

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

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“Private Equity” Joint Ventures

- A. The operating partner/sponsor has expertise and invests relatively little cash (e.g., 5% to 20%).
- B. The capital partner is typically an institutional investor/fund whose main contribution is cash (e.g., 80% to 95%).
- C. Typical economics:
 - Distributions are first made pro rata in accordance with with capital interests until all capital contributions are returned and a specific IRR hurdle is achieved.
 - Thereafter the operating partner also receives a greater proportion of the distributions as higher IRR hurdles are met (i.e., the “promote” or “carried interest”).

Types of Joint Ventures (cont'd)

- D. The operating partner is typically responsible for day-to-day management. The capital partner has the right to control and/or approve “major decisions” enumerated in the joint venture agreement.

- E. The operating partner or its affiliate usually provides any required completion, cost overrun, non-recourse carveout, environmental and other guaranties to lender. The operating partner sometimes provides cost overrun and/or completion guarantees to the capital partner.

- F. The capital partner or its affiliate sometimes enters into a reimbursement agreement with the operating partner (or its affiliate) to cover the capital partner’s share of certain guaranty obligations.

Other Types of Joint Ventures (cont'd)

1. 50/50(ish) joint ventures.
2. Preferred equity – really, disguised mezz debt. Fixed redemption (i.e., maturity) date, capped upside for preferred equity holder.

We will not be addressing these types of JVs.

Exit Mechanisms of Some Kind are Generally Included in all JV Agreements

Common Exit Mechanisms

1. Buy-Sell.
2. Put/Call.
3. Forced Property Sale/Right of First Refusal (ROFR).
4. Forced Property Sale/Right of First Offer (ROFO).

Threshold Issues for Structuring Joint Venture Exits

1. Understand your client's objectives (both for this investment and generally), legal structure, capitalization/liquidity, and tax and regulatory issues/constraints, and evaluate how each may impact its exit strategy.

2. Common capital partner issues:
 - Investment horizon – (e.g., open end vs. closed end fund);

 - Liquidity;

 - Potential changes in investment strategy for this asset and from exogenous factors;

 - Tax/REIT issues.

Threshold Issues for Structuring Joint Venture Exits (cont'd)

Common operating partner issues:

- Liquidity;
 - Maximize and monetize the promote;
 - Obtain cash for new investments;
 - Preserve fee income;
 - Avoid recapture of depreciation or phantom income.
3. Understand the business plan for the asset, the potential value creation event(s) and their expected timing.
 4. Consider whether your client is more likely to be the triggering party or the responding party and the seller or the buyer under any exit mechanism.

Buy Sell Basics

1. Application of the “divider-chooser” method of fair asset division.
2. Initiating partner names the assumed gross property value.
3. Responding partner must elect to either buy the initiating partner’s interest, or to sell its interest to the initiating partner, in each case for a price based upon the assumed gross property value set forth in the initiating partner’s notice.

Selected Buy-Sell Issues/Considerations

1. Pricing Honesty Assumption

- The assumption that, because the triggering partner doesn't know if it will be a buyer or a seller, it has an incentive to name a "fair" price.

2. Information Equivalency Assumption

- The assumption that, in valuing the property, neither partner is at a material disadvantage relative to the other partner.

3. Valuation Equivalency Assumption

- The assumption that the value derived from the investment by each partner comes primarily from the value of its JV interest.

Put/Call

Put/Call Basics

1. A partner with a put right has the ability to force its partner to acquire its interest.
2. A partner with a call right has the right to purchase the interest of its partner.
3. The purchase price is usually based upon the agreement of the partners or an appraisal procedure.

Put/Call Issues

1. Potential gaming in the timing of the exercise of the put or call.
2. Informational advantages/disadvantages.
3. Reliance on appraisal(s) for valuation.

ROFR

ROFR Basics

1. The partner that wants to sell must first obtain a purchase offer from a 3rd party.
2. The other partner then has the option to buy on the terms offered by the 3rd party buyer or to permit the other partner to sell on those terms to the 3rd party buyer.

ROFR Issues

1. Disfavored because it is viewed as “chilling” the ability to market and sell.
2. A potential buyer may want a breakup fee and/or cost reimbursement if it loses the opportunity to buy because the other partner exercises its ROFR.

Forced Property Sale/ROFO

Forced Property Sale/ROFO Basics

1. Initiating partner names the proposed sale price (often, the assumed gross property value).
2. Responding partner must elect to either (i) buy the initiating partner's interest (or the property) based upon the proposed sale price set forth in the initiating partner's notice or (ii) allow the property to be sold to a 3rd party.
3. If the responding partner does not elect to buy, the triggering partner can cause a sale of the property as long as the sale closes within a specified time period and the sale price is at least equal to, or sometimes within a percentage of, the proposed sale price set forth in the initiating partner's notice.

Selected Forced Property Sale/ROFO Issues/Considerations

1. Sale to a third party rather than to one of the partners reduces – but does not eliminate – “gaming” concerns.
2. How to deal with sale terms other than price and outside closing date.
3. Risk that a partner that wants to avoid or delay a property sale or buy-sell may trigger with an inflated price.
4. If the triggering partner is not the managing partner, does it have the authority to carry out the sale or must it rely on its partner to effectuate the sale.

Other Issues to Consider in Connection With Any Exit Remedy

1. When should the exit mechanisms become available?
2. Releases of guarantees/substitution of guarantors.
3. Allocation between the partners of pre and post-closing liabilities.
4. Remedies for defaults.
5. Lender and other third party consents.
6. Tax/regulatory issues.
7. Pricing and proration provisions when one partner is buying out another partner.

The Real Reason for the Exit Mechanisms: Leverage for the Negotiated Exit

1. Although it is unusual for a joint venture exit mechanism to be triggered and followed through to completion, these provisions set the stage for a negotiated separation of the partners or sale of the property.
2. If a joint venture exit mechanism is being used, this likely means that there has been a breakdown of some sort in the relationship between the partners or a divergence of investment objectives.
3. Because it doesn't take much for a partner that wants to avoid or at least stall the implementation of an exit mechanism to "gum up the works", precise drafting of these provisions is paramount.

Advantages to Negotiated Exits

1. No “gun to head” deadlines;
2. “Cool down” – more thoughtful approach;
3. May possibly take less time than the contractual exit mechanisms;
4. Can allow for more creative solutions;
5. Can preserve the relationship between parties (important if partners have a programmatic joint venture or otherwise anticipate doing business together in the future).

Disadvantages to Negotiated Exits

1. One partner, often the capital partner, may be at an informational disadvantage;
2. Can be more complicated;
3. Still have to agree on value, even if informally;
4. Risk that the effort to achieve the negotiated exit ultimately fails, resulting in a delay in the exercise of the contractual exit mechanisms, added legal costs and potentially a chilling of the marketing process if word gets out that the partners are in a disagreement over the exit process.

Conclusions

1. When and how partners will exit the joint venture is an important underwriting/investment consideration.
2. You need to understand its objectives, capitalization, liquidity and tax/regulatory concerns, and the business plan for the asset, and to anticipate how those factors may change over time.
3. Precise drafting is required to insure that, if the partners don't agree on an exit strategy, the contractual exit provisions provide your client with a viable way to exit the investment.