

Beginning with the End in Mind: Exit Mechanisms in Joint Venture Agreements

By Joan Hayden and John Sullivan¹

Introduction

“Hope springs eternal in the human breast.” – Alexander Pope

“Man plans; God laughs.” – Yiddish Proverb

Although partners generally enter into a real estate joint venture with great expectations and an alignment of their respective interests, things can change with the passage of time: events intercede, needs change and parties can fall out of love – with the property, with each other, and sometimes with both. A variety of mechanisms can be included in joint venture agreements to facilitate a parting of the ways when one partner wants to sell the joint venture’s investments or discontinue its relationship with its partner and the other partner does not share those objectives.

The typical joint venture exit mechanisms are well known; one or more of them are almost reflexively included in joint venture agreements.² However, a more thoughtful approach to those familiar devices will often yield a better result for both partners. The first step is to understand the legal structure of each of the partners, their relative resources, liquidity and bargaining power, and their respective motivations and business goals. With these issues in mind counsel should analyze how each of the exit mechanisms may impact the partners at different points in the life of the venture, taking into account the appropriate triggers and other critical issues such as tax concerns, lender rights, and guaranty and indemnity obligations. Proper planning at the formation of the joint venture can preserve or prolong the alignment of interests by minimizing conflicts between the partners, and ultimately assist each partner in achieving its primary goals with respect to the property and the partnership if and when it is time for a “divorce”.

Section 1 of this article contains a brief review of joint venture structures. Section 2 describes threshold considerations that may dictate the selection of different exit mechanisms. Section 3 describes some commonly used joint venture exit mechanisms, and Section 4 describes the issues raised by each of those exit mechanisms. Finally, Section 5 explores the arguments in favor of a “negotiated” exit – an agreement to unwind the joint venture that does not employ the

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² These exit mechanisms include a buy-sell, right of first offer (ROFO), a right of first refusal (ROFR), a ROFO or ROFR with forced asset sale right, a put/call, and unilateral sale right, all of which will be discussed below.

exit mechanisms set forth in the joint venture agreement, but that instead is negotiated and agreed upon by the partners at the time that they decide to part ways.³

1. Real Estate Joint Ventures Generally

For tax efficiency and to limit the liability of the joint venture investors, most real estate joint ventures are structured as limited liability companies.⁴ Most joint ventures are either “development joint ventures” involving new construction or substantial renovation of the property in question, or “operating joint ventures” focused primarily on leasing and operating an existing real estate project. For ease of discussion, in this article we will (i) use the term “joint venture” to apply to either a development joint venture or an operating joint venture, (ii) refer to the joint venture participants as “partners”, (iii) refer to the partner who is acting as a developer and/or handling day-to-day operating responsibilities as the “Operating Partner” and the partner who is primarily providing equity as the “Capital Partner” and (iv) assume that the joint venture owns (directly or indirectly) a single property and refer to that property as the “Property”.

In both development joint ventures and operating joint ventures, the Operating Partner will typically have sourced and tied up the asset and have local market knowledge and experience. The Operating Partner will be responsible for the day-to-day activities of the joint venture, subject to the Capital Partner’s right to approve “major decisions”; in cases where the Capital Partner is contributing the bulk of the required equity, the Capital Partner may have a unilateral right to make major decisions, with a delegation of authority to the Operating Partner to operate the day-to-day affairs of the joint venture in accordance with an agreed upon business plan and budget. Although the relative level of equity commitments varies from deal to deal, one common fact pattern is for the Operating Partner to make a relatively small capital commitment – often as little as 5% or 10% of the required equity capitalization – and for the Capital Partner to provide the balance of the equity capital. In a development joint venture, the Operating Partner or its affiliate will typically provide a completion guaranty to the construction lender (and in some cases to the Capital Partner) and assume disproportionate or entire responsibility for cost overruns. For purposes of this article, we will assume that the Capital Partner is contributing most of the required equity to the joint venture.⁵

Development joint ventures allow Capital Partners who do not have development expertise to participate in real estate development projects and, if things go according to plan, achieve returns commensurate with the development-related risks inherent in those investments. Operating joint ventures may be formed to achieve a variety of business goals. For instance, they may be set up to own mature, stabilized assets where the principal object of the joint venture is to obtain a stable return on invested capital, to add value through improved management of an existing property, to permit an existing owner to take money out of a property while retaining an

³ A number of existing ACREL Papers contain excellent analyses of joint venture exit mechanisms. See “Exiting the Real Estate Joint Venture” by Alvin Katz; “The Changing World of Real Estate Equity Investment” by Dean Pappas, Steven Waters, Vicki Harding, Gary Fluhrer and Robert Gottlieb; and “When Joint Venturers Can’t Agree/The Buy-Sell Revisited” by Elliot Surkin.

⁴ For some investors, particularly certain non-US investors, limited partnerships are preferred over limited liability companies.

⁵ Although joint ventures are often used as vehicles to acquire investment property by partners making substantially equal capital contributions, the considerations regarding exit mechanisms in those joint venture are different and beyond the scope of this article.

ownership stake, especially when debt markets are not an attractive source of capital, or to allow a foreign investor to own real estate in a tax efficient way.

In both development joint ventures and operating joint ventures, the distribution waterfall typically provides that distributions are first made to the partners ratably in proportion to their relative capital contributions until both partners have received the return of their respective capital contributions plus an additional amount sufficient to cause the Capital Partner to achieve a stated preferred return or internal rate of return (IRR), after which the Operating Partner is entitled to receive an increased and disproportionate share of distributions (the Operating Partner's share of distributions that exceeds its pro rata share of contributed capital is generally referred to as the "promote" or "carried interest").⁶

Whether a development joint venture or an operating joint venture is being formed, the motivations of the partners, the business plan for the asset, and the goals, capitalization and liquidity of each partner (both on an absolute basis and relative to each other) will all contribute to the selection and negotiation of joint venture exit provisions.

2. Threshold Issues to Consider When Structuring Exit Mechanisms

The basis for any successful joint venture is an alignment of the interest of the Operating Partner and the Capital Partner. At the outset of the joint venture there must be a meeting of the minds as to the business plan for the real estate investment in question, and agreement as to the anticipated events that will result in value creation for the joint venture. Is it to develop and lease a new building? A renovation or other repositioning that will result in increased rents? Is the Property in a transitioning market? Is it inefficiently managed or in need of substantial deferred maintenance? Determining what the value creation event(s) will be and when that value creation is likely to occur will be a principal factor in determining the holding period for the Property and appropriate triggers for exit mechanisms. Similarly, agreeing on a desired return expectation or the timeline for stabilization of a development project may dictate the first date an exit mechanism may be triggered.

In addition to the initial equity needed to acquire or construct the Property, the partners should consider and, if possible quantify, likely additional equity needs. Will either or both of the partners be required to fund additional equity if needed? What are the consequences to a partner of failing to fund additional equity it is required to contribute? An unwillingness or inability of a partner to fund required additional capital calls are events which might entitle the other partner to trigger an exit mechanism.

Other factors also need to be considered at the outset of any joint venture. For instance, agreeing on the leverage plan for the Property is critical to the success of the joint venture. The duration and terms of available debt financing will be an important factor in formulating a business plan. Refinancing following value creation can result in a partial or complete repayment of capital (and also possibly additional proceeds), and a refinancing may extend the period for operation of the joint venture and postpone the rights of either or both of the partners to trigger an exit mechanism.

⁶ The amount of the "promote" or "carried interest" can increase as the IRR to the Capital Partner increases.

Although the interests of the partners may be aligned through most of the life of a joint venture, those interests often diverge following a value creation event. Understanding your partner and its motivations, particularly in the long term, is critical. While partners may agree on shared business goals for the joint venture or the asset, they may have individual business goals as well, and those individual goals may be in conflict and may change with time.

A Capital Partner with a long term investment strategy may want to avoid a sale of the Property for as long as possible, while a Capital Partner that is a closed end fund may have a limited time horizon for ownership of the Property. Liquidity may also be an issue for a fund following the expiration of its investment period. The Capital Partner may change its investment strategy over time and determine that the Property is no longer a good fit for its portfolio, which may limit its desire to invest additional capital and/or cause it to seek an exit from the joint venture sooner than the Operating Partner would like. The Capital Partner may also want to sell the Property as part of a larger sale of a portfolio of assets it already owns or expects to acquire, which may create delay, valuation issues or other Operating Partner concerns that such an approach will not lead to best execution of the exit from the investment.

Similarly, the Operating Partner may have concerns that do not align it with the Capital Partner. The Operating Partner may have limited capital to invest and want to exit the joint venture as soon as the value creation event has occurred to monetize its “promote” or make its capital available for its next investment. It may also be looking to include the asset in a portfolio of assets it is assembling in the same or a regional location and may be loath to sell its interest but not in a position to buy the Property or the Capital Partner’s joint venture interest. A sale at an inopportune time could cause recapture of depreciation or even phantom income.

The legal structure of the partners and their tax positions will also influence the approach that they take to exit mechanisms. For example, and as described in further detail below, (i) a partner that holds its investment (directly or indirectly) through a Real Estate Investment Trust (“REIT”) will want a lockout period designed to protect it against the possibility of a tax on 100% of its net income from a sale of the Property (or its interest in the joint venture) as a “prohibited transaction” under Section 857(b)(6) of the Internal Revenue Code (the “Code”), and (ii) certain non-US investors may want the Property to be held through a REIT and typically (but not always) for any disposition to be structured as a sale of interests in that REIT. The selling member (or its direct or indirect owners) may want to defer tax recapture by retaining an interest in the joint venture for a certain period of time, guarantying some of the joint venture’s debt, and obtaining a “tax protection” agreement from the partnership.⁷

Finally, while the partners may agree upon a business plan at the beginning of their relationship, either partner may “fall out of love” with the asset over the term of the joint venture. For instance, a large institutional investor that is continually acquiring assets may determine that other assets in the relevant market are more attractive and thus seek to sell the Property. An Operating Partner that is unlikely to achieve its promote may not be willing to

⁷ Note that, on October 5, 2016, the IRS issued regulations that restrict the ability of partners to defer gain from the disposition of partnership interests by requiring that, for disguised sale purposes, all partnership liabilities be treated as nonrecourse obligations, thus precluding the use of so-called “bottom dollar guaranties” to defer gain recognition. The details of these new regulations, and their impact on the tax planning that may be involved in certain joint venture exit mechanisms, is outside of the scope of this article.

invest additional capital, whether financial or emotional, and want to turn its attention to other investment opportunities. Each of these conclusions could lead to one partner or the other to seek to exit the joint venture.

Of course, although one cannot plan for all contingencies, it is also advisable to consider how a failure of the business plan or exogenous events could affect the partners' plans. In a failed development project, the Capital Partner will probably want to get rid of the Operating Partner as soon as possible, but may also want to pull the plug on the entire project. The Operating Partner, on the other hand, even if behind in its "promote", may want more time to complete the development and stabilization of the asset. In an event like the great recession, the management fees were what kept many Operating Partners alive. Opting to sell its interest (or the project) in that type of environment and losing management of the property would have left many Operating Partners with nothing to show for their investments, while buying out the Capital Partner was often not an option, particularly with the frozen debt markets.

While neither partner has a crystal ball, each partner should perform its own analysis of (i) which partner is most likely to be the buyer in a buy/sell or other exit mechanism that gives one partner the option to acquire the other partner's joint venture interest or the Property and (ii) the ability of each partner to accomplish any such purchase. As described below, the answers to these questions will influence which exit mechanisms each partner wants to include in the joint venture agreement and the details of how it would like those exit mechanisms to work (e.g., response times, deposit requirements, closing date and closing conditions).⁸

3. Commonly Used Exit Mechanisms

(a) Buy/Sell

In a typical buy/sell provision, the partner wishing to initiate the buy/sell (the "Buy/Sell Initiating Partner") gives a notice to the other partner (the "Buy/Sell Responding Partner") in which the Buy/Sell Initiating Partner sets forth an assumed gross value for the Property.⁹ The Buy/Sell Responding Partner then has a set period of time to elect to either sell its interest in the joint venture to the Buy/Sell Initiating Partner or to purchase the Buy/Sell Initiating Partner's interest in the joint venture. Although the calculation of the purchase price for the joint venture interest of the selling partner can be done in more than one way, a common formulation is that the price for the selling partner's joint venture interest is the amount that the selling partner would receive if: (1) the Property were sold for an all-cash price equal to the assumed gross Property value stated in the notice from the Buy/Sell Initiating Partner,¹⁰ (2) all financing and other indebtedness of the joint venture (and any of its subsidiaries) were repaid in full, (3) any outstanding loans from one partner to the other partner were paid in full, (4) the resulting hypothetical net sale proceeds, and all other cash and cash equivalents of the joint venture (and

⁸ While outside the scope of this article, it is important to understand the transfer tax and real estate reassessments implications of the various exit mechanisms and determine if there are ways to structure the exit mechanisms to avoid or mitigate adverse results with respect to the same.

⁹ As noted below, some buy/sell provisions provide for a pricing of all of the assets of the joint venture.

¹⁰ Because the date of the hypothetical sale could impact the calculation of the amount that would be distributed to each partner, the joint venture agreement should specify the assumed closing date. In a joint venture where a partner receives a preferred return, that partner will usually want the assumed sale date to be the date on which the buy/sell transaction closes.

any of its subsidiaries), were distributed to the partners on the assumed sale date in accordance with the applicable distribution provisions of the joint venture agreement and (5) the joint venture were liquidated. In this article, we refer to this method of establishing the value of each partner's interest in the joint venture the "Hypothetical Property Sale Method."

Buy/sell provisions come in many flavors, and the optimal approach from each partner's perspective depends on the facts and circumstances that relate to that partner and the investment in question.¹¹

(b) Right of First Offer/Sale of Joint Venture Interest¹²

In a typical right of first offer ("ROFO") provision for the sale of a joint venture interest, a partner desiring to sell its interest in the joint venture (the "ROFO Offeror") gives a written notice to the other partner (the "ROFO Offeree") that sets forth the proposed price for the ROFO Offeror's interest in the joint venture. The ROFO Offeree then has a set amount of time to elect to purchase that interest for the offered price and, if it elects to purchase, to close on the same. If the ROFO Offeree does not exercise its purchase right, the ROFO Offeror has a set period of time during which it may sell its interest to a third party as long as the price at least equals a specified floor amount – i.e., the price to be paid by the third party buyer must be equal to, or very close to, the price at which the joint venture interest was offered to the ROFO Offeree (e.g., 95-98% of the price offered to the ROFO Offeree). If the ROFO Offeror does not complete the sale of its interest to a third party at a price at least equal to the floor price within the applicable sale period, any future sale of that interest would once again be subject to the ROFO in favor of the other partner.

Joint venture agreements sometimes contain tag-along and/or drag-along provisions that apply when one partner is selling some or all of its joint venture interest to a third party. Although these provisions are fairly straight forward when the joint venture interests are "straight up" (e.g., distributions are always made in accordance with the percentages of capital contributions), they become considerably more difficult to draft properly and to implement in practice when the joint venture agreement has "promote" or "carried interest" distributions. An example of a tag along provision is attached as Exhibit A.

(c) Forced Property Sale Provision/ROFO

In some transactions, the joint venture agreement will contain a mechanism allowing one partner to force a sale of the Property (a "Forced Property Sale"). Sometimes, particularly when

¹¹ As noted below, certain investors may prefer not to have any buy/sell provision in the joint venture agreement.

¹² Transfers of a portion of a partner's joint venture interest to a third party, while not complete exit mechanisms, are often considered by the partners and included in the joint venture agreement. Such partial transfers can accomplish a number of business objectives for both the Capital Partner and the Operating Partner, including limiting downside risk, monetizing appreciation, limiting geographic or single asset exposure, and allowing for a redeployment of capital. A non-institutional Operating Partner may seek the ability to transfer some of its interest for estate planning purposes. Because the Capital Partner typically wants the Operating Partner (and/or certain key individuals employed by affiliates of the Operating Partner) to have control of the Operating Partner and a minimum amount of equity (or "skin") in the game, direct and indirect transfers of the Operating Partner's interest to unrelated third parties are usually subject to the Operating Partner (and sometimes certain "key individuals") continuing to meet minimum ownership and control requirements. Capital Partners that are funds may request the right to transfer some or all of its investment to one or more other funds managed by such Capital Partner or its affiliate.

one partner has invested a very modest amount of the equity, the majority partner may have the right to force a sale of Property without having to give the other partner the opportunity to be a buyer. More typically, the right to force a sale of the Property is subject to a right of first offer in favor of the other joint venture partner. This mechanism is similar to the right of first offer governing a sale of a partner's interest in the joint venture described above, except that, if the responding partner does not elect to buy, the partner that initiated the process can sell the Property (not just its interest in the joint venture) to a third party at a price at least equal to, or within some percentage of, the price at which the Property was offered to the other partner. As with the joint venture interest ROFO, if the responding partner does not elect to buy and the initiating partner does not complete the sale of the Property to a third party at the minimum price and within the applicable sale period, any future sale of the Property is usually once again subject to the right of first offer in favor of the other partner. Although joint venture agreements sometimes provide that, if the responding partner elects to buy, it must buy the Property, these provisions frequently give the buying partner the right to structure the transaction as a purchase of the selling partner's interest in the joint venture.

In a variation on the Forced Property Sale/ROFO provision described above, the joint venture agreement may provide that: (i) the initiating partner's notice does not contain a proposed price for the Property but instead offers the responding partner a period of time in which the responding partner may propose the price for the Property, and (ii) if the responding partner proposes a price within that time period, the initiating partner may either (y) acquire the Property for that price (or the responding partner's joint venture interest based on a value derived from that price) or (z) require that the Property be marketed and sold to a third party at a price at least equal to, or within some percentage of, the price that was proposed by the responding partner. When this approach is used, if the responding partner fails to propose the price for the Property within the allotted response time, the initiating partner can require that the Property be marketed and sold to a third party without a floor price.

As noted above, Forced Property Sale/ ROFO provisions provide that, if the holder of the ROFO does not elect to buy, any sale to a third party must close within a specified period of time and the sale price must be at least equal to, or within some percentage of, the price offered to the holder of the ROFO. Joint venture agreements will sometimes provide that the partner that desires to have the Property sold may elect to have the sale close for a price that is less than the floor price as long as, at the closing, the other partner receives the same amount that it would have received if the Property had been sold for the floor price. This "make-whole" payment can be funded through a reallocation of the distribution of the sale proceeds from the joint venture (i.e., by decreasing the amount distributed to the partner that elected to cause the sale at a price below the floor price and increasing the amount distributed to the other partner by the same amount) and/or by a payment directly from the partner that exercised the Property Forced Sale to the other partner.¹³

¹³ Another joint venture exit mechanism is the right to of a partner to sell its joint venture interest or the Property subject to a right of first refusal in favor of the other partner. Although a right of first offer has similarities with a right of first refusal, the critical difference between the two is when the purchase right is activated: "A right of first refusal is triggered when a seller of an asset subject to such right has agreed to sell the asset to a third-party buyer. The holder of a right of first refusal then has the option to purchase the asset on the same terms as those accepted by the third-party buyer. Thus, a right of first refusal allows a property owner to negotiate a sale with a third party,

(d) Put/Call

The put/call exit mechanism needs little explanation. A partner that has a put right may require that the other partner purchase its interest in the joint venture, and a partner that has a call right may require that the other partner sell its joint venture interest to it. In each case, the value of the joint venture interest being sold is typically calculated using the Hypothetical Property Sale Method, except that the assumed sale price for the Property is usually as agreed upon by the partners or as established by an appraisal process, which can take many forms.

Joint venture agreements will sometimes grant a partner a call right on the other partner's joint venture interest upon certain defaults by such other partner, and in those circumstances the purchase price for the defaulting partner's interest might be (x) the fair market value of such interest, (y) a percentage of the fair market value of such interest or (z) the lesser of the defaulting partner's unreturned capital contributions and the fair market value of that interest (or some percentage of the fair market value of that interest).

In development projects where a guaranteed maximum price or fixed price construction contract is not in place when the joint venture acquires the Property, the Capital Partner may attempt to obtain the right to put its interest to the Operator Partner, or to force a sale of the Property, if the final cost of the project exceeds the originally budgeted cost by more than a certain percentage. When a put is used in this situation, the price for the Capital Partner's interest is often its unreturned capital contributions plus a stated return thereon.

4. Considerations and Issues in Selected Exit Mechanisms

Each joint venture exit mechanism has its advantages and disadvantages and, as noted above, how each partner evaluates the same depends on a number of factors, including its investment goals, its capitalization and liquidity (both on an absolute basis and relative to its partner) and the nature of the underlying investment. The questions and issues that should be considered with respect to the joint venture exit mechanisms described above include the following.

(a) Buy/Sell Considerations and Issues

The buy/sell can be viewed as an application of the divider-chooser method of fair asset division. Under this methodology, each of two parties¹⁴ can act in a way designed to guaranty

subject to the right-holders right to match the terms of and preempt any sale of the Property negotiated between the owner and a potential third-party buyer. A right of first offer, in contrast, prohibits the owners from negotiating a transaction with a third party until the Property has been offered to the right-holder." *RCMLS II LLC v. Lincoln Circle Associates, et al.*, C.A. No. 9478-VCL, Memo. Op. (Del. Ch. July 28, 2014). A right of first offer provision can be used in lieu of, or in conjunction with, a right of first refusal. Rights of first refusal are used less frequently than rights of first offer, in large part because of a concern that a right of first refusal will "chill" the ability of the selling partner to market and sell its interest and/or lead to potential buyers demanding a break-up fee for being a stalking horse in the sale transaction.

¹⁴ The Polish mathematician Hugo Steinhaus, one of the founders of modern game theory, was one of the first people to come up with a methodology (known as the "lone divider method") for applying the "I cut, you choose" approach when the asset is to be divided among three parties. Just as the math gets more complex when more than two parties are involved, buy/sells get more complex when there are more than two joint venture partners. This article does not attempt to deal with the added complexities involved in buy/sells involving more than two parties.

that it receives a share of the asset in question that, based on that party's valuation criteria, is at least as valuable to it as the remainder of the applicable asset.¹⁵ The example that is often used to illustrate this principle involves a cake to be divided between two parties; one party (the divider) cuts the cake, and the other party (the chooser) chooses which piece to eat.¹⁶ Because the divider does not know which piece of the cake it will get, it has an incentive to divide the cake in a way that causes each piece to be of equal value to the divider.¹⁷ Similarly, it is generally assumed that, because the partner that initiates the buy/sell does not know whether it will be a buyer or a seller, it will have an incentive to set forth an assumed fair market value for the Property that is consistent with its good faith opinion of the Property's actual value, thus creating an inherent honesty in the buy/sell pricing methodology (In this article, we refer to that assumption as the "Pricing Honesty Assumption"). In addition, when parties agree to include a buy/sell provision in a joint venture agreement, they may assume that, when it comes time to initiate or respond to a buy/sell notice, neither party will be at a material informational advantage or disadvantage relative to the other (In this article, we refer to that assumption as the "Information Equivalency Assumption"). Finally, an implicit assumption with respect to a buy/sell is that the value derived from the investment by each partner is limited to the value of its interest in the joint venture calculated in accordance with the distribution waterfall of the joint venture agreement (In this article, we refer to that assumption as the "Valuation Equivalency Assumption"). The extent to which these assumptions are true will vary from transaction to transaction, and each assumption should be tested in any transaction in which a buy/sell is being considered.

An important consideration in determining the validity of the Pricing Honesty Assumption in a given investment is whether, if a buy/sell is initiated, each partner has roughly the same ability to elect to be a buyer. If the partners do not have a relatively equal ability to be a buyer in a buy/sell, the partner with the superior buying power may be tempted to initiate the buy/sell with a value that is less than what it thinks is the true fair market value of the Property on the theory that, at least on the margin, the other partner may be predisposed to be a seller rather than a buyer.¹⁸

The most obvious example of asymmetry in the ability of the partners to be a buyer in a buy/sell that might tilt a buy/sell procedure that appears to be fair on its face in favor of one partner or the other is the relative capitalization and liquidity of the partners. For example, in a

¹⁵ The origins of the divider-chooser method of asset division can be traced as far back as the Book of Genesis: "So Abram said to Lot, Let's not have any quarreling between you and me, or between your herders and mine, for we are close relatives. Is not the whole land before you? Let's part company. If you go to the left, I'll go to the right; if you go to the right, I'll go to the left." Genesis, Ch. 13, v8.

¹⁶ See "The Changing World of Real Estate Equity Investment" by Dean Pappas, Steven Waters, Vicki Harding, Gary Fluhrer and Robert Gottlieb, American College of Real Estate Lawyers.

¹⁷ Note that the divider will always receive a portion of the asset that, to the divider, has the same value as the portion of the asset selected by the chooser, whereas although the chooser will always receive a portion of the asset that, to the chooser, is at least as valuable as the portion that goes to the divider, it is possible that the chooser could receive a portion of the asset that, to the chooser, is more valuable than the portion that goes to the divider. Thus, fair asset division theory generally holds that it is better to be the chooser than the divider. Likewise, in the context of joint venture exit mechanisms, some investors are of the view that it is better to be the party that elects to buy or sell (the chooser) rather than the party that names the price (the divider).

¹⁸ Of course, this could be a dangerous gambit for the initiating partner because, if it guesses wrong and the other partner elects to buy, the initiating partner will have sold its interest for less than what it thinks that interest is worth.

joint venture between an institutional Capital Partner with a large capital investment in the joint-venture and a non-institutional Operating Partner with a much smaller capital investment, the institutional Capital Partner may have relatively easy access to the cash needed to buy out its partner and will need considerably less cash to do so, whereas the Operating Partner may need to secure additional equity and/or debt in order to acquire the interest of the Capital Partner. As less obvious example of when a buy/sell may be very unfavorable to one of the partners might be where the Property is held through a private REIT, in which case, depending on the ownership of the partners, the acquisition by one partner of the other partner's joint venture interest could cause the REIT to be closely held.

Although Capital Partners that are institutional investors are often better positioned to be a buyer than less well capitalized operators/sponsors, institutional investors can face challenges of their own in responding to buy/sell notices. For example, if the Capital Partner is a private equity fund and the fund's investment period has ended, it may not have the ability to increase its investment in the Property, or an increase in that investment may require approval by the fund's limited partners and/or advisory committee. Depending on the size and nature of the investment, an increase in its investment in the applicable property may create issues with respect to the Capital Partner's asset allocation and/or diversification requirements. The Capital Partner may need to obtain investment committee or other internal approvals to increase its investment in the Property, and it may be difficult to get those approvals by the deadline for a response to the buy/sell notice.¹⁹ Finally, for some non-U.S. investors, their investment will become significantly less tax efficient if they own 50% or more (by vote or value) of the joint venture and/or control the joint venture.²⁰

Even if one assumes that the partner that is in a better position to be a buyer than the other partner will not attempt to use that advantage to "game" the buy/sell pricing, a partner that is concerned about its ability to come up with the funds that would be required to buy out its partner may resist the inclusion of a buy/sell provision on the basis that it doesn't want to be forced to be a seller, even if the price is "fair."

If the Information Equivalency Assumption is untrue in one or more material respects, the partner with the superior knowledge – typically the Operating Partner – could attempt to use that advantage to set a price that, unbeknownst to the other partner, is not indicative of the Property's true value. For example, if the Operating Partner knows that it is highly likely that a new lease for a significant portion of the Property will be signed in the not too distant future but the Capital Partner does not also have that information, the Operating Partner could try to "game" the system by initiating the buy/sell with a value that reflects some, but not all, of the incremental value that would be created by this new lease. In this situation, the value selected by

¹⁹ The institutional investor can (and should) protect itself from this risk by making sure that the response period provided for in the joint venture agreement is sufficiently long to allow it to obtain any necessary internal approvals and to issue any applicable capital calls.

²⁰ At the risk of over-doing the cake cutting analogy, offering an investor that will suffer a material tax cost if it elects to buy is a bit like asking a diabetic to choose which slice of the cake it wants to eat.

the Operating Partner may appear to be above market to the responding partner, thus making the Capital Partner inclined to elect to sell.²¹

The Value Equivalency Assumption will be valid if the value derived from the investment by each partner consists primarily of the value of its interest in the joint venture calculated in accordance with the distribution waterfall of the joint venture agreement. If this is the case, a properly drafted buy/sell provision should accurately value each partner's interest in the joint venture. When considering how it values its interest in a joint venture, however, a partner may take into account factors that are unique to it such as the net present value of fees that such partner or its affiliates receive as long as that partner holds its interest in the joint venture or the reputational, branding and/or marketing benefits that such partner derives from its investment in the joint venture. If these types of factors are a material component of how one partner (but not the other) values its interest in a joint venture, the buy/sell valuation approach may be problematic for the partner that places material value on components of the investment that are not captured by the buy/sell pricing methodology.

A partner that may be at a material disadvantage in a buy/sell because of potential impediments in its ability to elect to acquire the other partner's interest, because of a material informational disadvantage, or because they do not believe that a buy/sell valuation provision will accurately value its joint venture interest should consider the following:

- Attempt to avoid having a buy/sell in the joint venture agreement. As noted above, there are a number of alternative liquidity provisions that can be included in the joint venture agreement that do not force the partner that did not initiate the liquidity provision to be a buyer or seller. This is especially true for certain non-US investors who will face significant additional tax costs if they elect to be a buyer in a buy/sell.²²
- If the joint venture agreement will contain a buy/sell provision, (i) provide for a reasonably long period to elect to buy or sell and, if an election to buy is made, to close on the acquisition, (ii) try to minimize the amount of the deposit that must be posted by the partner that elects to buy and (iii) try to limit the remedy of the selling partner for a default by the buying partner in its obligation to buy to retention of the deposit.²³
- To mitigate a potential informational advantage the joint venture agreement could require that a buy/sell notice contain representations about certain topics, such as absence of information known to the triggering partner but not disclosed to the responding partner regarding any offers to purchase the Property or to enter into a major lease for the Property.

²¹ Whether the Operating Partner's actions in this regard would constitute a breach of the implied covenant of good faith and fair dealing and/or its fiduciary duties (assuming that such fiduciary duties have not been effectively waived) is beyond the scope of this article.

²² Although this type of investor could elect to buy and then attempt to find a new joint venture partner before the buy/sell closing date, proceeding in this manner would put that investor in a difficult position when it comes to negotiating with its putative new partner.

²³ Of course, all of this is a two-edged sword, as the same provisions will apply no matter which partner triggers the buy/sell.

(b) ROFO/Forced Sale Considerations and Issues

Some of the issues described above with respect to the Pricing Honesty Assumption, the Information Equivalency Assumption²⁴ and the Value Equivalency Assumption can also be relevant in the ROFO and Forced Property Sale context. However, because the ROFO and Forced Property Sale provisions result in a sale to a third party if the responding partner does not elect to buy, the concerns about potential valuation “gaming” may be less acute. Some partners, especially Capital Partners who are concerned about being at an informational disadvantage, may require that, even if they trigger the Forced Property Sale/ROFO, the responding partner must propose the value for the Property.²⁵

As noted above, an implicit premise in a buy/sell provision is that the uncertainty about whether the triggering partner will be the buyer or the seller provides an incentive for the triggering partner to select an assumed value for the Property that reflects its good faith opinion of the Property’s fair market value. In a ROFO provision, assuming that the ROFO Offeror has a good faith desire to sell its joint venture interest or the Property, it likewise will have an incentive to propose a realistic value. The ROFO Offeror won’t want to use a value that is materially less than what it thinks is the fair market value of the Property (or its joint venture interest). If the partner that sets the value uses a value that is materially above the fair market value of the Property or, if applicable, its joint venture interest, it is unlikely that either the other partner or any third party will buy at the above-market price. What if, however, the partner that triggers the ROFO provision has less pure motives – for example, what if it is concerned about its joint venture partner exercising a buy/sell or forced sale right, and it wants to forestall that exercise. A less than scrupulous joint venture partner could trigger the ROFO with a value that is substantially above market, knowing that its partner is unlikely to buy at the inflated price and knowing that it will be unlikely to sell its joint venture interest or the Property to a third party at that price. Assuming that the ROFO notice cannot be “trumped” by the exercise of another exit mechanism (e.g., a buy/sell), this partner will have effectively frozen the other partner out from exercising any exit rights until the end of the ROFO sale period. Although there is no complete solution to this risk (other than choosing the right partner), one protective measure is to provide that, if a partner triggers the ROFO, the responding partner does not elect to buy and the partner that triggered the ROFO is unsuccessful in selling to a third party during the sale period, the triggering partner is locked out from exercising the ROFO again for a specific period of time.

Joint ventures are inherently relationship-driven. Although no doubt an over-simplification, one adage with respect to joint ventures is: “If you pick the right partner, nothing else matters, and if you pick the wrong partner, nothing else matters.” Given the importance of joint venture partners sharing a common objective and being able to work together affectively in good times and in bad, each joint venture partner will want to limit the other’s ability to transfer its interest in the joint venture. As noted above, in a typical ROFO provision for the sale of a partner’s joint venture interest, if the ROFO Offeree does not elect to buy the joint venture interest of the ROFO Offeror, the ROFO Offeror may sell its joint venture interest to a third

²⁴ The ROFO provision that requires that the responding partner name the assumed value for the Property is one way that certain investors attempt to mitigate a perceived informational disadvantage.

²⁵ See the above provisions about the “chooser” being at an advantage.

party.²⁶ This raises the question of whether a ROFO Offeree that does not elect to buy should have a right to approve the identity of the third party buyer and, if not, whether the joint venture agreement should provide that the third party buyer must meet specified qualifications. Issues to consider in this respect include the following:

- Would granting the ROFO Offeree the right to approve the third party buyer unduly hinder the ability of the JV ROFO Offeror to obtain the desired liquidity? If such an approval right exists, (i) should there be a reasonableness standard and should the ROFO Offeree have to base its decision solely on factors enumerated in the joint venture agreement and (ii) should there be an expedited dispute resolution mechanism?
- The criteria that must be satisfied by the third party buyer typically consist of things like net worth, liquidity and experience with investments in similar properties. Should there, however, be different standards depending on which partner is selling? For example, if the Operating Partner is selling, should there be requirements that relate to experience managing similar properties that should not apply if the Capital Partner is selling?
- Should there be provisions designed to prevent a sale to certain competitors of the ROFO Offeree or to certain parties that, based on negative prior experience, would be objectionable to the ROFO Offeree?

As noted above, for tax and/or regulatory reasons, certain investors may not, as a practical matter, be in a position to elect to buy in response to a ROFO notice involving the sale of the other partner's joint venture interest. Investors in this position may want to insist that the joint venture agreement provide that it have a tag-along right with respect to any sale by its joint venture partner of its interest in the joint venture.

Joint venture agreements are often highly customized to reflect the particular investment, the nature and objectives (business, tax and otherwise) of the joint venture partners and the roles and responsibilities of each partner. As a result, it is often difficult for a third party buyer to step into an existing joint venture relationship. In light of these facts, many investors believe that a sale of its joint venture interest would, as a practical matter, be difficult to accomplish, and that any such sale would likely involve a discount to the amount that the selling partner would receive if the Property were sold.²⁷ For these reasons, many investors view a Forced Property Sale provision as a superior exit mechanism to a right to sell its joint venture interest. Forced Property Sale provisions are not, however, free from potential pitfalls. Under a Forced Property Sale provision with a ROFO, the assumption is that, if the responding partner does not elect to buy the interest of a triggering partner in the joint venture, the Property will be sold to a third party as long as the minimum price is achieved and the sale closes within the applicable sale period. This works reasonably well when the triggering partner is the Operating Partner of the joint venture. The path to this exit is, however, less clear when the partner that exercised the forced sale is not the Operating Partner. If both the Operating Partner and the Capital Partner

²⁶ As noted above, the sale to a third party typically has to close within a set period of time and the price usually has to at least equal to, or within a percentage of, the price offered to the ROFO Offeree.

²⁷ The circumstance in which it may be easiest for a third party buyer to step into a joint venture agreement is when the partner that is selling its interest has a relatively passive role in the joint venture and is selling to a buyer that is also comfortable in that type of role.

desire to sell there likely would not have been any reason for the Capital Partner to exercise its forced sale right. Thus, in a situation where the Capital Partner has exercised a forced sale right, the Operating Partner may be a reluctant seller. This puts the Capital Partner at risk that the Operating Partner will not be motivated to cause the sale to occur at the minimum price before the end of the sale window. To address this issue, joint venture agreements should at a minimum obligate the Operating Partner to use commercially reasonable efforts to market and sell the Property for a price at least equal to the minimum price established by the ROFO/Forced Sale procedure. The joint venture agreement might also (i) give the partner that triggered the Forced Property Sale Provision the right to select the third party broker that will handle the marketing of the Property, (ii) give the partner that triggered the Forced Property Sale provision the right to establish (or at least approve) the offering materials and marketing plan and (iii) obligate the Operating Partner to provide the partner that triggered the Forced Property Sale provision with copies of all purchase offers and otherwise to keep such partner informed with respect to the sale and marketing process. Some investors require that if they trigger a Forced Property Sale provision with a ROFO and the other partner does not elect to buy, then the partner that triggered the forced sale has the right to control the marketing and sale process even if it otherwise is not the Operating Partner.²⁸

(c) Put/Call Considerations and Issues

In the buy/sell and ROFO exit provisions described above, the assumed value of the joint venture's property is established by one of the partners. To avoid potential disputes, many joint venture agreements make it clear that the partner setting the Property value in a buy/sell or ROFO may do so in its sole and absolute discretion and without any fiduciary duty to the other partner. Many real estate investors prefer this type of market-driven valuation mechanism to an appraisal-driven valuation. Because put/call provisions typically employ an appraisal based approach to valuation, investors who do not like to make investment decisions based on appraised values may disfavor put/call provisions.

The issue of informational advantages/disadvantages should be considered in the context of any proposed put/call provision. In most joint ventures, the Operating Partner will have superior day-to-day knowledge of factors that may impact the value of the Property, and this could allow the Operating Partner to attempt to use this information to its advantage in the timing of its exercise of a put or call. For example, an Operating Partner who has reason to believe that a significant new lease will be signed in the future may have an incentive to exercise its call right before the lease is signed so that the appraised value of the Property will not reflect the incremental value that this new lease might create. To partially mitigate this risk, the Capital Partner might require that the put/call can only be exercised during certain pre-determined time periods. In addition, in any appraisal based valuation, the Operating Partner may have an advantage if it has greater access to the appraiser(s) than the Capital Partner. If the joint venture agreement includes appraisal based buy-out rights, the Capital Partner should consider having the appraisal procedure provisions of the joint venture agreement include the "rules of the road" with respect to communications with the appraisers. One approach to these provisions provision is attached as Exhibit B.

²⁸ For tax and/or regulatory reasons, the ability to control the sale process may not be a practical solution for certain non-US investors.

(d) Other Considerations and Issues

Pricing Details

As noted above, many joint venture agreements use the Hypothetical Property Sale Method to establish the value of each partner's joint venture interest when one partner is acquiring the interest of the other partner. In the authors' experience, all or virtually all of the value in the joint venture usually consists of the net equity in the Property and cash and cash equivalents, in which event the Hypothetical Property Sale Method is a reasonably accurate way to establish the value of each partner's joint venture interest. Another approach is to value all of the assets of the joint venture. For a detailed and very useful explanation of the differences between these two approaches, see "*Hypothetical JV Sales to Value JV Interests in ROFOs, Buy/Sells, Puts, and Calls*" by Stevens A. Carey and Phillip G. Nichols, *The Real Estate Finance Journal*, Spring/Summer 2016 (the "Carey/Nichols Article").

Regardless of whether the Hypothetical Property Sale Method or the "all asset" method is used, there are a number of important issues to be considered when drafting the purchase price calculation provisions of buy/sells, ROFOs, puts and calls. These issues, most of which are examined in detail in the Carey/Nichols Article, including the following:

- How do you account for cash and cash equivalents? Do you assume that all cash and cash equivalents are distributed at the same time as the hypothetical sale of the Property? Do you take a deduction for reserves?
- Should there be a deduction from the assumed gross property value for costs that would be incurred in an actual sale (e.g., transfer taxes, brokerage fees, prepayment/defeasance costs)?
- If there are material non-cash assets other than the Property, will they be valued and, if so, how will they be valued?
- How should you deal with contingent liabilities?
- How should the prorations of income and expense be handled?
- What if there are capital contributions or distributions between the issuance of the buy/sell, ROFO or put/call notice and the closing? Should there be a prohibition on capital calls while the applicable exit mechanism transaction is pending, perhaps with some exceptions?
- If there are loans from one partner to another, how should they be accounted for at the time of the sale? For example, if the selling partner is the borrower under a loan to the purchasing partner and the amount of the loan that is outstanding at the time of sale exceeds the purchase price for the selling partner's interests, should the purchase price be zero on the theory that partner loans are intended to be non-recourse loans, or should the selling partner have to write a check to the purchasing partner for the amount of the deficiency?
- How should the joint venture agreement deal with the possibility of a disagreement over the calculation of the net amount due to the selling partner? If the partners have taken the buy/sell or ROFO provisions through to the closing rather than engaging in a negotiated transaction, that could be a sign of a breakdown in the relationship. In order to preserve certainty of closing, it is advisable to have the joint venture agreement provide that, in the event of a

disagreement over the calculation of the net amount due to the selling partner, the closing will not be delayed on account of that disagreement and, in such event, the net amount payable to the seller at the closing will be determined by the joint venture's outside accountants. Some investors prefer to have the decision of the accountants in this regard be binding (perhaps absent manifest error), whereas other investors prefer to have the ability to seek a judicial determination of the proper calculation of the amount due to the selling partner.

Tax Considerations

Many real estate investors are REITs and/or make their joint venture investments through private REITs. Although gains from sales of real property are generally qualifying REIT income, a REIT pays a tax equal to 100% of its net income from certain "prohibited transactions," which are sales or other dispositions of property (other than foreclosure property) held for sale to customers in the ordinary course of a trade or business (i.e., "dealer property"). "Net income from prohibited transactions" is gain on such dispositions, less deductions "directly connected with" the dispositions. Loss on a prohibited transaction has no effect on net income from prohibited transactions. Given the specter of a 100% tax, any investor that is a REIT or that holds its interest in the joint venture (directly or indirectly) through a REIT will want to structure the exit mechanisms in a way that minimizes the risk that a sale of the Property or its interest in the joint venture could be a "prohibited transaction". Section 857(b)(6) of the Code contains a "safe harbor" under which, if various conditions are met, the sale in question will not be a "prohibited transaction." One of the requirements of this safe harbor is that the property in question be held for the production of rental income for at least two years. As a result, many investors that are REITs or that hold their investments in joint ventures through REITs will want a lockout period at least equal to this two year period.²⁹

Although the recently enacted Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") allows certain non-US pension funds to dispose of real estate without being subject to FIRPTA withholding requirements, many non-US investors still require that their interests in US real estate be held through a REIT and that any sale of such real estate be accomplished by a sale of the equity interests in that REIT (a "REIT Interest Sale"). This requirement presents a number of questions that should be considered by the other joint venture partner. First, a REIT Interest Sale is inherently more complicated, time-consuming and expensive than a sale of real estate. The buyer in a REIT Interest Sale will want representations, warranties and indemnities (from a creditworthy entity) covering "entity" and tax matters that would not be relevant in a typical real estate sale. The caps on these types of representations, warranties and indemnities will usually be higher than the caps on typical real estate representations (on certain "fundamental" reps, the cap is often the purchase price). In addition the survival periods will be longer than those found in real estate sales (for tax items, the applicable statute of limitations). The buyer (or its accountants or other advisors) may want to conduct due diligence beyond what would be done in an asset sale, and the buyer may require a REIT opinion from the seller's counsel. In light of these additional complexities and costs, the

²⁹ Note that a REIT investor will typically want to not only prevent any sale of the Property before the end of this two year period, but also to prevent any exercise of a buy/sell or ROFO by its partner until that two year period has ended, as the same tax risks arise when a REIT sells its joint venture interest; otherwise, the REIT investor could find itself at a disadvantage because electing to be a seller could trigger adverse tax consequences for it.

joint venture partner that does not derive any benefit from engaging in a REIT Interest Sale rather than a real estate sale may propose that the partner who benefits from the REIT Interest Sale be solely responsible for all incremental costs and indemnities that are required in order to effectuate a REIT Interest Sale rather than a sale of the real estate.³⁰ The partner that is sensitive to these REIT issues may, of course, take the position that structuring an exit in a way that is tax efficient for it is simply a cost of that type of capital. Second, and perhaps more importantly, the partner that does not benefit from the REIT Interest Sale structure should consider whether the price that can be obtained for the equity interests in the REIT will be less than the price that could be obtained for the real estate. In the strong market that we have experienced over the last several years, the general consensus seems to be that, at least for large, high quality properties, there is no meaningful discount in the price that buyers will pay for the REIT interests as opposed to the real estate (assuming that the buyer gets customary representations, warranties and indemnities from a credit worthy party). It is, however, possible to draft the marketing and sale provisions of the joint venture agreement (i) to obligate the partner controlling the sale to require that bidders make separate bids for the real estate and the REIT interests and (ii) to provide that, if the offer for the real estate exceeds the offer for the REIT interests, the partner that benefits from the REIT Interest Sale must elect to either pay the delta to the other partner or consent to the real estate sale.

Lender Consents

Ideally, the partners will be successful in getting the loan documents to allow transfers of direct and indirect interests in the joint venture between the partners and their respective affiliates without the need for lender consent. Although this can sometimes be achieved for stabilized properties, for properties that are undergoing development or significant redevelopment, lenders will often refuse to preapprove transfers to joint venture partners that do not have the requisite development/redevelopment experience. If the transfer of interests to a particular partner is not allowed under the loan documents, that partner will want to be sure that its obligation to close on the purchase of the other partner's interest is subject to obtaining the requisite lender consent, and the other partner will want the purchasing partner to be obligated to use commercially reasonable efforts to obtain that consent.

Releases

When a partner or its affiliate has entered into a guaranty or indemnity in favor of the joint venture (or its subsidiary), it will want to be sure that its obligation to sell its joint venture interest to the other partner is conditioned upon it being released from obligations under the applicable guaranty or indemnity that arise from and after the time of the sale. Joint venture agreements will sometimes provide that, if a release cannot be obtained from the lender, the selling partner must nonetheless proceed with the sale as long as it and/or its affiliate obtain an indemnification from a creditworthy indemnitor. It is common for the joint venture agreement to provide that the buying partner must offer a creditworthy replacement guarantor or indemnitor to assume the obligations under the guaranty or indemnity that arise from and after the closing of the partnership interest sale.

³⁰ See Foreign Investment in US Real Estate – Now More than Ever, Andrew J. Weiner and Frederick L. Klein, ACREL Fall 2016. (Fall 2016 Meeting Materials, American College of Real Estate Lawyers.)

Closing Conditions

Should the obligation of the purchasing partner to close be subject to any closing conditions such as the absence of a material casualty or condemnation? How the joint venture partners think about this question should depend, in part, on their level of capitalization and liquidity. On the one hand, because the purchasing partner already owns an interest in the joint venture, it has already taken a share of the risks inherent in owning the Property. On the other hand, if the purchasing partner is likely to have to finance its purchase through additional debt or equity, its financing and/or equity provider may condition its loan or investment on the absence of certain material adverse changes.

Default Remedies

Joint venture agreements need to set forth the remedies that apply if a partner that becomes obligated to buy or sell its interests in the joint venture defaults in its obligations to complete the transaction. How each partner views these remedies will depend, in part, on how it assesses the probability that it will become the buyer and the risk that, if it becomes the buyer, it will default in its purchase obligation. Although well capitalized joint venture partners may be confident in their ability to complete the purchase of their partner's joint venture interest, for less well capitalized partners, and particularly for those that would need to raise additional funds in order to complete the closing, the risk of a default can be real.

The remedies in joint venture agreements that can be asserted against a defaulting buyer often include one or more of the following:

- The selling partner may retain the deposit as liquidated damage in its sole remedy.³¹
- The partner that was to be the seller can “turn the tables” and acquire the interest of the defaulting buyer for a price that is based upon the assumed property value that was used to calculate the sale price for the interest of the defaulting buyer or a percentage of that assumed property value.³²
- The defaulting buyer is prohibited from subsequently exercising the exit provisions of the joint venture agreement for a period of time (or for the duration of the joint venture).
- The selling partner can sell its interest in the joint venture (if the applicable transaction involved the sale of a joint venture interest) or the Property (if the applicable transaction involved the sale of the Property) to a third party without having to offer the same to the defaulting buyer.³³

The typical remedy against a seller that defaults in its obligation to sell its joint venture interest is specific performance. It is worth considering, however, whether there is a risk that

³¹ Partners worried about potentially defaulting as a purchaser will want to keep the deposit as small as possible and have retention of the deposit be the other partner's sole remedy.

³² If the tables are turned and the assumed property value is a percentage of the originally named property value, then if the property is leveraged, the percentage reduction in the price for the applicable joint venture interest will be greater than the percentage reduction of the assumed gross property value.

³³ Consider whether any such sale should have to be concluded within a certain period of time and whether there should be any required minimum price.

specific performance will not be available with respect to the obligation to sell a joint venture interest. A defaulting seller is sometimes locked out from its own exercise of the exit mechanisms for some period of time.

Interim Operations

Once one partner has become obligated to acquire the interests of another partner, should there be any changes in the operational/governance provisions of the joint venture agreement? For example, if the purchasing partner is not the Operating Partner, should its approval rights be increased once it has committed to acquire the other partner's interest? The deposit of the purchasing partner is effectively non-refundable. One way to think about approval rights during this interim period is to consider how the approval rights in the joint venture agreement compare to the approval rights that would typically be granted to a buyer of the Property who has posted a non-refundable deposit.

Sequencing of Exit Mechanisms

When a joint venture agreement contains multiple exit mechanisms that can be triggered during the same time period, the joint venture agreement should address the relative priority among these provisions: If one exit mechanism has been triggered and the transaction contemplated thereunder is pending, no other exit mechanism may be triggered until the pending transaction either closes or terminates. Likewise, if the joint venture has entered into a purchase and sale agreement for the sale of the Property in accordance with the joint venture agreement, the partners should not be entitled to trigger exit mechanisms while the contemplated transaction is pending.³⁴ Occasionally, a joint venture agreement will provide that if a partner exercises a particular exit mechanism, the other partner may "trump" the exercise of that exit mechanism by exercising another exit mechanism.

The Negotiated Exit – (a/k/a Real Life)

No contractual exit mechanism is perfect. There are potential conflicts, risks, economic shortcomings and possible misalignment of interests with any exit mechanism, no matter how thoughtfully constructed. Even if the lockout period is carefully selected at the time of execution of the joint venture agreement, an intervening event may cause the exit mechanism period to be triggered at an inopportune time for one or the other of the partners. Exit mechanisms may thwart or at least postpone achievement of the individual goals of one or both partners, requiring them to devote additional capital or debt to property they don't want to own in the long term or forcing them to buy property that fits their portfolio needs at what they consider to be an inflated price. Exit mechanisms may require one or more of the partners to act with insufficient information or to make a guess about a property or market at a time when market information is uncertain. They may also contribute to significant delay in marketing a property, potentially causing both partners to "miss the market" and resulting in a failed sale transaction or less net proceeds for both partners.

While they are a necessary part of every joint venture agreement, exit mechanisms should be recognized for what they are: contractual rights exercised when the partners cannot agree.

³⁴ Consider whether the same rule should apply if a non-binding term sheet or letter of intent has been signed.

Turning to exit mechanisms to dispose of property or terminate the joint venture relationship is an explicit acknowledgement that there is a disagreement about the continued ownership of the property by the venture or the continued relationship between the partners. Given the inherent risks and uncertainty of result in executing exit mechanisms, it is not surprising that they are used more as a last resort or “club” to get the partners to the table and talking. In fact, in the authors’ experience, joint venture exit mechanisms are not often triggered and, when they are triggered, they are rarely followed through to completion. While an exit mechanism may be initiated, it often serves as nothing more than a way for the partners to start discussions about an exit that may or may not track the joint venture agreements provisions (In this article, we refer to that as a “negotiated exit”).

Entering into a negotiated exit does not, of course, eliminate the analysis that needs to be done prior to triggering any exit mechanism. Each partner needs to determine what it thinks the value of the Property is and that value must make sense to both partners. Each partner needs to determine whether the full value creation has occurred or if more value creation is possible if given more time, and each needs to determine if it prefers to remain an owner or be a seller. A partner that wants to continue to be an owner may need to assess the debt and equity markets to determine whether it can obtain new capital. Where a project has not been successful, both partners need to be clear-eyed about the reasons for the failure and determine whether a change of management will bring success or whether inherent issues with the asset or the market make any turnaround efforts unlikely to succeed, thereby suggesting a sale.

A negotiated exit will not eliminate all of the risks present in other exit mechanisms, and it may, in fact, present additional risks and complications. For instance, if the Information Equivalency Assumption is untrue, there will still be opportunities for one partner to game the other partner by withholding information. Depending on the outcome that would likely result if the contractual exit mechanisms were triggered and followed to conclusion, one partner may have very little bargaining power. The partners need to agree on the negotiated course of action. Even if they reach that agreement, there is no way of being sure that the agreed upon course of action will succeed. If an impasse caused one of the partners to trigger (or threaten to trigger) an exit mechanism in the first place, the prospects of agreeing on a course of action and following it through to completion may not be good. Failure to agree, or failure to carry out the agreed upon plan of action to conclusion, can lead to litigation or re-starting the contractual exit process, causing delay and further costs. If the decision is made for one partner to buy the other out, the negotiated agreements with respect to issues like lender consents, taxes, etc. described above and contained in the joint venture exit mechanism provisions may be up for renegotiation. In addition, negotiated exits may include master leases, financing from a partner, tax deferred exits, profit participations, property swaps and other arrangements, any or all of which can be more complicated than the transaction contemplated by the exit mechanisms set forth in the joint venture agreement.

That said, there may be real advantages to seeking a negotiated exit. The absence of the “gun to the head” that the deadlines contained in contractual exit mechanisms impose may allow for more thoughtful consideration of the issues by each partner. The negotiated exit discussions may also allow the partners to “cool down,” encouraging them to respond to each other in a more reflective, rather than reflexive, manner. Despite the more open-ended time frame for discussion, a negotiated exit may ultimately result in a resolution in less time than the exit

mechanism process set forth in the joint venture agreement. More creative solutions to bridge the disagreement on the way forward for the asset may be achieved, and it may be possible for a partner to achieve its secondary goals in a way that some of the exit mechanisms would not allow. For example, if an Operating Partner is “out of the money” – that is, it has no realistic possibility of receiving any promote distributions – and the Capital Partner wants to own the Property, the partners might agree that the Operating Partner would relinquish its interest to the Capital Partner in exchange for retaining the management of the property and earning management fees. If the Operating Partner is convinced there is future value to be achieved and the Capital Partner is not, the Capital Partner may trade away its forced sale right (or other exit mechanism rights) for some cash and upside potential. Finally, a negotiated exit may work to preserve the relationship between the partners, which can be particularly important where the partners have other investments together or expect to make them in the future. Finally, by allowing the partners to mutually agree on the sale/purchase price the negotiated exit eliminates the pricing issues inherent in the buy/sell, ROFO or appraisal procedures.

Conclusion

Joint venture exit mechanisms are inherently complex. The decision as to which exit mechanisms to include in a joint venture agreement, and the details of how those provisions should be drafted, should be based upon careful consideration of a myriad of factors, including the investment objectives of each partner, each partner’s legal structure, capitalization, liquidity and tax objectives, and the facts and circumstances surrounding the Property. Although the joint venture agreement exit provisions may rarely be followed through to completion, they are nonetheless important provisions because they set the backdrop for the negotiation between the partners over how they will part ways, and they provide a last resort exit procedure from the joint venture if the partners are unable to reach agreement on a negotiated exit.

Exhibit A

Operating Partner Tag Along Provision³⁵

(A) Not less than twenty (20) days before closing on a sale of some or all of its interest in the Partnership to a third party in accordance with Section [] hereof, the Capital Partner shall give the Operating Partner a written notice (the “Sale Notice”) that sets forth: (1) the identity of the purchaser (the “Purchaser”), (2) the price (the “Sale Price”) that the Purchaser has offered to pay for the direct or indirect interest in the Partnership to be sold by the Capital Partner (or its direct or indirect owner) and any other material economic terms of the sale, (3) the anticipated closing date for such sale (the “Sale Closing”), (4) the nationally recognized title insurance company selected by the Capital Partner and/or Purchaser (the “Escrow Agent”) to serve as escrow agent for the transaction, and (5) the assignment and related documents to be executed and delivered by the Operating Partner or its direct or indirect owner if it elects to exercise the Operating Partner Tag Along Right, which documents shall be substantially in the same form as those to be delivered by Capital Partner (or its direct or indirect owner), subject to such factual changes as may be reasonably necessary to reflect the identity of the parties and the interests being sold (the “Operating Partner Assignment Documents”).

(B) If the Operating Partner receives a Sale Notice, it may, by delivering a written notice (a “Tag Along Notice”) to the Capital Partner within twenty (20) days of its receipt of such Sale Notice, irrevocably elect to exercise its right (the “Operating Partner Tag Along Right”) to sell the Operating Partner Pro Rata Tag Along Share (the “Tag Along Interest”) as part of such sale. If the Capital Partner is directly or indirectly selling one hundred percent (100%) of its Interest in the Partnership, the “Operating Partner Pro Rata Tag Along Share” shall mean one hundred percent (100%) of the Operating Partner’s Interest in the Partnership. If the Capital Partner is directly or indirectly selling less than one hundred percent (100%) of its Interest in the Partnership, the “Operating Partner Pro Rata Tag Along Share” shall mean the portion of the Operating Partner’s Interest in the Partnership that is equal to the product obtained by multiplying (Y) Operating Partner’s Percentage Interest in the Partnership by (Z) a fraction, (i) the numerator of which is the total Percentage Interest of the Capital Partner being sold in the transaction to which the Operating Partner Tag Along Right applies (determined on a look-through basis if the Capital Partner is effecting an indirect transfer) and (ii) the denominator of which is the Percentage Interest held by the Capital Partner immediately before such sale. By way of example only, and except as otherwise provided herein if the Capital Partner elects to reduce the Percentage Interests being sold as provided for in Subsection (C) below, if: (1) the aggregate Percentage Interests held by the Capital Partner were 80%; (2) the Percentage Interest of the Operating Partner were 20%; and (3) the Capital Partner were selling a 30% Percentage Interest in the Partnership in a sale that is subject to the Operating Partner Tag Along Right (i.e., the Capital Partner were selling 37.5% of its 80% Percentage Interest), then the Operating

³⁵ This sample provision assumes that the Capital Partner has a right to sell some or all of its interest in the Joint Venture and that the Operating Partner has a tag along right in connection with such sale. If the Operating Partner were to have a similar sale right, the Capital Partner might want a reciprocal tag along right. As noted above, tag along (and drag along) rights work best when the interests being sold have the same economic attributes; for example, if one partner has the right to disproportionate distributions (e.g., “carried interest” or “promote” distributions), then tag along (and drag along) provisions get more complex. The above sample provision assumes that the interests being sold have identical economic attributes.

Partner Pro Rata Tag Along Share would be 7.5% [$0.2 \times 30/80$, or 37.5% of Operating Partner's 20% Percentage Interest], and subject to Subsection C below, the Operating Partner would have the right to sell a 7.5% Percentage Interest to the Purchaser simultaneously with the sale by the Capital Partner on the terms and conditions set forth herein. If the Operating Partner does not provide a Tag Along Notice to the Capital Partner within twenty (20) days of its receipt of the Sale Notice, the Operating Partner shall conclusively be deemed not to have exercised the Operating Partner Tag Along Right with respect to the applicable sale. If the Operating Partner timely exercises the Operating Partner Tag Along Rights, the sale of the Operating Partner's Tag Along Interest shall be at the same price (on a relative percentage interest basis) (the "Tag Along Price"), and otherwise on the same terms and conditions, as the sale by the Capital Partner.³⁶

(C) If the Operating Partner timely exercises the Operating Partner Tag Along Right and the Purchaser is not willing to purchase all of the interest of the Capital Partner (or its direct or indirect owner) to be sold plus the Operating Partner Pro Rata Tag Along Share, but the Purchaser is willing to purchase less than all of such interests, then the Capital Partner shall have the option (but not the obligation), in its sole discretion, to proceed with a sale in which the total Percentage Interest of the Capital Partner (or its direct or indirect owner) being sold in the transaction is reduced, in which case (1) the Operating Partner Pro Rata Tag Along Share shall be re-calculated and adjusted in accordance with subsection (B) above based on the reduced total Percentage Interest of the Capital Partner (or its direct or indirect owner) to be sold, and (2) the Capital Partner and the Operating Partner shall be bound to proceed with the sale in accordance with the initially designated terms, but with Percentage Interests adjusted as provided in this Subsection (C). The Operating Partner shall have no right to retract, rescind, or adjust its Tag Along Notice on account of any adjustment of Percentage Interests being sold in accordance with this Subsection (C).

(D) If the Operating Partner exercises its Tag Along Right: (1) it shall, simultaneously with such exercise, deliver in escrow four (4) originals of the Operating Partner Assignment Documents to Escrow Agent (and a failure to do so shall constitute a waiver of the applicable Operating Partner Tag Along Right); and (2) it shall: (i) promptly execute and deliver such other assignments of interest, amendments to this Agreement, and other instruments as the Capital Partner or Purchaser reasonably deem necessary or desirable to evidence the assignment of the Operating Partner's Tag Along Interest to the Purchaser in exchange for the Tag Along Price (together with the Operating Partner Assignment Documents, the "Assignment Documents"); and (ii) instruct the Escrow Agent to release the Assignment Documents to the Capital Partner or the Purchaser simultaneously with the Sale Closing and payment of the Tag Along Price to the Operating Partner.

(E) Each of the Operating Partner and Capital Partner shall pay the costs of its own lawyers and advisors in connection with any sale pursuant to this Section [_____] and any costs (such as regulatory filings) that are particular to the Operating Partner or the Capital Partner, as applicable. In connection with any sale with respect to which the Operating Partner exercises the Operating Partner Tag Along Right, the Operating Partner and the Capital Partner shall share pro rata (based upon their relative Percentage Interests being sold) in: (1) any post-closing liabilities or obligations relating to such sale (other than any liability relating to any representation or

³⁶ The parties should consider how any outstanding partner loans should be handled as part of this sale.

warranty made by a selling Partner with respect to the Interest being sold by it, its authority to complete such sale, and the due authorization, execution, delivery and enforceability of documents executed by it, which shall be personal to the applicable selling Partner), (2) any escrow or holdback established in connection with such sale, (3) any transfer taxes payable in connection with such sale (other than any transfer taxes that are paid by the Purchaser), and (4) any prepayment costs, consent fees, assumption fees, review fees, lender's legal fees and other amounts paid to any [Project Lender] or under any [Project Financing Documents] in connection with such sale (other than any such costs that are paid by the Purchaser).

Exhibit B

Appraisal Procedures³⁷

A. For a period of thirty (30) days after either Partner has given an Appraisal Notice under [Section _____] of this Agreement (such 30-day period, the “Pre-Appraisal Period”), the Capital Partner and the Operating Partner shall consult with each other to determine if, each acting in its sole discretion, they can reach a written agreement on the identity of a single Qualified Appraiser (defined below) to determine the fair market value of the Property (any such single Qualified Appraiser approved in writing by both the Capital Partner and the Operating Partner, the “Single Appraiser”). If, before the end of the Pre-Appraisal Period, the Capital Partner and the Operating Partner have agreed in writing on a Single Appraiser, then the fair market value of the Property (the “Property FMV”) shall be determined by the Single Appraiser in accordance with Section B below; if no Single Appraiser is agreed upon in writing by the Capital Partner and the Operating Partner before the end of the Pre-Appraisal Period, the Capital Partner and the Operating Partner shall each, within thirty (30) days after the end of the Pre-Appraisal Period, appoint a Qualified Appraiser by written notice of such appointment to the other (each such appraiser is hereinafter referred to as a “Party Appraiser”). The two Party Appraisers so appointed shall thereafter appoint a third Qualified Appraiser (the “Third Appraiser”) within thirty (30) days of the appointment of the second Party Appraiser. If the two Party Appraisers fail to appoint the Third Appraiser within such thirty (30) day period, either the Capital Partner or the Operating Partner may request that the head of the [_____] Chapter of the Appraisal Institute (or any successor thereof or other recognized professional association of real estate appraisers, as agreed upon in writing by the Capital Partner and the Operating Partner) designate a third Qualified Appraiser to act as the Third Appraiser. Each of the three appraisers so appointed shall, within thirty (30) days after the appointment of the Third Appraiser, provide the Capital Partner and the Operating Partner with their written opinion as to the fair market value of the Property in accordance with Section B below. If one of the appraisals is within [two percent (2%)] of the average of the other two appraisals, the “Property FMV” shall be the numerical average of all three appraisals; otherwise, the “Property FMV” shall be the numerical average of the two closest appraisals (or, if one value is equidistant between the other two, the arithmetic average of all three values).

B. The appraisals and appraisal process provided for in this Schedule shall be conducted in accordance with the following procedures:

(i) The Single Appraiser or, if applicable, the Third Appraiser, shall be engaged to make a determination of the fair market value of Property pursuant to a written engagement letter that is consistent with the terms of this Schedule and submitted jointly by the Capital Partner and the Operating Partner;

(ii) Each appraiser appointed pursuant to this Schedule shall be instructed (1) to apply the most current applicable Uniform Standards of Professional Appraisal Practice, as

³⁷ These sample appraisal procedures are drafted from the perspective of an investor concerned about the ability of its partner to unduly influence the appraisal process, and certain components of these sample provisions may not be appropriate or desirable depending on the facts and position of the parties to the joint venture agreement.

promulgated by the Appraisal Foundation, (2) to determine the fair market value of the Property based on the all-cash price a willing buyer would pay to a willing seller for the Property in an arms-length transaction, and (3) to assume that the Property were sold free and clear of all liens and encumbrances;

(iii) Communications with the Single Appraiser or, if applicable, the Third Appraiser, regarding the engagement shall be conducted jointly by the Capital Partner and the Operating Partner. Except as provided herein, neither the Capital Partner nor the Operating Partner, nor any Person acting on their behalf, shall have independent substantive communications (orally, by email, fax, letter or otherwise) with the Single Appraiser or, if applicable, the Third Appraiser, without the participation of the other. Neither Party Appraiser, nor anyone acting on such appraiser's behalf, shall have any substantive communications (orally, by email, fax, letter or otherwise) with the Third Appraiser until the appraisal process contemplated hereby has been completed;

(iv) Within thirty (30) days of the engagement of the Single Appraiser or, if applicable, the Third Appraiser, the Capital Partner and the Operating Partner shall each deliver to such Appraiser each party's respective Argus (or equivalent) model and a description of their material assumptions, reports and other back-up or explanatory information as such party may elect (but excluding any written determination of the market value of the Property prepared by its respective Party Appraiser or any other Third Party appraiser) (collectively, the "Party Appraisal Package"). Each party shall deliver a copy of its respective Party Appraisal Package to the other party concurrently with delivery to such Appraiser and by the same delivery method. Other than the delivery of the Party Appraisal Packages, neither the Capital Partner, the Operating Partner or the Party Appraisers, or anyone acting on their behalf, shall submit any additional material information to the Single Appraiser or, if applicable, the Third Appraiser, or have any substantive discussions concerning the Property with the Single Appraiser or, if applicable, the Third Appraiser, except with the participation of the other parties;

(v) Any substantive questions or other substantive communications from the Single Appraiser or, if applicable, the Third Appraiser, shall be submitted in writing and delivered to both the Capital Partner and the Operating Partner concurrently and by the same method of delivery. With respect to questions relating to the engagement of the Single Appraiser or, if applicable, the Third Appraiser, the Capital Partner and the Operating Partner shall submit a joint written response. With respect to any other questions submitted by any appraiser, the Capital Partner and the Operating Partner shall, within ten (10) days of the receipt of such questions, submit any response in writing, delivered to the Single Appraiser or, if applicable, the Third Appraiser, and the other party concurrently and by the same method of delivery; and

(vi) The engagement of the Single Appraiser or, if applicable, the Third Appraiser, shall require that, if the Operating Partner, its Party Appraiser or anyone acting on its behalf, or the Capital Partner, its Party Appraiser or anyone acting on its behalf, communicates with or delivers information to such Appraiser in material violation of this Schedule, such Appraiser shall be required to send notice of such breach to the non-breaching party; in which event the non-breaching party may, in its sole discretion, elect by written notice to the breaching party: (1) in the case of a Single Appraiser, to disqualify such appraiser, in which event the Capital Partner and the Operating Partner promptly shall recommence the process set forth in

Schedule; or (2) in the event that Party Appraisers have been appointed, to have the Appraised Property Value determined without regard to the appraisal submitted by the Party Appraiser selected by the breaching party.

C. If the Capital Partner and the Operating Partner agree on a Single Appraiser, they shall each pay one half of the costs due to such appraiser; otherwise, each party shall pay 100% of the costs of the Party Appraiser selected by it and 50% of the cost of the Third Appraiser.

As used herein the term "Qualified Appraiser" means an appraiser who: (i) is not, directly or indirectly, in Control of, Controlled by or under common Control with the Capital Partner, the Operating Partner or their respective Affiliates; (ii) has not been an employee of the Capital Partner, the Operating Partner or their respective Affiliates at any time within the three (3) years immediately preceding his or her appointment hereunder; (iii) is licensed to appraise commercial real estate in jurisdiction where the Property is located and is a member of the American Institute of Real Estate Appraisers (or any successor association or body of comparable standing if such institute is not then in existence); and (iv) has, for at least ten (10) years immediately preceding his or her appointment hereunder, been actively engaged in the appraisal of properties similar to the Property in the same market as the Property. As used herein, the term "Appraisal Foundation" means The Appraisal Foundation headquartered in Washington, D.C. and authorized by Congress as the source of appraisal standards and appraiser qualifications (or any successor association or body of comparable standing if such foundation is not then in existence).