The Efficacy Of Real Estate Joint Venture Exit Strategies

By **Kris Ferranti and Jonathan Newman** (April 18, 2022)

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Real estate, like many industries, routinely utilizes joint ventures as an efficient way to pool capital resources in order to acquire, develop or operate real estate assets.

However, joint ventures raise a panoply of issues, including the responsibility of joint venture partners to provide for additional capital, determining the joint venture's governance, and how profits will be divided.

But, among the most important issues facing venturers is selecting the right modes of exit, be it by the disposition of the venture's assets or transfers of interests in the venture. The COVID-19 pandemic has highlighted the need for venturers to prepare for unanticipated events, from supply chain and governmental delays to increased expenses and the deterioration in market conditions — any of which may jeopardize the venture's success.

For any number of reasons, venturers may be unable to navigate together through these and other disruptive events. In anticipation of the unexpected, exit strategies should be considered at the outset of joint venture formation. While this can be thought of as akin to negotiating a separation agreement on the eve of the wedding, an exit from a venture is as inevitable as the proverbial death and taxes.

Businesspeople and counsel have a range of options when it comes to exits, and it may be tempting to include as many of the customary triggers as possible — be it the rights of first offer or refusal, buy-sells, forced sales, or tag and drag provisions.[1] However, in the case of joint ventures, more may not be better; and parties would be well-served to consider which of the myriad options are in fact best suited to the particular venture based on the assets, the nature and number of venturers, and relative holdings in the venture.

We review below the most common exit rights and the considerations that may be helpful in selecting the right mix. But let us begin by noting a number of elements common to virtually all transfers.

Issues Common to All Exit Strategies

Financing Considerations

As with so many issues between borrowers and lenders, treatment of direct or indirect transfers of the loan collateral is essentially a zero-sum game. A borrower will want its lender to permit whatever transfer rights have been negotiated in its joint venture agreement, and whatever else may arise in the future.

In contrast, the lender will want a static situation — no transfers of, or in, the mortgaged property. The result, of course, will be somewhere in between.

A transfer of the property and a related loan assumption will undoubtedly require lender

approval — most likely in the lender's discretion, but possibly with approval to be based on an objective set of criteria.

At the other extreme, transfers of minority passive interests may well be unrestricted but for compliance with the lender's know-your-client and related diligence requirements for the introduction of any new investor holding a specified percentage interest, often as little as 10%.

A lender will be reluctant to waive its right to approve, or to preapprove, transfers of controlling or majority interests in its borrower, as its loan will have been underwritten in significant part on the credit standing, experience, and track record of the operating venturer and any capital venturer holding a significant percentage of the equity.

Compromises usually center around preapproval of affiliate transfers, possible replacements of a capital venturer with a class of eligible institutional investors, and, less frequently, preapproval of a short list of replacement operating venturers.

Venturers must recognize that the applicable loan documents are paramount; time spent negotiating the transfer provisions of a venture agreement is time wasted unless the corollary provisions of the loan documents and the venture agreement are reconciled. The venture lender may well permit only a subset of the transfers contemplated by the venture agreement. But knowing when the lender must be consulted will at least avoid unpleasant surprises.

Transfer Taxes

While many jurisdictions only impose transfer taxes on outright sales of property, a not-insignificant number impose taxes on transfers of indirect or beneficial interests, and this is a trend that is expected to continue in the years to come.[2]

Thus, venturers owning property in one of the latter jurisdictions, or in anticipation of such a tax in the future, should allocate responsibility for such tax between the applicable venturers. Most often, the selling venturer will be responsible for any transfer taxes. But the parties may agree to treat transfer taxes as a company (i.e., shared) expense or to allocate otherwise.[3]

In jurisdictions where successive transfers can be aggregated, the parties should also take care to address responsibility for transfer taxes among transferors whose transfers have been aggregated.

Consider, for instance, an initial transfer relating to a significant minority percentage interest in the venture, perhaps 49%, and a successive transfer of only 3% interest. If these transfers are aggregated, a tax on the transfer of a greater than 50% interest may be triggered. How should that tax be allocated among the selling venturers?

Related Parties

Venturers do not always hold their interests through a single entity. An operating venturer may hold its promote interest in a separate vehicle, especially if its friends-and-family investors are not intended to share in the promote.

An investment fund may be investing through successive funds or with a co-investor. While it may be preferable for related parties to aggregate those interests in a single vehicle

outside the venture, this may not always happen. In such cases, it is important that related interests be aggregated for voting and consent purposes and in respect of buy-sell, put options, tag and drag rights, and other transfers.

Remedies

One can hardly imagine a contract of sale or a loan agreement without comprehensive provisions on remedies. However, the subject of remedies often receives short shrift in joint venture agreements. The joint venture agreement will likely contain detailed provisions concerning any failure to contribute capital or to remove an operating venturer, but what about other breaches?

What if a venturer has violated the transfer provisions of the venture agreement or the related provisions of the loan? Would there be a clear right to sue for breach of covenant? What would be the measure of damages? Would the breaching venturer be liable for default interest on the loan or other indirect damages?

What if the selling party in a buy-sell refuses to sell its interest? Is the remedy of specific performance available to the acquiring venturer? Are liquidated damages, in the form of a deposit or otherwise, available to the transferring venturer where the acquirer has defaulted?

Is a party wrongfully withholding consent to a transfer liable for damages or only for specific performance?

Issues Particular to Certain Exit Strategies

Rights to Approve Asset Dispositions

The right to approve a sale of venture assets is among the most fundamental of rights available to venturers. But is unanimous approval of a sale always appropriate? Are there circumstances in which a venturer should lose its right to approve a sale? It can be argued, for instance, that an operating venturer removed from management for cause should forfeit its right to approve a disposition.

However, others would argue that a removed operating venturer especially requires the right not only to approve, but to force, a disposition in order to preserve any accrued return or promote.

What about a venturer failing to contribute capital? Should the customary default loan or cram-down remedies be the sole remedies for a failure to contribute capital, or should the nonfunding venturer also lose its right to approve venture decisions?

Should the nonfunding venturer retain the right to make certain fundamental decisions, which could have a disproportionately adverse impact of such member? Should the revoked voting rights be reinstated upon repayment of the default loan?

Parties negotiating venture agreements should also consider the interplay of various provisions. Let's posit, for example, a venture agreement with dispositions requiring unanimous approval, but also a forced sale right in favor of one of the venturers. Does the latter right necessarily trump the requirement for unanimity?

Forced Sale Rights

Venture agreements often include the right of one or more venturers to trigger or force a sale of the property. This right is usually subject to a right of the nontriggering venturer to buy out the interests of the triggering venturer for the amount that the latter would have received if the property were sold for the price specified by the triggering venturer.

But parties to a negotiation should be careful to avoid a "what's good for the goose is good for the gander" mindset. A forced sale right is usually considered a perquisite of a super-majority investor with the sheer leverage to require the ability to liquefy its investment at any time or perhaps after a lockout period.

A minority venturer may assert that the supermajority venturer is not disadvantaged by affording the same right to other investors, given that it can remain in control simply by buying out the triggering venturer. But is this not akin to a put right on the part of the minority party?

An operating venturer entitled to a promote may be particularly sensitive to the need to force a sale of the property in order to realize on its promote. There is certainly some credence to this argument, but a less drastic approach may be to permit the venturer to crystalize its promote without triggering a sale.

A promoted venturer may be amenable to this approach but will likely require some ability to avoid having to make an immediate capital infusion by spreading out the promote payments over time or delaying payment until a refinancing opportunity arises. The venturer receiving the promote may, in these circumstances, receive a promissory note entitling it to some return on the deferred promote payment. Should such a note be a negotiable instrument?

Buy-Sell Rights

Many regard a buy-sell as perhaps the most equitable of all exit approaches, in that the uncertainty of whether the recipient of a buy-sell notice will elect to buy or to sell cautions the parties against injudicious pricing. But a minority — perhaps the operating — venturer might still argue that the provision is inherently unfair, at least where the more substantial investor triggers the buy-sell.

The latter would contend that its ability to buy out its majority venturer is more theoretical than real and, in fact, offers little pricing protection. At the minimum, the minority venturer in receipt of a buy-sell notice may need substantial additional time to be able to obtain financing or to identify a replacement investor before it must respond to the election notice or close on the purchase.

And what of the triggers for the buy-sell? Often the buy-sell right may only be triggered upon a deadlock on a significant decision requiring unanimity. Skeptics would argue, however, that it is simply too easy to manufacture a deadlock and that such a limited buy-sell is, in fact, tantamount to a discretionary trigger. Also, are all major decisions to be treated as equal, or should less drastic remedies attach to less fundamental matters?

Think back to the forced sale right. Some argue that a forced sale right is unnecessary if the buy-sell provision may be triggered for any reason rather than only in the event of a deadlock on specified decisions. The venturer seeking the forced sale right can control its destiny, so the argument goes, in the same manner as in a forced sale simply by initiating the buy-sell.

If the initiating venturer becomes the seller, then it has indeed accomplished its goal of liquefying its investment. But, if the recipient of the buy-sell notice elects instead to sell its interest, then the initiating venturer need only acquire the other venturer's interest to be in a position to take control.

But the marked difference is, of course, that the initiating venturer must first infuse capital to buy out the other venturer before being able to liquefy its interests. And a tax-sensitive investor may, in fact, suffer a significant detriment if an acquisition of the balance of the venture interests wreaks havoc on its tax planning.

Approval Rights for Transfers of Interests

Virtually all venture agreements will address the rights of venturers to dispose of their interests outside a sale of the property. Affiliate transfers are almost invariably permitted, but care should be taken that the affiliated transferee will, in fact, have the necessary economic substance to meet any future capital requirements.

Transfers to unrelated parties are probably more often discussed than acted upon. A super-majority venturer may have difficulty finding an unrelated buyer for its interest even if the venture agreement permits such a transfer. Indeed, the market seems, perhaps incongruously, to show more interest in acquiring a significant minority stake than a super-majority interest because of the tax advantages available to a sovereign wealth fund holding a less than 50% interest.

For the operating venturer, its institutional co-venturer may be unwilling to permit it to sell its stake to an unknown operator but may be willing to permit the operating venturer to sell down— though perhaps only after any anticipated development or repositioning has been completed.

Rights of First Offer or Refusal

Venture agreements often, but not always, include preemptive rights on the part of a nontransferring venturer to purchase the interest of a transferring venturer.

These rights should be considered to augment, rather than replace, bargained for approval rights — as a nontransferring venturer should not be forced to buy out an existing venturer in order to avoid having to accept a new co-venturer. Care must be taken that the venture agreement reflects this intent.

But, should this always be the case? Could an existing venturer assert that the failure to exercise a right of first refusal — where the identity of the acquirer of the interest is known — is tantamount to approval of the transfer?

Conventional wisdom is that rights of first offer are to be preferred as less chilling of the market for the asset to be transferred. However, a right of first refusal may be appropriate where, as in the case of a venture, the effect of a transfer is something of a forced marriage. A venturer may be comfortable with a right of first refusal, but it should be certain that it will retain an approval right in respect of any transfer that follows a waiver of a preemptive right to purchase.

Tag-Along/Drag-Along Rights

Tag or drag rights are perhaps less commonplace than other exit mechanisms. Still, they can be helpful where there is a significant discrepancy in the size of the venture interests or substantial reliance on the expertise of, or relationship with, an operating venturer. Clearly, a drag right enhances the liquidity of a venturer's interest in that its exercise can effectively turn a partial interest sale into the equivalent of an asset sale.

A majority venturer may be well-served by a drag right to prevent a venturer holding an insignificant percentage interest from blocking a disposition. A tag right would customarily accompany a drag right and would seem appropriate so long as the percentage interest tagging along is fairly nominal, and therefore, not likely to impact the economics of the proposed transaction to any significant extent.

Put/Call Rights

Put and call rights are even less common in the market. A key reason is that they may be triggered even without a proposed disposition. A venturer could, subject to an agreed lockout period, require a co-venturer to acquire its interest at any time, without regard to the status of the underlying investment or the availability of funds to complete the acquisition.

These rights would most likely be contemplated where venturers have significantly different investment horizons, and the acquiring venturer has sufficient liquidity to be able to consummate a purchase on short notice and without substantial disruption to its affairs.

Summary

However uncomfortable it may be to negotiate the terms of an exit or dissolution of a joint venture on the eve of formation, counsel and their clients cannot afford to ignore the issue or fail to select the best approaches available.

Even the most amicable of ventures will ultimately end in a transfer of interests or a liquidation of assets and unwinding of the venture. Preparing for that eventuality now is the best way to ensure that the separation goes as smoothly as the honeymoon stage of the marriage.

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[1] For more information regarding the various removal mechanism see Lisa M. Brill, The Art of Removal: Replacing Managers In Joint Ventures, Real Estate Finance & Investments, Mar. 18, 2018, at 8.

[2] See N.Y. Tax Law § 1402 (McKinney 2020); Cal. Rev. & Tax. Code § 11925 (West 1999); D.C. Code § 47-903 (2019).

[3] Care should be taken whenever responsibility is allocated contrary to statute, as the effect may be to trigger a "gross-up" of the tax, as additional consideration for the sale. See, e.g., N.Y.C. Admin. Code § 11-2104.