case to reimburse the sponsor's staff costs (the typical real estate joint venture will not have its own employees), outside professionals, and operating expenses. Eventually, the joint venture will want to exit its investment, with the proceeds going to the venturers or, in rare cases, being reinvested in further projects within the joint venture.

MONEY IN • As the first and most fundamental issue for any joint venture, the venturers must agree on who will contribute how much money, and when. This requires an understanding of the joint venture's likely cash requirements, financing, budget, business plan, and timing.

If the parties form their joint venture to acquire a stabilized project, each venturer will probably want all the other venturers to fund their full capital contributions at closing, to avoid the need to think about credit issues, funding delays, unexpected reasons not to fund, and the like.

If the transaction will proceed in stages, however, the parties may agree to defer some anticipated cash contributions, particularly if only one venturer intends to write checks over time and has impeccable credit. (During the late real estate boom, sovereign wealth funds often met that standard. Even such funds may attract closer scrutiny in future joint ventures.) In joint venture negotiations, a venturer playing this role will often be referred to as the "investor" or the "money partner," even in a limited liability company.

If the parties form their joint venture after one of the parties has already invested capital in the project — for example, obtaining site control, seeking entitlements, and doing initial design work — the new venturer may need to reimburse its share of the first venturer's costs to date, or make some form of balancing contribution at closing or over time.

Future Capital Calls

If the joint venture needs additional money down the road (a capital call), who officially makes that determination? Once the determination has been made, what are the venturers' obligations to contribute? The venturers will usually agree to contribute in proportion to their relative investments in the joint venture — typically the same percentages that would govern distribution of ultimate profits of the joint venture.

As soon as any degree of complexity enters the picture, though, this simple and "fair" allocation may no longer make sense. For example, one of the venturers might act as the money partner, typically up to a certain point only. After that, the venturers' responsibility to contribute more funds could change completely. And if the developer partner will receive a special priority distribution in exchange for bringing to the table its development skills, then the money partner might ask the developer partner to bear more than its straight "percentage share" of capital calls that arise from construction problems. The money partner may also want to assure that the developer partner maintains a certain level of investment and risk in any event. These and other circumstances could drive the parties to negotiate some other allocation of responsibility for future capital needs.

In negotiating any joint venture provisions about future capital calls, the parties should consider at least the following:

- What conditions and limitations should apply to future capital calls? Should they require unanimous approval? What if the parties can't agree? Does the venture die? Do the answers vary depending on what led to the capital call?
- Should the managing venturer have the right to call for capital up to a certain amount, or only for certain purposes? Should capital calls beyond that level trigger any change in management and control?
- Should the nonmanaging venturer be exempt from all or certain capital calls, under the theory that the managing venturer was supposed to bring the expertise necessary to keep budget and expenses under control and consistent with expectations? If the nonmanaging venturer is receiving its interest in the deal as compensation for putting the deal together or contributing land, for example, then that venturer very well might expect to have no obligation to contribute further capital, and no risk of seeing its interest in the transaction drop if that venturer doesn't contribute. All of that may sound very reasonable and fair to the extent that capital calls arise from the managing venturer's mismanagement of the development process. If circumstances entirely beyond the managing venturer's control caused the problems, though, the managing venturer might insist that even a passive venturer bear its share of the risk.

The amount, timing, conditions, and allocation of additional (unanticipated) capital calls will often represent one of the most hotly negotiated issues in any joint venture agreement. As with so many other issues in any joint venture agreement, there is no single "right" or "standard" answer to the question. The answer depends very much on what risks each venturer has agreed to bear as part of the larger project.

Reluctant Contributors: The Squeezedown

If a venturer fails to contribute additional funds when required to do so, what can the other venturers do? Customarily, the defaulting venturer will face some so-called squeezedown of its interest in the joint venture, i.e., an adjustment to reflect relative contributions to the joint venture's capital taking into account the default. Those calculations will usually include some penalty against the defaulting venturer, although the documents will call it an adjustment or an enhancement but never a penalty.

For example, assume a 50/50 joint venture initially capitalized with \$1000. The venture has never distributed any capital back to venturers. It now needs another \$200. One venturer doesn't fund its \$100 share — a default in the amount of \$100. The other venturer funds the full \$200 capital call. Before any adjustment or enhancement, the defaulting venturer's share of the venture would become \$500/\$1200. The other venturer's share would become \$700/\$1200.

The defaulting venturer would, however, also then face a further adjustment equal to some percentage of the defaulted amount. In this example, the further adjustment might equal 10 percent of

$100, or a further adjustment of $10. The percentages would then adjust as if the defaulting venturer's capital in the deal had dropped by another $10, with the other venturer's capital increasing by the same amount. The new shares would become $490/$1200 and $710/$1200.

A venturer that expected to be the nondefaulting venturer would want these adjustments to apply only for future profit sharing, but not for future capital calls. That venturer might also want the right to force a defaulting venturer to leave the venture if its interest were reduced below a certain point. And a venturer that expected to be the defaulting venturer might want the calculations to include some imputed return on previously invested capital before calculating any squeezedown.

Regardless of the nuances, adjustments like these can add up, particularly because any adjustment factor is in effect automatically doubled, representing both a decrease in the defaulting party's share and an increase in the nondefaulting venturer's share. They can also create odd tax results. And the nondefaulting venturer may regard having a larger share of a failing venture as something less than an ideal remedy against the defaulting venturer.

Treating The Covered Amount As A Loan

In place of a squeezedown, the venturer that covers a defaulting venturer's contribution could have the right, at its option, to treat the covering payment as a loan to the defaulting venturer, or to recharacterize the entire capital call ($200 in the example) as a loan from that venturer to the joint venture. In either case, the loan would bear interest at a rate high enough to compensate the covering venturer for its incremental risk. The loan would typically be repaid from funds later available in the joint venture, before the defaulting venturer received any further distributions. Still, it leaves the nondefaulting venturer with greater exposure to a potentially failing project.

Control Issues

If one venturer covers another venturer's share of a capital call, then the covering venturer may want greater control of joint venture affairs. Therefore, the management and control provisions of the joint venture agreement, discussed below, may change in favor of the covering venturer so long as the covered venturer has not made the covering venturer whole. For example, if the managing venturer defaults, then the nonmanaging venturer could take over management. Conversely, if the money partner defaults, then the money partner could lose some or all of its approval rights.

Failure to contribute may also result in a forced buyout of the defaulting venturer, probably on somewhat unfavorable terms — though not unfavorable enough to constitute a "penalty."

Other Claims For Failure To Fund

Can the joint venture or any of the venturers sue the venturer that failed to fund its share of a capital call? Or sue the principals of that venturer? The answer may constitute one of the most important negotiations in any joint venture agreement. As a general principle, any venturer will want the ability to walk away from an unsuccessful project, consistent with the usual theory of real estate transactions, by which any investor always preserves the right to walk away. Under that view of the world, failure to fund may result in dilution, subordination, lost control rights, or not seeing any money from the venture for a very long time, but the defaulter's other assets will not be at risk.

Conversely, if a venturer expects to be the nondefaulting venturer, that venturer will fear that the measures just discussed will not adequately protect that venturer from the consequences of having a deadbeat in the deal.

The parties may, of course, want to vary from that general approach. For example, perhaps a venturer should have made its full contribution at closing, but didn't. Or if a money partner has committed a specific dollar amount to the project, that will probably be the whole reason the money partner is in the deal. In these cases, a venturer that does not fund should face meaningful consequences. Or a money partner will want to know the developer partner has serious "skin in the game" and exposure to the risk of a failed project.

Absent such circumstances, the venturers may want the joint venture agreement to negate any personal liability for failure to fund future capital calls. In that case, the only consequences of failure to fund will consist of the measures described above. The treatment of such a default might also vary with circumstances such as the stage of the project, the amount of money involved, and whether the defaulting venturer gave ample prior notice of its default.

Even if the venturers negotiate complete "walkaway" rights in their agreement, they still must remember that lenders and other third parties may demand guaranties and other credit support from the venturers or, more likely, their principals. Such measures could render walkaway rights rather worthless, as discussed later in this article.

MONEY OUT • If the joint venture makes money, the parties need to resolve when and how that money gets distributed. If one venturer has contributed management skill, particular assets, disproportionate funds, appreciated assets, or the like, then that venturer may receive some preferential return or payment from the joint venture. Any remaining funds would ordinarily be distributed in proportion to the percentage interests of the venturers.

Filling The Buckets

Depending on the circumstances, however, the proportions between the venturers might change over time. For example, if a developer partner contributes its development skills and its interest in a project, but a money partner contributes all future funds for the project, the parties might agree on a so-called waterfall. Under such an arrangement, all available cash — after payment of all third-party expenses — gets applied to fill various "buckets" in order. Those buckets and their sizes might vary depending on whether the available cash arises from the venture's operations or a capital transaction such as the sale or refinancing of an asset. Here is how a typical waterfall might work.

First, it could give the developer partner, off the top, a fixed development or management fee. If the property produces gross revenue, this fee could take the form of a percentage of gross revenue. Such a fee gives the developer partner a super-priority claim to available cash flow, before the joint venture makes any other distributions to the venturers. This claim may to some degree make the developer partner more like a creditor than an equity investor. This may give the other venturer some discomfort.

Next, the venturers might each receive a preferred return on its invested cash, such as a high single-digit percentage per annum. This preferred return would go largely to the money partner, in recognition that the money partner contributed the lion's share of the venture's capital.

Then, some percentage of any capital proceeds, or all, could go to the venturers in proportion to their invested capital until each venturer has received back a certain amount or all of its invested cash. Again, this bucket would go mostly to the money partner.

After that, or perhaps in place of the preceding two buckets, any remaining cash could go x percent to the developer partner and y percent to the money partner until the money partner has achieved an "internal rate of return" (to be explained in a moment, and typically referred to as "IRR") equal to z percent.

After the money partner has achieved an IRR of z percent, the split would shift a bit in favor of the developer partner, until the money partner has achieved an even higher IRR. These adjustments can repeat, or beyond some point the split can remain constant.

Internal Rate Of Return

The IRR that plays a central role in many joint venture waterfalls consists of a calculation that, in effect, looks at the money partner's investment in the project as if it were one or more deposits into a hypothetical bank account. Each distribution of funds from the project to the money partner becomes a hypothetical withdrawal from the bank account, in each case leaving an account balance of zero at the time of the calculation. The calculation then asks what interest rate the hypothetical bank account would have paid, over its entire life from the first deposit to that most recent withdrawal (which hypothetically zeroed out the account). The result becomes the money partner's IRR as of the date of measurement.

Any IRR calculation typically assumes compounding at least once a year. The formula should clarify whether the targeted IRR percentage (z percent in the waterfall example above) is expressed before or after compounding. If the money partner may also lend money to the joint venture, the definition of IRR should expressly either disregard any loans or take them into account. The same would apply for any fees the joint venture might pay the money partner.

"Promote" Payment

As a variation on the series of buckets just described, the developer partner might receive a so-called promote payment (e.g., x percent of net operating income or of some other profit measure), which might go up as the project's profitability goes up. The joint venture would typically pay the promote only after filling certain other buckets in the waterfall. Multiple promotes could exist at different levels of the waterfall. Multiple assets could have multiple waterfalls, with certain buckets (e.g., the developer partner's promote) being available (perhaps held within the joint venture) to help solve problems in other assets. In some cases, it might make sense to calculate the developer partner's promote as a share of the distributions that go to the money partner.

New Money/Old Money

If venturers enter the joint venture at different stages in its life, the parties may need to negotiate an entirely different structure, perhaps giving "old money" or "new money" its own special buckets in the waterfall. For example, a new money partner that comes into a troubled transaction will want all the existing venturers to agree that part or all of their investments will become subordinated both to the new capital and to a certain level of return on that capital. The "old" venturers will, however, want their previous investment to be honored to some degree, even if some of it is relegated to a highly subordinated bucket in the new waterfall.

Allocate Taxes To Track Other Allocations

In any event, the joint venture agreement will, as a general matter, need to allocate tax attributes in way that tracks the allocations of risks and benefits. Tax lawyers can, however, sometimes devise tax-optimized allocations (or at least deferrals of taxation) to reflect the special circumstances of the parties. At the same time, tax counsel will also want to identify and deal with any situation where a venturer might be deemed to receive taxable income but doesn't receive enough cash to pay the resulting tax — "phantom income."

Controlling The Distributions

Depending on who is involved in the joint venture and the level of complexity, the joint venture agreement should perhaps require the managing venturer to make distributions at least quarterly. The other venturer will also want to limit the managing venturer's discretion to set aside (or not set aside) reserves before making distributions. These reserves might, for example, cover anticipated losses, working capital, maintenance, capital expenditures, leasing, or other expected outlays.

SERVICES TO JOINT VENTURE • Often one venturer or its related company will provide special expertise to the joint venture. The joint venture will often sign a separate agreement with that service provider. The fee income from these services will represent an important part of that particular venturer's financial motivation for doing the deal. That venturer may well give up some other piece of the deal in reliance on receiving fee income.

The venture will often treat these fees as if they were paid to third-party service providers — i.e., they will come ahead of any payments to the venturers in their capacity as equity investors. The venturers will expect arrangements like these to be entered into at arm's length and on a commercially reasonable basis. At the same time, though, the venturer whose affiliate provides services will want comfort that the fee income for its affiliate is relatively safe. That venturer will want to know the venture can't cut off the fee income on a whim or if, for example, the money partner decides that the project no longer needs the developer partner's affiliate.

Conversely, if the developer partner truly does fail to live up to its responsibilities, the money partner will want to be able to cut off the bleeding and create an attractive opportunity for a replacement developer partner.

Address Services At The Outset

The parties should resolve the terms of any arrangement of this type as part of the basic joint venture negotiations. For example, if an affiliate of the managing venturer provides services under a separate agreement, the parties should negotiate and sign that agreement at the same time as the joint venture agreement.

When does a default under the joint venture or the separate agreement trigger consequences under the other of those two? If the managing venturer loses some of its control rights because of cost overruns or other problems, when does that loss also have implications for the separate services agreement? If the developer partner fails to meet a capital call — perhaps above a certain threshold — does that have consequences for the services agreement?

Resolution of these issues will not always be black and white. For example, the developer partner might retain some rights while losing others, with the result varying with circumstances. Or the money partner might have the right to take control under certain circumstances, without cutting off the developer partner's fee income. Or the agreement could guarantee the developer partner some minimum fee income or payment if the money partner "kicked out" the developer partner. These discussions will often throw off more heat as they relate to leasing commissions than as they relate to ordinary property management fees.

Future Lender's Concerns

The parties should also look ahead to the agenda of any future lender to the joint venture. Whoever will receive fee income from the joint venture should be ready to show that, if the venture didn't pay those fees, it would need to pay the same fees — or more — to an independent third party to receive comparable services. Otherwise, a lender may regard fees of this type as a thinly veiled technique to pull money out of the project and will ask at a minimum that the fees be subordinated to debt service. Even if the fees and services are bona fide and arm's length, the lender will usually want the right to kick out the service provider if the loan goes into default.

The party receiving fee income may produce a more satisfactory outcome in these discussions by addressing the issue as a fundamental part of the deal and part of the overall package from the beginning, as opposed to waiting for the lender to discover it as some kind of "smoking gun."

Interests Of Unrelated Venturers

If any dispute arises over the relationship between the joint venture and a venturer whose affiliate provides services to the joint venture, or if any such agreement may need to be amended, the unrelated venturer will want to control those discussions and any action that the joint venture might take against the service provider.

Particularly if the joint venture does not agree to pay management or development fees to an affiliate of the developer partner, the developer partner may instead seek generous rights to have certain overhead and project-related costs reimbursed.

CREDIT ENHANCEMENT • Anyone structuring a joint venture must look ahead to the venture's strategy for financing its business. In commercial real estate, this has typically meant that the venture would obtain institutional financing for the vast majority of its capital requirements, although for now that traditional technique has become virtually unavailable. To whatever extent the venture will obtain outside financing, the lender will probably ask for some form of credit support from the principals of at least one of the venturers. The parties should plan ahead for that likelihood. Again, they need to consider some important questions.

If lenders or other third parties will require guaranties or a letter of credit (an "L/C") to support the joint venture's obligations, which venturer must arrange those credit support measures? Will that venturer be entitled to receive compensation from the joint venture for the credit exposure it has agreed to undertake? Fees of this type may represent an attractive mechanism to pull money out of a project, if the venture's lender will allow it.

What happens among the venturers, and their principals, if an L/C or guaranty is called upon? Ordinarily the joint venture should become obligated to reimburse all funds paid out and should make a capital call on (at least) the venturers and possibly their individual principals. The joint venture's lender may object to such provisions, though, or may insist that obligations to the lender take precedence in any case.

Guaranties And Reimbursements

Regardless of any arrangements that involve the joint venture, if an individual principal of any venturer is at risk for a particular obligation, that principal may want the right to have the other venturers' principals reimburse their share of any payments the individual principal actually makes. That obligation will typically take the form of a reimbursement, contribution, or indemnity agreement.

In some cases, however, a venturer will deliver a guaranty or L/C in place of a cash capital contribution. If the lender ever draws on such a guaranty or L/C, the venturer's principal will need to write a check, but should not expect to be reimbursed, because the check simply amounts to a deferred version of the capital contribution that the venturer otherwise "should have" made to the venture at the outset. The venturer would then receive a capital contribution credit for the check, but no reimbursements from anyone else.

Similarly, if a venturer has joined the transaction because it can provide construction expertise, that venturer may need to sign a completion guaranty in favor of the venture's lender. If the lender ever calls upon that guaranty, the guarantor should not always have the right to seek reimbursement from the other venturers or their principals. If, for example, the guarantor also assured the other venturers that the guarantor would finish the job for a certain total price, then responsibility for any overruns should belong to the guarantor, not the venturers as a group, or their principals.

In these cases, the guarantor's obligations to the lender will often exceed those to the joint venture, leaving the joint venture with some residual risk. Treatment of that risk will require some fine-tuning.

Whenever a principal delivers any guaranties to the venture's lender, the principal must ask itself whether it will have the ability to control the risks being guarantied. For example, if the principal guaranties the venture's completion of the project, the principal will want to assure itself that the joint venture agreement gives the principal (through its affiliated venturer and perhaps directly) enough rights within the joint venture to get the project completed. This could, for example, require allowing the completion guarantor to enter the project, take over the construction process (or control it from inception), approve change orders, enter into and enforce contracts, or take other actions.

Any joint venture documentation should categorize very clearly any credit support that any of the venturers or their principals might provide for the joint venture's lender, and discuss exactly what happens if the lender ever draws upon the credit support.

MANAGEMENT AND CONTROL • Ordinarily, one venturer will act as managing venturer with authority to handle day-to-day operations and decisions of the joint venture. If a joint venture's affairs are complex, one venturer may manage some operations on a day-to-day basis and another venturer may manage others.

Major Decisions

Specified major decisions would, however, require unanimous agreement or a specified percentage vote if the joint venture had more than two venturers. In a real estate joint venture, major decisions might include:

- Acquisition of additional property;
- Adoption of (or major change in) an overall development plan;
- Approval of financing (especially given that the venturers may have differing appetites for risk);
- Change of use;
- Disposition of the property;
- Leases exceeding a certain size or duration;
- Budgetary decisions of certain major kinds; and
- A decision to terminate the joint venture and wind up its affairs.

For some of these items, the joint venture agreement might give the managing venturer authority to approve and close transactions that satisfied certain criteria.

Exit Date

One crucial issue in negotiating any joint venture will relate to the anticipated exit date. Just how long do the venturers plan to stay in the deal? Many transactions contemplate a three- to five-year "hold" — enough time to implement the parties' turnaround and value creation strategy — with the understanding that the joint venture will try to sell the property after that period. Some joint ventures contemplate a longer holding period. A condominium development project might anticipate a full sell-out in three years.

If the joint venture doesn't meet the agreed schedule, the agreement might provide for consequences, such as allowing the money partner to take control of the marketing program or other elements of the business. Today's market environment demonstrates, however, that a joint venture's failure to meet its target dates does not necessarily reflect badly on the managing venturer.

Approval Rights

A money partner will often seek a long list of approval rights. Taken far enough, this approach will mean that the managing venturer has no management discretion at all. If the managing venturer must obtain approval to make practically any decision, then the managing venturer can become little more than the money partner's hired hand, because ultimately the money partner's preferences become the only preferences that matter. That can happen even though the managing venturer nominally is the only venturer with authority to initiate any action, and any action also requires the managing venturer's initiation or concurrence. The whole arrangement can become impractical.

For those and many other reasons, the managing venturer will typically try to trim back approval requirements so they apply only to fundamentally important decisions and actions of the venture. The outcome of that discussion will depend on leverage and circumstances, but even if the money partner wins the discussion, the result may be a venture that just won't work. And, from the money partner's perspective, too many approval rights may become a burden, because the money partner typically does not want to spend its time on day-to-day management; it wants to bring in competent managers to assume that burden.

Broad Powers For Managing Venturers

In some cases, such as a limited partnership with purely passive investors, the managing venturer will have sole authority to make practically all decisions, subject only to restrictions on dealing with affiliates or otherwise in bad faith.

Control rights may change over time or as circumstances change, such as if the joint venture fails to meet specific goals or if the managing venturer violates the agreement (perhaps subject to a cure period) or files bankruptcy. Of course, any adverse actions triggered by bankruptcy will probably not be enforceable.

If the managing venturer's principal delivered any form of guaranty to the joint venture's lender, the managing venturer may insist that any change of control take effect only if the new managing venturer delivers a replacement guaranty and persuades the lender to release the original guaranty.

Control Rights In The Business Plan

The venturers will often agree to a business plan when they form their joint venture. This can become an exhibit to the joint venture agreement, though it should paint with relatively broad strokes and the venturers should resist the temptation to go into excessive detail, much of which will turn out to be wrong. As long as the managing venturer's decisions generally conformed to the business plan, the managing venturer would not need to go back for any approvals.

The nonmanaging venturer may want the right to audit the joint venture's books. If the audit discloses discrepancies, the managing venturer (or at least the joint venture itself) should pay for the audit.

Deed In Lieu Of Foreclosure

One particular decision raises its own set of knotty issues: the decision to deliver a deed in lieu of foreclosure to the joint venture's mortgage lender. As background, the principal of the developer partner will often deliver to the joint venture's lender a contingent guaranty of the loan that either expressly or indirectly may make the guarantor liable for the entire loan if it goes into default and the borrower does not promptly deliver a deed in lieu of foreclosure. Thus, the joint venture's delivery of such a deed will often be motivated by precisely such a guaranty.

Does the delivery of such a deed amount to self-dealing and make the venturer liable to the other venturer? The managing venturer and its principals certainly hope not. The time to raise that issue is in negotiating the original joint venture agreement, although it is hardly a typical issue on any joint venturer's agenda.

In the atypical case where the venturers actually undertake that discussion, they will also probably want to discuss the decision process for a bankruptcy filing for the joint venture. The joint venture's lender will often insist that the principals of some or all the venturers give the lender a personal guaranty of the entire loan, triggered if the borrower files bankruptcy. Any venturer whose principal has signed such a guaranty will want to be able to prevent the joint venture from filing bankruptcy.

Similar dynamics may drive other control measures within the joint venture agreement. Issues of control — and its limits and possible adjustments — will often trigger extensive negotiations and ripple through other terms of the agreement. The outcome will vary from deal to deal, depending on the agenda of each party and the overall purpose of the joint venture. No real standard exists in this area, except that usually each venturer will want as much control as it can get over all decisions.

TRANSFERABILITY • Anyone going into a joint venture would like to know how they can get out of it. One possible exit strategy would consist of selling the venturer's interest to some third party, a new investor who would take over the seller's interest in the transaction. As a practical matter, though, any such sale will usually produce a less attractive price than the seller would receive if the joint venture were to sell all its assets in an orderly way. And whichever venturer does not sell will not relish the possibility of finding itself "in bed" with an unanticipated new co-venturer.

Typical Transferees

Ordinarily, the joint venture agreement will prohibit transfers of any kind except to affiliates or family members or under other specified and highly negotiated circumstances. And if any of the venturers are themselves entities — rather than individuals — the joint venture agreement will typically limit transfers of stock or other equity in those entities and potentially their parent entities. The agreement may, however, allow transfers to certain types of potential transferees, or even any transferee from a list of the usual likely transferees given the nature of the transaction. In any event, the agreement will define certain categories of prohibited transferees, such as competitors of the other venturer and parties whose names appear on lists of possible terrorists.

Nature Of The Individual Transfer Right

A venturer's transfer rights may vary depending on the venturer's role in the deal and the stage of the transaction. For example, if a venturer brings to the transaction great expertise in construction, the joint venture agreement may prohibit any transfer by that venturer (except to affiliates, with a parent guaranty) until construction has reached a certain stage. The documents may even require the developer partner to maintain certain individuals in certain roles within its organization. After that, the venturer might be allowed to transfer to a certain group of permitted transferees.

If a transfer requires consent and the other venturer refuses to consent, this will sometimes trigger a liquidation or the buy-sell procedure discussed below, at least if the impasse arises after completion of construction.

Lenders, municipalities, a hotel manager, or others may impose requirements that a particular principal maintain a certain level of control of the joint venture. How do these requirements interact with permitted transfers, or the right of the money partner to replace the developer partner if the developer partner does not live up to the performance standards in the joint venture agreement? The money partner may require, as a condition to its investment, that whenever these third parties come into the deal, they must approve in advance the money partner's possible termination of the developer partner, perhaps subject to replacement of the developer partner by a new party that meets certain agreed standards.

Any joint venture agreement may also give each venturer rights if the other venturer wants to sell its interest. For example, if one venturer wants to sell, the other venturer might have the right to match, or the first right to make an offer, or the right to "tag along" for any transaction, i.e., sell its interest on the same terms (equitably adjusted) to the same buyer. Correspondingly, a venturer that initiates a sale of its interest may in some circumstances have a "drag-along" right, i.e., the right to force the other venturer to sell its interest on the same terms (equitably adjusted) to the same buyer.

Borrowings Or Investments Backed By Equity Pledge Or Preferred Equity

Will either venturer want to obtain mezzanine financing, or arrange other borrowings or investments not secured by the property but backed by an equity pledge or preferred equity? The transfer restrictions in any joint venture agreement will usually prohibit any such transactions. Therefore, if a venturer anticipates entering into them (e.g., a syndication of the interests of the money partner), the joint venture agreement should expressly provide for and facilitate such transactions, with appropriate protections for the other venturer.

DEADLOCKS AND BUY-SELL • Any joint venture agreement will need to deal with the possibility that the venturers cannot agree on a major decision that requires unanimous approval. Other serious problems may arise that would justify undoing the joint venture. And, at a certain point, a venturer may want the right to terminate the relationship for any reason or no reason (for example if the venture has achieved stabilization or, after a certain period, a venturer wants to do something else or can no longer legally participate in the joint venture).

To cover these circumstances, a joint venture agreement will often establish a buy-sell mechanism. If a venturer initiates the buy-sell process, that venturer must specify a deemed value for all assets of the joint venture. The other venturer then must choose one of two options. He can either buy out the first venturer, or be bought out himself. In either case, the price for the buy-out will equal the distribution that the seller would receive if the joint venture were to sell all its assets at the value specified by the party invoking the buy-sell mechanism, pay all transaction costs of the sale, operate in the ordinary course of business (with income and expenses allocated in accordance with the agreement) through the date of closing, pay all its debts, and distribute what's left over.

The process sounds rather logical and intelligent, as it allows an orderly exit at a price that should reflect the true value of the venture's assets. As a practical matter, however, a buy-sell can rapidly become very dramatic and traumatic, starting with the facially simple issue of how one might value the joint venture's assets and continuing with the fact that the venturers may have incomplete information about the venture's assets and business and unequal ability to obtain that information.

Triggering Events And Disincentives

For those and other reasons, if a joint venture agreement provides for a buy-sell at all, the process can often only occur at a specified stage in the life of the joint venture, e.g., after completion of construction or after a specified number of years or during certain window periods. In addition, as a disincentive to invoke the buy-sell option, the parties may want to build in some form of discount factor against whichever party initiates any buy-sell process. For example, if that party ends up buying, then the seller might receive an extra two percent of the amount otherwise payable; and if that party ends up selling, the seller might receive two percent less than the amount otherwise payable. Though such measures may create just the right (dis)incentives to initiate the buy-sell process, they are not common. One might say it makes no sense to "penalize" whichever party happened to pull the trigger first once the joint venture was already doomed (much as a judge in divorce court doesn't care who initiated the divorce or who cheated first).

Buy-sell mechanisms also create problems if the two venturers bring unequal financial strength to the table, or if one venturer's share of the deal is substantially larger than the other's. To some degree the parties can solve these problems by:

- Providing for a very long closing period, so the purchaser can arrange financing; or
- Allowing the purchaser to pay most of the purchase price over time, with the obligation secured only by the joint venture assets.

The possible selling venturer (most likely the money partner) might find either of these prospects quite unattractive, and will also worry that the buying venturer might announce it intends to buy out the other venturer, but then default. In that case, the selling venturer may want the right to take over the joint venture and exercise other rights and remedies against the defaulting venturer.

In many joint ventures, the venturers rely on the buy-sell mechanism as a backstop to give both parties an incentive to act reasonably and negotiate reasonable resolutions to differences of opinion. In practice, buy-sell mechanisms raise a wide range of nonobvious issues, of which those mentioned above represent only the tip of the iceberg. Thus, a buy-sell mechanism seems likely to create its own controversies and even litigation if ever implemented. These mechanisms have rarely been tested. They and their uncertainties may simply motivate the parties to resolve their differences.

Forced Sale Option

Given the limitations of buy-sell provisions, the parties may also negotiate provisions allowing either to force an orderly sale of the joint venture's assets under the same types of circumstances that might allow either venturer to trigger a buy-sell. Such a forced sale might also give both venturers the right to purchase on appropriate terms.

The law governing the joint venture may also give each venturer the right to require a dissolution under certain circumstances. Any joint venture agreement will typically limit or supersede those statutory triggers for dissolution, and may also modify the dissolution procedure that might otherwise apply by statute.

To the extent that the joint venture has any recourse or guarantied indebtedness, or one venturer has provided any other form of guaranty or an L/C, this raises special issues for a buy-sell mechanism, a forced sale of the joint venture's properties, or a dissolution toward similar ends. In those cases, whatever party provided the credit support will want to be released from any liability or exposure.

For that and other reasons, any buy-sell arrangement, or other possible buy-out of one venturer by another, will need to be taken into account in negotiating loan documents and other third-party agreements of the joint venture. Those documents and agreements should, if at all possible, allow the venturers to close their buy-sell or other exit transaction without triggering a default or needing anyone's permission. And if that seems not to be possible, the parties will want to know that as early as possible in the life of the transaction and, if possible, figure out some way to mitigate the problem.

FORMATION OF CONSTITUENT ENTITIES • In structuring a joint venture, the venturers and their counsel must also think about what entities will constitute the venturers of the joint venture. In the rare case where the parties set up the joint venture as a general partnership, each venturer will have personal liability for all the debts of the joint venture. Particularly in those cases, each venturer will often establish a single-purpose shell corporation to serve as a venturer, subject to whatever net worth requirements may apply.

Careful structuring of the constituent entities may also provide a future mechanism to reshuffle joint venture interests in a graceful and inconspicuous way and in a way that may possibly mitigate future transfer taxes. The joint venture agreement transfer restrictions should, however, reach any such transfers. Multiple tiers of entities may also facilitate various levels of mezzanine financing.

Lender Requirements

Lender requirements may drive the formation of subsidiaries owned by the main joint venture entity. For example, if the joint venture anticipates obtaining mortgage financing, the lender will typically want the actual borrowing entity to have very simple organizational documents, devoting far more attention to single purpose entity issues than to any of the business issues discussed in this article. In those cases, the parties will typically set up a property-owning entity that does nothing more than meet the lender's requirements. The "true" ultimate joint venture entity will own all the equity interests of the neutered entity that actually owns the lender's collateral. That way, the lender may not need to worry as much about the business negotiations between the venturers. Recent bankruptcy decisions suggest, however, that lenders may pay more attention than in the past to exactly who owns the single-purpose borrowing entity, and how that structure is set up.

Other Entities In The Ownership Structure

In short, part of the process of structuring a joint venture consists of deciding what other entities need to play a role in the ownership structure, and how those entities will be structured. Venturers and their counsel should make and implement those decisions when forming the initial ownership structure, as they can be more expensive and complex to implement later. They may even turn out to be impossible to implement, if they require third-party consents from uncooperative counterparties.

If the venture plans to undertake multiple separate projects, similar issues will arise in structuring each project. The documents will also need to define the degree of interconnection between the projects. For example, if one project makes money and the other loses money, must they feed each other? The issues of multiple projects otherwise lie outside the scope of this article.

TAX PLANNING • Any joint venture structure must take into account federal income tax concerns. Partnership taxation rules (which typically apply to limited liability companies as well) are exceedingly complex and sometimes nonintuitive. As an overall theme, those rules seek to assure that at the end of the day (taking into account the entire lifespan of the investment, all the way from the first dollar invested through disposition and liquidation of all assets), the use of a partnership results in the same amount of taxable income as if just one person had undertaken the entire transaction. That may sound simple, but in practice it is not. Anyone going into a significant joint venture transaction must arrange tax counsel early in the structuring process.

Choice Of Entity

The first legal/tax issue in structuring any joint venture will relate to the specific choice of entity type: limited liability company; limited partnership; general partnership; or something else? The limited liability company has become the vehicle of choice for virtually all joint ventures, because it offers the tax benefits of a partnership, the liability protection of a corporation, and a flexibility unknown to either.

The specific circumstances of any transaction will drive the decision, though. For example, if a state imposes taxes on a limited liability company but not a partnership, the parties may prefer a partnership. As another example, if the venture anticipates acquiring distressed loans, the venture's tax counsel will need to focus on the special tax characteristics of those investments, including the possible tax effect of a restructuring of one of these loans in a way that reduces the face amount of the loan to some number that still exceeds the joint venture's investment in the asset.

The creation of the joint venture may itself incur transfer taxes. Who must pay them? Can the parties mitigate them? Those are questions to answer early in structuring a new joint venture.

Each party should also think about any tax decisions down the road that might particularly affect that party. In some cases, the documents will hardwire that decision into the agreement between the parties. In other cases, certain major tax decisions will require unanimous approval.

Tax-Exempt Entities

If a venturer is a pension fund, employee benefit plan, or some other form of tax-exempt entity or related to one, that will trigger tax issues rippling through the entire agreement, and otherwise beyond the scope of this article. Further issues may arise if a venturer is subject to bank regulation, either at the outset or because the venturer's parent company qualifies as a bank holding company after the venture was formed. Other venturers may bring with them other regulatory issues.

DUE DILIGENCE • If one venturer has already started work on the project or transaction when the parties form their joint venture, the venturer buying into the project will want to perform full real estate due diligence — almost as if that venturer were buying the project outright.

In these cases, one venturer already controls some asset or opportunity, but creation of the joint venture may require consents or approvals by various counterparties, such as landlords and governmental authorities. The venturer buying into the deal will want to identify those consents or approvals and make sure they are in place at the time of closing, or the parties have at least dealt with the possibility that the consents and approvals will not be obtained or will cost money to obtain.

Any potential venturer will often want to perform a background check, to get comfortable with its new co-venturer. Given today's heightened sensitivity about money laundering, prohibited parties, regulatory controls, and the like, a full background check may represent one of the first action items for any proposed joint venture. Any such background check may first require appropriate written consents.

The parties will also care a great deal about understanding one another's character, reputation, business philosophy, creditworthiness, and resources. As a practical matter, these will probably matter more than all the rights and remedies in the joint venture agreement.

A FEW OTHER ISSUES • Sometimes the parties form a joint venture very early in the life of a development project, long before the required pieces of the project have come together. In these cases, the money partner may worry about limiting its exposure should the project not come together as planned, or when planned.

New Members

Particularly for a project that has not yet "come together," a joint venture agreement may provide some mechanism to admit new venturers down the road.

Fiduciary Duties

The parties to any joint venture undertake their transaction in the shadow of partnership law principles that impose on each partner a fiduciary duty to any other partner. The scope of that duty will sometimes be uncertain and not known until a court decides what it means. Similar duties may apply in a limited liability company, but also might not. Given that backdrop, any parties to a joint venture agreement will want to define the nature of their obligations to one another. Does either venturer owe the other any form of fiduciary duty? Just how much? And what about the converse? In exercising its approval rights, can the money partner consider its own "selfish" interests without regard to the larger interests of the joint venture?

Termination

Sometimes a joint venture agreement should establish a specific termination date or at least a termination process. This is not essential, however. Any concerns in this area may be addressed by a well-structured buy-sell mechanism (subject however to the caveats above) or provisions allowing one venturer to force a sale of the venture's assets under certain circumstances.

Visibility

Each venturer will often have its own agenda about publicity, visibility in the industry, and how the project will be identified. These concerns can sometimes create substantial issues. In negotiating the joint venture agreement, the parties should think through those issues and try to satisfy both parties' agendas, a goal that can almost always be achieved.

If the parties intend to keep the project and the joint venture confidential, they should say so. These restrictions may fall away at a certain point in the life of the joint venture.

Competing Ventures

Typically, a joint venture agreement will expressly allow each venturer to participate in ventures and other investments that compete with the business of the joint venture. If the parties desire to prevent such competition, they should add appropriate restrictions to the joint venture agreement. For most real estate investments, such restrictions will not make sense, given the huge number of competing properties, developers, and other players at every level of the market. Still, a money partner may extract from the developer partner a promise not to enter into competing projects within a certain radius, at least until the venture's project reaches a certain level of completion or sell-out. These restrictions probably appear more often in development projects — particularly developments for sale — than in joint ventures to acquire and hold an existing project.

If the developer partner already owns competing projects, the joint venture agreement may contain provisions to try to prevent the developer from favoring a competing project over this one in lease negotiations.

Purely Legal Issues

Beyond the wide range of joint venture negotiations this article covers, any joint venture agreement will also raise issues of a more purely legal nature. In resolving those issues, the parties and their counsel will consider themes very similar to those discussed throughout this article. The outcome of these lesser issues will often reflect the treatment of the more substantial issues discussed earlier in this article.