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Workshop 5

Joint Venture Negotiations: Watching for Pitfalls

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I. **Introduction**
   A. **Structure of Joint Venture**
      1. Joint ownership of an entity (typically limited partnership or limited liability company)
      2. Contractual relationship (e.g., joint venture agreement and/or program agreement)

   B. **Each Transaction is Very Fact Specific**
      1. Highly negotiated transactions
      2. Not all investors have same concerns
      3. Different types of JVs: Single Asset, Multi-Asset, Programmatic, Clubs, Funds
      4. Leverage of the parties may differ from one transaction to another
      5. Majority/Minority v. Co-Control transactions
      6. Added complexity if more than 2 parties are involved (especially with respect to capital contribution, management and exit provisions) or tiered JV structure (e.g., co-GP)

II. **Basic Contents of JV Agreement**
   A. **Contributions:** How much will this investment cost?

   B. **Distributions:** How do we take money out of the venture?

   C. **Management:** How do we live with each other?

   D. **Transfers/Exit Strategy:** How do we go our separate ways?

III. **Contributions**
   A. **Initial Contributions**
      1. Usually involves contributions of cash, property, receivables or services
      2. JV may assume purchase agreement and fund deposits - address closing issues
      3. Capitalization of due diligence and negotiation costs

   B. **Capital Calls**
      1. Who has the right to make a capital call?
      2. Under what circumstances may a capital call be made?
         i. Acquisition of property
         ii. Discretionary capital calls
         iii. Required expenditures (e.g., budgeted items, preservation of property)
         iv. Cost overruns—specific to development transactions
            a. How are the overruns determined - initial vs final budgets, use of contingency and savings
            b. What portion and categories of overruns will developer bear? JV will typically share "force majeure" (heavily negotiated)
            c. Will developer recover funded overruns in the waterfall?
         v. Reimbursement of payments made under guaranties on behalf of the company
         vi. Exigent circumstances

   C. **Failure to Fund a Capital Call**
      1. Funding member's right to claw back its funded contribution
      2. Funding failed capital call on behalf of defaulting member

i. Loan to company
ii. Loan to defaulting member
iii. Capital contribution to company followed by punitive dilution (1.5x or 2x)
a. Default loans may convert to dilutive capital contribution
b. Proportionate dilution of promote
c. Impact on future funding obligations

D. **Percentage Interests**
1. Usually based on capital contributions
2. Anti-dilution protection (FMV vs. contributed capital, right to contribute capital on pro rata basis, consent right over capital calls)
3. Punitive dilution

IV. **Distributions**
A. **Distribution Waterfall**
1. What is being distributed?
i. Available cash (consider right to set reserves)
ii. Operating Cash Flow vs. Capital Event proceeds
iii. Loans to the company are paid prior to distributions of available cash
iv. Tax distributions
2. When will distributions be made?
3. Who is entitled to receive distributions?

B. **"IRR" or "Internal Rate of Return"**
1. Return of capital
2. Return on capital
3. "Preferred Return" = specified IRR on returned capital

C. **Promote/Carry**
1. "Promote" or "Carried Interest" = disproportionate share of profits in joint venture
2. Loss of promote
i. Right to assign to a successor manager
ii. Freezing of promote based on FMV at relevant date
3. Crystallization or redemption of promote in long-term hold transactions
4. Clawback of promote

V. **Management**
A. **Management Structures**
1. Member managed
2. Manager managed
3. Board managed

B. **Operating Member Duties**
1. Day-to-day operation
2. Reporting requirements (e.g., monthly, quarterly and annual)
3. Preparation of budgets and business plans

C. **Limitations on Authority/ Major Decisions (e.g., sales, acquisitions, financings, mergers, bankruptcy, approval of budgets, dissolution/liquidation, etc.)**
1. Major Decision list acts as list of consent rights
i. Capital member may have right to propose Major Decisions and override operator on non-fundamental actions
ii. Multi-party ventures may use supermajority or unanimous standards
iii. Coordinate with affiliate agreements and lower-tier JVs
2. Affiliate transactions
3. Restrictive Covenants (these usually apply only to operating member)
i. Exclusivity
ii. Non-Compete
iii. Key Person/ Devotion of time
iv. Non-Solicitation of employees
v. Obligation to offer future opportunities to joint venture

4. Member Defaults (these usually apply only to operating member)
    i. "Bad Acts" (fraud, willful misconduct, gross negligence, criminal conduct)
    ii. Breach of JV obligations - monetary vs. non-monetary
    iii. Bankruptcy or unpermitted transfers
    iv. Breach of affiliate contracts or related venture agreements
    v. Notice and cure/ contest rights, particularly for non-senior employees
5. Remedies
    i. Removal of operating member as manager
    ii. Loss of Promote by operating member - may be limited to "really bad acts" or removal prior to substantial completion
    iii. Call Right—non-defaulting member will have the right to buy out operating member's interest at a discount
    iv. Acceleration of exit rights by non-defaulting member
    v. Loss of ROFO rights by defaulting member

D. **Deadlocks**
1. Deadlock resolution mechanism
    i. Buy/sell
    ii. Acceleration of exit rights (e.g., forced sale right)
    iii. Put/call
    iv. Arbitration/mediation
2. No deadlock resolution mechanism

VI. **Transfers/Exit Strategy**

A. **Definition of "Transfer"**
1. Direct v. indirect transfers (how high up the chain do you have to go?)
2. Change of control provisions
3. Pledges

B. **Permitted Transfers**
1. Transfers to affiliates/controlled entities
2. Transfers among JV partners
3. Lockout periods
    i. After a certain lockout period, members have the right to cause a sale of their interests in the company
    ii. Is right limited to "all" the interests or to "any portion" of the interests?
    iii. Usually accompanied by ROFO/ROFR in favor of the other member(s)
4. Right of first offer/first refusal
    i. Right of first refusal has more chilling effect on ability to transfer
    ii. Which party is required to put the price on the table?
    iii. Determine interest price based on proceeds that parties would receive in hypothetical sale of assets at offered price, with certain cost deductions
    iv. Timing of decisions and sale procedures (must sell at 95-98% of offered price)
5. Tag/drag rights
    i. Tag rights allows non-selling member to sell interests together with selling member in connection with proposed sale
    ii. Drag rights allows selling member to force non-selling member to sell its interests in connection with proposed sale

C. **Forced Sale Right**
1. After a certain lockout period, members have the right to cause a sale of the company or the assets of the company
2. Maybe accelerated by certain events (e.g., removal/ cause event)
3. Usually accompanied by right of first offer/ first refusal in favor of the other members

D. **Buy-Sell**
1. After the occurrence of certain trigger events, a particular member may designate a price for the entire company which will be used to calculate the price at which the other member(s) must elect either (x) to buy the designating member's interest or (y) to sell its interest to the designating member
2. Price for interests determined on a liquidated basis

3. Potential disadvantage to operating member that does not have liquidity

E. **Put/Calls**
1. Primarily used in connection with defaults
2. Pricing issues - valuation mechanism to determine FMV (e.g., multiple appraisals)

F. **Other Exit Issues to Consider**
1. Requirement to pay off loans made by exiting member to company
2. Release of guaranties and other credit enhancement provided by exiting member
3. Minority investor hold up value
4. Additional complexity if joint venture has more than 2 members (e.g., defaults of one member, one member elects to sell and another elects to buy, etc.)
5. Deal-specific restrictions may apply (e.g., REIT share sale requirements, opportunity zone 10-year hold period)