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Workshop 22

Joint Ventures: Issues and Solutions Bumps in the Road — A Practical Discussion of Legal Issues and Solutions When Things Don't Go as Planned

Presented to

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by:

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This session will be a practical interactive discussion of common issues joint venture Members encounter when things do not go as planned and potential solutions. Topics will include what happens when a joint venture needs more money and when sponsors and investors do not agree on key business decisions. We will also cover other typical joint venture pressure points, including capital contribution issues, allocation of control and decision making, exit strategies, and implications on project and loan guarantees.

1. INTRODUCTIONS

2. OVERVIEW AND GOALS OF PROGRAM

3. ORGANIZATIONAL MATTERS

    a. When to form the JV? When is a pre-formation or pre-closing cost sharing agreement necessary? How are pre-formation decisions made? What if target property must be acquired prior to construction financing?

    b. "Newco" or existing entity?

    c. Does the JV agreement govern Subsidiaries? Conflicts between governing documents.

4. CONTRIBUTIONS AND CAPITAL ACCOUNTS

    a. Initial, Additional, Mandatory, Optional

    b. Are contributions recourse or not? And to Whom?

    c. Who can call capital?

    d. Do capital calls require Member consent? If so, does the JV Agreement provide sufficient flexibility to call necessary capital?

        i. Capital required by approved Budget.

        ii. Capital within some variance outside of approved Budget.

        iii. Capital Required by approved business plan. Consider practical problems associated with this, including typical vagueness of plans.

        iv. Non-Discretionary Expenses and what does this include? (Taxes, debt service, approved expenses, etc.)

        v. Cost Overruns (if applicable). How handled? (discretionary/non-discretionary; expected/unexpected; causation).

    e. Remedies for failure to contribute capital.

        i. Are stated remedies for failure to fund capital exclusive or inclusive of other remedies available per the JV Agreement or at law or in equity? A 5% Member may not have the resources to fund the 95% Member's share of a capital contribution as a Member Loan or Default Contribution.

        ii. Member Loans vs. Company Loans. At what rate? Consider priority of Member Loan if Member in default.

        iii. Dilution. Often nominal effect.

iv. Removal of Manager/Managing Member. Consider interplay with transfer provisions in loan documents [see below re: removal].

v. Loss of Voting/Approval Rights [see below re: fundamental decisions].

vi. Sale, put/call, discounted redemption or other exit rights. Consider interplay with transfer provisions in loan documents.

5. MANAGEMENT

a. If Manager or Managing Member managed, what standard of care applies? Fiduciary duty? Prudent Person? Other?

i. Watch for "right" or "authority to make" day to day decisions versus a duty and obligation.

ii. Often non-disclosure by the Manager results in effects to the JV and/or the capital Member as significant as a Major Decision. Does standard of care and fiduciary duty change after removal (apply to capital Member's manager after removal)?

b. Key Persons. Who? How used? Required time standard. Required ownership and management involvement. Required minimum equity.

c. Major Decisions. Who can request?

i. Sale (carve out liquidity/exit rights). Does approval right include approval of sale documents or just purchaser, price and material terms of sale?

ii. Acquisitions.

iii. Financings and Refinancings. Consider positions and interests of Members. A 90%/95% Member may need unilateral refinancing and/or capital call rights to repay maturing debt (or to paydown debt to remedy failed financial covenants). Does approval right include approval of loan documents or just material financing terms generally?

iv. Budgets and restrictions on expenditures.

v. Material litigation/settlements.

vi. Making loans or issuing guaranties.

vii. Affiliate contracts/transactions.

d. Fundamental Decisions that survive removal as Manager or Managing Member or material default/cause event.

i. What are typical fundamental decisions?

ii. Consider whether defaulting minority should have any approval rights.

iii. A common fundamental decision is that the removed member or manager does not have to contribute capital without approval. Consider if that is appropriate in refinance or loan maturity situations.

iv. Should 90%/95% capital Member make all decisions so long as result is not disproportionate to removed member?

v. Watch for form references to "Members".

e. Resolving Major Decision Impasses - elevation to senior management, capital provider override, mediation/arbitration, buy/sell or other exit rights.

f. Consider Major Decision Impasse mechanisms in context of the Venture and the urgency of the Major Decision – e.g., development projects vs. stabilized projects; sale vs. litigation / settlement decisions. Often a disagreement should not trigger dispute resolution.

g. Define removal events (only "bad boy" acts or more general defaults that are not cured within applicable cure periods). How to handle events causing reputational damage but unrelated to the asset?

h. Consider if removal events include a default under an affiliated service agreement (asset management agreement; property management agreement; development services agreement; general constructor contract).

i. Cure allowed only if caused by employee other than Key Persons or Management Personnel?

ii. Must terminate employment of employee/person responsible for the removal event vs. simply removing such individual from any involvement with the JV and its business?

iii. Full restitution to JV (non-defaulting Members) – required in all events or may be provided to satisfy cure right if event is not otherwise curable? How determined?

iv. If multiple non-defaulting Members, who can exercise? Any non-defaulting Member or all or some threshold percentage of non-defaulting Members. Same issue arises with respect to the selection of a replacement Manager, Managing Member or governance structure.

i. Dispute/Right to Challenge Removal.

i. Is removal effected post or pre dispute resolution? If post-dispute, then how are decisions made during the interim dispute period – is the removed Manager/Managing Member limited to Fundamental Decisions only?

ii. Expedited Arbitration or Provisional Remedy.

iii. Viability of reinstatement of Manager / Managing Member (and affiliate contracts) if removed Manager / Managing Member prevails in dispute or damages remedy?

j. Additional Consequences of Removal.

i. Forfeiture of service fees; termination of service agreements; non-defaulting Member selects replacement. Note interplay with loan documents. Consider practical issues when in mid-stream development.

ii. Loss of Promote – all or part of Promote depending on the severity of the removal event? Crystallize promote?

iii. Put/Call or opening of other exit rights for non-defaulting Members. If removed Manager / Managing Member interest is called, redeemed or purchased, is the price discounted due to the removal and removal event? Are damages resulting from the removal event offset against the price paid to Manager / Managing Member? How calculated?

iv. Exit right for removed Member via forced sale with ROFO or put (liquidity) right at FMV determined in a valuation process.

v. Consequences and remedies can also vary depend on the removal event. For example, removal for cause versus death of Key Person.

k. Guaranty releases / release of liability.

i. Commercially reasonable efforts vs. obligation to release removed Member's or affiliate's guaranties and recourse obligations in respect of the JV and its business – release only for post-removal periods?

ii. Indemnity to removed Member for recourse liabilities arising from acts, omissions, events or conditions post-removal – who provides indemnity? Creditworthy entity or Member SPE?

iii. Obligation to repay debt if release of guaranties/recourse obligations is not secured?

iv. Release of liability for cost overruns resulting from post-removal events – difficult to draft for given that the line is grey between overruns caused by events prior to removal vs. post-removal. Should removed Developer be penalized for failing to deliver the completed project?

l. Guaranties.

i. Who provides loan and other Guaranties/indemnities?

ii. Guaranty fees payable to Member?

iii. JV indemnity/reimbursement for Guaranty losses.

iv. Contribution/Indemnity Agreements – credit support for reimbursement to Guarantor.

m. If purpose is development or value add, consider transition of Management from developer sponsor to capital Member at stabilization. Often tied to a crystalization event.

6. EXIT STRATEGIES.

a. Buy/Sell.

i. Consider whether sponsor Member is disadvantaged given disparity in liquidity: (1) Propose different exit/liquidity mechanisms; (2) Lengthen response and closing periods to provide time to raise capital to make a "buy" election; (3) Reduce deposit amount (if applicable) and limit other remedies for default in buy/sell; (4) Require objective valuation process (e.g., baseball appraisal process) to establish buy/sell value; (5) Require some level of purchase money financing from selling Member to allow less liquid Member to exercise buy option.

ii. Consider whether capital Member is disadvantaged given that the sponsor will have more information regarding the Project: (1) Require detailed representations and warranties from selling Member; (2) Require certified copy of material communications received by purchasing Member regarding potential sale, financing or leasing of the

Property or that would otherwise be reasonably expected to affect the value of the property.

iii. Consider practical implications of timing of process or ambiguity in process.

b. Right to Sell JV Interest subject to ROFO/ROFR.

i. Sale of JV Interests versus Assets

ii. Should a sponsor/developer Member with a minority (e.g., 5% to 10%) have the right to force a sale of the JVs assets even if the capital Member has a ROFO?

iii. Consider whether a defaulted Member loses its ROFO/ROFR?

iv. What if pricing comes in below the threshold price (e.g., 95% of the offered price)? Does the exercising Member have a second try at the forced sale at such lower price?

v. Does the ROFO apply to terms other than price? What if other economic terms effectively undermine the stated price? Focus on net proceeds?

vi. Forced Sale after an event or expiration of a time period. What happens if timing is off – down-market?

c. Put/Call Liquidity Rights.

i. Is it a one-time right and/or is exercise of the right restricted to some period of time?

ii. Valuation process – use current appraisals (if available) or baseball appraisal process with each party selecting an appraiser at its cost and, if the two appraisals are not within a threshold percentage of each other (say 5%), a third appraiser is selected. Use BOVs?

iii. Consider if prior service/affiliation with a Member will disqualify appraisers/brokers, clarify that this condition applies to the individual vs. the company (e.g., many large institutions have worked with all major brokerage companies and many different appraisal companies).

iv. Is the formula for determining the purchase price sufficiently detailed?

v. If the non-exercising Member disagrees with the valuation, should the non-exercising Member have the right to make an election other than purchasing the exercising Member's interest? On what terms?

vi. What happens if the Property does not sell within the allotted time period? Can the non-exercising Member exercise the put/liquidity right again (perhaps after a lockout period)? Can the non-exercising Member require the JV to accept an offer below the threshold price subject to a right of first refusal in favor of the other Member?

d. Common Issues in Drafting Liquidity Rights.

i. Include Default & Remedies Provisions – often forfeiture of a deposit as liquidated damages if purchaser is the defaulting party, and specific performance if seller is the defaulting party.

ii. Should there be additional remedies? (1) Right of the non-defaulting Member to sell the Property for a period of time without further consent of the defaulting Member? (2)

Default is removal/cause event that triggers the consequences of removal? (3) Lockout of defaulting Member's right to exercise exit/liquidity rights (e.g., the defaulting Member may be locked out from exercising an exit right for 2 or 3 years post-default).

iii. Release of selling Member's guaranties and other recourse obligations (similar issues to those that arise upon a removal).

iv. What if the provision doesn't cover transaction and closing mechanics. Who drafts documents? Who is escrow agent? How are costs and prorations determined? What representations and warranties are appropriate? Any closing conditions - financing?

7. MISCELLANEOUS

a. Consider interplay between commonly drafted amendment provision (amendment requires all parties) with removal and fundamental decision concepts.

b. Retention or offset rights by capital Member. Against current and future fees and distributions only? Clawback?

c. Consider practical implications to sponsor of offset against fees and of a clawback. Fees are usually to pay for the business and spent as received. Smaller sponsors often don't have deep enough pockets for these provisions.