THE ART OF REMOVAL: REPLACING MANAGERS IN JOINT VENTURES

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As lawyers we are loath to tell our clients that there is no wholly satisfactory solution to a problem they have asked us to address. This frequently arises in the negotiation of manager removal provisions in joint venture agreements. In the typical real estate joint venture there is an operator that manages the day-to-day operations of the venture and likely holds a modest equity stake (called in this article, the manager) and an investor who contributes money to the venture based on its confidence in the manager's ability to manage the venture and the underlying real estate and to produce satisfactory returns on the investment. But what happens if the manager commits bad acts, breaches the agreements or generally does not live up to expectations? The manager removal provision in a joint venture is a contractual remedy which allows the investor to remove the manager as the controlling member of the venture under certain agreed circumstances such as bad acts, material breach or insolvency, and to step into its place or appoint a new manager.

Removal provisions are rarely addressed in the term sheet stage of negotiations. In the early days of negotiation the parties tend to focus on the three tenets of a joint venture: capital contributions, decision-making and exit. While it makes sense to raise removal provisions with clients during term sheet negotiations so they can consider how they want to address the issue, I do not often recommend that the parties negotiate removal provisions at this stage. Removal provisions open up a rabbit hole that must be carefully navigated as this article will explain. If anything, during the term sheet phase, the parties should confirm that the joint venture arrangement will contain "agreed removal provisions".

Of course there are joint ventures where the investor will never have the contractual right to remove the manager. For example, minority investors will not often have this right. Some managers have an established track record that allows them to reject requests for removal rights and still find sufficient equity for their projects. However, for the majority of joint ventures, the investor will require some ability to remove the manager when things go wrong.

This article will examine typical contractual removal rights, limitations on removal and effects of removal.

SCOPE OF REMOVAL

A manager of a joint venture who has devoted significant time and resources into arranging an investment, and who is likely not to receive a significant monetary benefit until the investment is stabilized or there is a capital event, will not readily accept that it can be removed as manager, and thereby lose the promote and fees that are typically paid to the manager and its affiliates. Hence, to start, the manager's position will be to limit the investor's removal right to unquestionable bad acts – gross negligence, willful misconduct, fraud or criminality. The investor will certainly accept such removal rights, but will typically want more, including the right to remove the manager for material breach of the joint venture agreement (including for failure to contribute funds when required to do so), criminal acts, misappropriation and insolvency. We often see managers agree to these removal triggers, subject to notice and cure rights where appropriate. Where removal is due to failure to contribute capital, the manager may want the removal right to apply only after the failure to contribute has diluted its interest by a certain percentage, or after it has failed to contribute a certain dollar amount.

Removal rights do not always stop there. If the project's developer or property manager is an affiliate of the manager, the investor may also want to provide that bad acts of the developer or property manager or its material breach of the development agreement or property management agreement constitute a removal event. Similarly, the investor may want removal rights in the event of a default under applicable loan documents. Loan defaults end up being trickier to negotiate since a default may be due to acts of the investor, e.g., if the investor consented to a decision which led to the loan default or failed to provide required capital which to avoid a loan default. A common ground may be to provide that a loan default is only a removal event when it is solely caused by the manager. There is no right or wrong answer and the resolution will depend on facts and circumstances and an agreed allocation of risk.

Not all removal events are based on bad acts or breaches. The investor may want the right to remove the manager if certain benchmarks are not satisfied. For example, if the joint venture is developing a residential condominium and certain sales thresholds have not been met by a certain date, or if the joint venture is leasing a multi-tenanted building and a certain percentage of space remains vacant after a certain date, the investor would be able to remove the manager. Managers tend to push back on these sorts of removal rights and a middle ground is often for the investor or its designee to take over, or play a more active role in, sales and marketing or leasing for the project rather than removal. Removal may also be triggered if one or more key persons of the manager are no longer actively involved in the day-to-day management of the joint venture whether due to death or disability or leaving the company generally. Here, the manager will typically want the opportunity to find a reasonably suitable replacement key person before the removal is permitted.

LIMITATIONS ON REMOVAL

The investor should understand that removal has consequences and that there may be serious impediments to removing the manager.

The primary impediment is the project's financing. The investor should always review any applicable loan documents to determine whether lender consent is required for removal. If consent is required and not obtained, the removal would likely trigger an event of default under the loan documents. Many lenders make loans based on their relationship with the manager or its track record. In these circumstances, it would not be unusual for the loan documents to provide that a change of control of the borrower (i.e., replacing the existing manager with the investor as manager) would be an event of default under the loan documents entitling the lender to exercise remedies. This would mean that removal would cause great risk to the project. The manager knowing this would likely condition removal on receiving all necessary third party consents.

If possible, investors should take care to negotiate loan documents which give them the flexibility they need to remove a manager. In the ideal world, the change of control upon removal would be permitted under the loan documents. A middle ground would be for removal to be permitted as long as the investor engages a satisfactory third party manager or developer, or for the lender to agree to be reasonable when considering a change of control.

Even if that hurdle is satisfied, the next impediment to removing the manager is providing the lender with a replacement guarantor. In most real estate joint ventures, the manager or its affiliate provides all loan guaranties. As discussed in more detail below, a manager may require as a condition to removal that the investor provide replacement guarantors and, based on experience, a lender will also require replacement guarantors as a condition to removal. Not all investors will have a suitable party to serve as guarantor. Many lenders will require a U.S. guarantor that meets certain net worth and liquidity requirements. Absent a guaranty, the lender may accept a letter of credit, but that requires a relationship with a bank acceptable to the lender and sufficient available funds to obtain the letter of credit, and a lender willing to quantity potential exposure.

In some cases, the lender will not even agree to be reasonable when considering a change of control. This does not necessarily mean that the investor should not invest in the project. If a removal event occurs and the investor wants to remove the manager, most likely there are issues under the loan as well. If the investor has a plan to put the project and loan back on track, the lender may be amenable to supporting the change of control. In addition, the investor could always remove the manager and pay off the loan thereby taking over the project and avoiding a loan default. Of course, this means that the investor would need to find alternative financing (not always an easy feat), but it is a path to taking control of the project.

This is the first half of a two-part piece on removal provisions in joint venture agreements. The second half, which discusses enforcement, the consequences of removal, and exit strategies will be published in the March 26 issue.

ENFORCEMENT OF REMOVAL

When an investor determines that a removal event has occurred, the next step is to enforce removal provisions of the joint venture agreement. Here, it is important that the joint venture agreement provides a clear path to removal. By way of example, several years ago I was involved in a matter where a real estate project had not performed as well as expected and the investor was not happy with certain decisions the manager had made. Eventually, the investor sent a notice that the manager was in material breach of the joint venture agreement beyond the required cure period and that the manager was thereby removed as manager effectively immediately. The manager wrote a letter back, disputing the breach and rejecting the removal. Both parties wrote letters to the Delaware Secretary of State, each proclaiming to be the rightful manager of the venture. The manager wrote letters to each service provider asserting its rights as manager and requesting that the service providers not take instruction from the investor. Many letters were exchanged. The investor was at a disadvantage – it did not have relationships with most service providers for the project since it had not been involved in day to day operations, and for those it knew, given their relationship with the existing manager who paid the bills, the service providers were not inclined to take instruction from the investor. In addition, the investor did not have access to company bank accounts or books and records to actually run the business. The parties were clearly at an impasse and the project was stalled. The joint venture agreement was silent as to how to resolve disputes which meant that the only path – without an agreement to the contrary - would be through litigation. Neither party wanted to go through a very public, time-consuming and costly litigation. Both parties had reputational concerns, and the investor did not want to remain in a venture with a manager it did not fully trust for another few years as the litigation worked its way through the courts. In the end, the parties agreed to mediate their dispute and ended up agreeing to a settlement whereby the manager bought the investor out of the venture at an agreed price.

To avoid situations like this one, any disputes with respect to removal, if not otherwise resolved between the parties, should be determined by expedited arbitration. There are many different arbitral tribunals to choose from. The customary approach is for the manager to remain in control until the arbitrator has issued its determination (but with the investor having additional approval rights or the right to appoint an asset manager to oversee the investment), which can be obtained fairly expeditiously. The investor may want to make sure that the manager does not receive any monetary benefit during this period of time, so the joint venture agreement may provide that no distributions of promote or fees will be made to the manager until the arbitration is resolved. The investor will also be in a stronger position if from the beginning of the venture the investor was included as a signatory on company accounts. Finally, the investor should make sure that the indemnification provisions in the joint venture agreement do not permit the manager to fund its defense costs through company funds. Costs related to defense or pursuing a claim should be borne by the parties until a resolution is reached and them the prevailing party should be responsible for all costs and expenses. If the arbitrator requires payment prior to the end of the proceeding, the parties may agree upfront in the joint venture agreement that the fees would be split equally until there is a resolution where the prevailing party would be reimbursed.

CONSEQUENCES OF REMOVAL

Removing a manager does not cure all ills; issues may still arise post-removal. When an investor removes a manager, the manager remains a party to the joint venture agreement either by virtue of its affiliate's non-managing member stake or by conversion of its managing member position to a non-managing member position upon removal.

First, upon removal, the investor will typically require that the manager forfeit any promote or carried interest that it would have received as manager. The manager will push back on this position and argue that, especially if the removal is close to the time when the parties would realize on the investment, that the manager has rightfully earned the promote. Here, we often see the parties get creative in how they address whether the manager should remain entitled to promote or a portion thereof. For example, if the removal event was due to a true bad act – fraud, gross negligence, willful misconduct – no promote would be received; however, if the removal event was due to a breach or death or disability of the key person, the promote would still be earned. Where promote is still earned, we sometimes see the concept of a so-called "hypothetical promote". The joint venture will value its assets as of the date of removal and distributable proceeds to determine the promote the manager would have received had the assets been sold and joint venture liquidated on that date. It would be rare for the joint venture to have the funds to pay the removed manager the promote on that date, so the joint venture would provide a promissory note to the removed manager in the amount of the hypothetical promote which would be paid upon a capital event or liquidation of the joint venture.

The investor may agree to pay the removed manager a promote in some circumstances as provided above, but it has other considerations as well. If the investor has removed the manager it likely needs to find a replacement manager with experience to satisfy the lender and act as a replacement guarantor. Any replacement manager will require some sort of payment or promote and the investor will need to make sure that there are sufficient funds for that payment and for itself. The investor may not be sympathetic to the removed manager's position.

Second, once the removal right is triggered, the investor will typically have the right to terminate all affiliate agreements, including any development or management agreement, even if it does not elect to remove the manager. The manager or its affiliate will be paid any fees owing up to the date of removal, but so long as the development agreement or management agreement provides that the developer or manager is paid currently, there is rarely any push back on these termination rights. The investor should also have the right to enter into replacement agreements in its discretion.

Third, the investor will want to make sure that the removed manager does not retain significant decision-making rights which could hold up operation or development of a project. Because of this, investors will generally try to limit the removed manager's approval rights. The manager (or its affiliate member) still has equity in the project so it is likely to want to retain all if not some of the voting rights available to an non-managing member investor in the joint venture. Again, a compromise if often negotiated whereby the removed manager retains some fundamental corporate rights such as approvals over changes to the purpose of the joint venture, bankruptcy or increasing contribution obligations.

Finally, the manager will require that the investor replace it on all guaranties for claims arising from events after the removal. As mentioned above, the lender will likely require this as well, but in cases where the investor does not have a satisfactory replacement guarantor and the lender does not require one, the investor may want the removed manager (or its affiliate) to remain as guarantor with indemnifications from the investor for any claims arising after removal.

EXIT STRATEGIES

As mentioned above, post-removal the removed manager remains a party to the joint venture. Assuming that the removal is not amicable and depending on the removed manager's rights post-removal, the removed member may be able to obstruct progress of the underlying project or venture. Because of this, the investor may try to negotiate a call option whereby the investor can acquire the removed manager's interests. The investor will likely want to acquire the interests at a discount, but while I see this raised during negotiations, I do not often see it agreed between the parties.

More common is that the removal would allow the investor to exercise a buy-sell or a forced sale ROFO (basically, upon initiation by the investor, the removed manager could elect to acquire the investor's interests and, if it elects not to, the investor would have the right to sell the property to a third party). Managers which have a more significant stake in the underlying project may also push back on this right. Whether this right makes sense needs to be considered in light of the investor's rights post-removal. The investor may control the joint venture at this point, including having the sole right to decide whether to sell the underlying real estate, so it may not need to use a buy-sell or forced sale ROFO as an exit strategy. However, if the removed manager has approval rights over a sale and has not provided its approval, exercising a buy-sell or forced sale ROFO may make sense.

Exercising remedies such as these may work well with a stabilized asset, but, with a development project which has not yet reached completion or stabilization, a sale may not make sense and interests may be difficult to value. This does not mean that using these remedies in a removal situation is not possible, but exercising the remedies may not make sense economically.

CONCLUSION

Negotiating removal rights is an art, not a science, and there is not a one size fits all approach. Every party comes to the table with its own concerns, requirements and tolerance for veering from its preferred position.

Manager removals are in fact fairly rare. In many cases where there is a claim for removal, the parties no longer want to be joint venture partners and are willing to come to the table to negotiate a work out of their disputes rather than the black and white result of litigation or arbitration. Alternatively, an investor who would otherwise have the right to remove a manager may elect not to do so because stepping into the shoes of the manager may expose it to greater liability. Removing a manager that has completion obligations under a joint venture agreement may shift those obligations to the investor.

In sum, there are many nuances that the parties need to consider when negotiating removal provisions and the outcome for both parties will likely not be wholly satisfactory. The best practice is to negotiate the clearest removal provisions you can, but also know your partner. If you are the investor, perform diligence on the manager's track record and performance on other projects. If you are the manager, make sure that you are comfortable that the investor will be a reasonable player who will not bring a removal claim capriciously. The removal provisions should not consume your joint venture negotiation, but they should be thoughtfully considered by both parties given the facts and circumstances of the project.

NEWS IN BRIEF

MADISON REALTY CLOSES $37.5M FIRST MORTGAGE

Madison Realty Capital has closed a $37.5 million first mortgage collateralized by a mixed-use development site and two adjacent commercial buildings located in Queens, N.Y., the company announced. The firm originated the loan on behalf of developer **AB Capstone** in seven days. AB Capstone, which has completed more than 1.5 million square feet of ground-up development and value-added projects, will use proceeds to buy out an existing partner, complete the acquisition of the properties, pay off previous financing on the development site, and fund construction of the new building's foundation. The company is planning to build a 17-story, 129-unit residential building, with 90,000 square feet of commercial space.

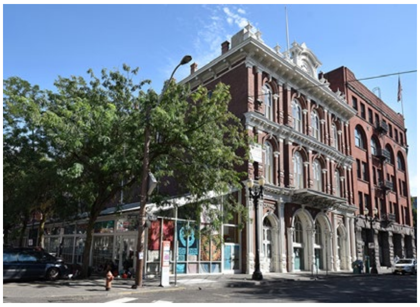
REBNY: BIG APPLE SALES ACTIVITY FALLS

New York City saw a big drop in investment sales activity in the second half of 2017, according to a new report from the Real Estate Board of New York. Total investment sales consideration for completed transactions was $17bn, a 37% decline from $26.8bn in the second half of 2016. Citywide investment sales activity retreated by 19% year-over-year, dropping to 2,334 transactions in the second half of 2017 from 2,880.

Despite declines in total investment sales consideration and activity across the boroughs, the Bronx recorded gains with investors spending $1.5bn on investment property trades in the second half of 2017 compared to $1.4bn in the second half of 2016. The increase was skewed by two property sales with large price tags, including the $115m sale of an office building at 260 East 161st Street in Concourse Village, and the $86m sale of the Frances Schervier Home and Hospital at 720 West 231st Street.

SQUARE MILE ORIGINATES PORTLAND, PHILADELPHIA LOANS

Square Mile Capital Management has originated a $44.3 million loan secured by a five-building, 121,000-square-foot office portfolio located in the Old Town neighborhood of Portland. The borrower, NBP Capital, recently acquired the portfolio from Swift Real Estate Partners. The loan includes additional proceeds to fund future capital expenditures and leasing costs. The properties are 70% occupied, with NBP planning to renovate and re-lease the assets.



The firm has also originated an acquisition loan secured by the Philadelphia Marriott West, a 289-key hotel located in Conshohocken. The borrower is Columbia Sussex Corporation, a privately-owned hotel owner and operator based in Crestview Hills, Kentucky. Columbia Sussex will use the financing for acquisitions and renovations. Hodges Ward Elliot's New York City office arranged the financing.

HUNT MORTGAGE HIRES BOUTON

Hunt Mortgage Group has hired **Owen Bouton** has a director, the company announced. Bouton will focus on originating loans for clients located in the Southeast as part of a larger push to build the firm's proprietary lending platform. He will operate out of the firm's Charleston and Atlanta offices. He will report tom **John Beam**, managing director. Prior to joining Hunt Mortgage Group, Bouton worked as a loan originator at LStar Capital, a subsidiary of Lone Star Funds. He's also worked at CIBC and JPMorgan.