COMMERCIAL REAL ESTATE JOINT VENTURES

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A Real Estate Joint Venture ("JV") is essentially a business arrangement in which two or more parties agree to combine their resources in order to develop or acquire a real estate project. The JV facilitates the union between those professionals who are experts in facilitating the development of commercial real estate projects and possess the ability to source, acquire, manage and develop real estate projects and the capital providers which consist generally of institutional investors that provide the capital needed for a real estate project. There are several considerations involved in structuring a JV which include the entity selection, elements of control by each party, distribution priorities, future capital requirements and exit considerations. Additionally, each party should have a firm understanding of the fiduciary relationship between the parties which is established upon the creation of the JV.

Role of Joint Ventures in Commercial Real Estate

The joint venture structure plays an important role in the development of commercial real estate projects since it provides investors with a mechanism to satisfy large capital requirements that coincide with projects (particularly large scale commercial real estate developments). The JV facilitates the union between those professionals who are experts in facilitating the development of commercial real estate projects and possess the ability to source, acquire, manage and develop real estate projects ("Operating Party") and the capital providers which consist generally of institutional investors that provide the capital needed for a real estate project ("Capital Party"). Accordingly, a common joint venture structure consist of the formation of a business entity by

the Operating Party and the Capital Party to hold title and conduct all activities necessary in order to acquire, develop, and manage a commercial real estate project. The terms and conditions agreed upon by the parties are set forth in a JV agreement.

Business Entity Selection

Generally, the entity types that are considered for a commercial real estate project include, limited liability company ("LLC"), limited partnership ("LP"), general partnership ("GP"), and corporation. In determining which entity to select the parties should consider a number of factors including tax considerations, regulatory concerns, and the legal environment created by the establishment of each entity type. However, tax considerations generally drive the decision regarding entity selection since the agreement (operating, partnership or shareholder) can be structured to address other considerations along with incorporating the business terms and conditions associated with the JV. Regardless of the entity type that is selected, generally, the JV will be structured as a bankruptcy remote single purpose entity ("SPE"). A SPE consist of an entity formed for a single purpose (the development of a single real estate project). If the JV obtains debt financing, the lender will generally require that the entity is a SPE.

Limited Liability Company

The existence of a New Jersey LLC begins upon the filing of a certificate of formation pursuant to the Public Records Filing for New Business Entity with the New Jersey Department of

Treasury, Division of Revenue & Enterprise Services.[1] The certificate of formation will require the designation of a qualified agent for service of process. It should be noted that the LLC members do not have to codify their agreement in writing; however, it is important to note that during the negotiation process in establishing the LLC, terms of the agreement between the parties, including the purpose of the enterprise along with the member's respective rights and liabilities, should be codified within an agreement prior to formation in order to reduce the potential for problems in the future. Accordingly, in order to avoid any specific misunderstandings regarding the business terms and conditions including capital requirements, special allocations, distributions, approval rights and control issues, the parties should enter into an operating agreement that sets forth the appropriate business terms agreed upon by the parties.

Once the LLC has been duly formed, for legal purposes the LLC is now recognized as an entity separate and apart from its members. As a result, the LLC can only be held responsible for the entity's debts, and the members are typically not personally liable for the entity's obligations or liabilities absent a personal guaranty of an individual member.

The LLC structure allows some flexibility in the manner in which the members' initially provide consideration for their interests in the entity. A member's capital contribution to the LLC may validly consist of money, property, services rendered, or a binding obligation to contribute such at a later date; typically the only limitations on a member's contribution are those provided in the certificate of formation or the operating agreement. No matter how the interest is initially secured, once made these capital contributions determine how the LLC profits, losses and

[1] N.J.S.A. 42:2C

distributions of money or property are made amongst the members unless these allocations are stated differently in the operating agreement.

Limited Partnership

The LP is comprised of one or more general partners, who have all the same rights and liabilities as they would as members of a general partnership, and one or more 'limited' partners. The limited partners' responsibilities to the limited partnership are merely the contribution of capital; limited partners have no management rights or responsibilities and accordingly, cannot be held liable for any of the partnership obligations in excess of their capital contributions. The existence of a New Jersey LP begins upon the filing of a certificate of formation pursuant to the Public Records Filing for New Business Entity with the New Jersey Department of Treasury, Division of Revenue & Enterprise Services.[2] The certificate of formation will require the designation of a qualified agent for service of process. It should be noted that as with LLC formation and operation, the limited partners do not have to codify their agreement in writing; however, it is important to note that during the negotiation process in establishing the LP, the terms of the agreement between the parties, including the purpose of the enterprise along with the member's respective rights and liabilities, should be codified within an agreement prior to formation in order to reduce the potential for problems in the future. Accordingly, in order to avoid any specific misunderstandings regarding the business terms and conditions including capital requirements, special allocations, distributions, approval rights and control issues, the parties should enter into a partnership agreement that sets forth the appropriate business terms agreed upon by the parties.

[2] N.J.S.A. 42:2C

The limited partnership entity is typically the best partnership vehicle for passive investors in real estate, as it allows them to invest in the enterprise and share in their allocation of profits if the project is a success, but their status as limited partners typically precludes them from incurring liabilities in excess of their initial capital contributions. It is important to note that there is a significant difference regarding the question of liability between general partners and limited partners. Specifically, general partners are deemed to be jointly and severally liable only to third parties for causes of action arising from actions undertaken in the course of partnership and are not liable to the limited partners for the actions of another general partner unless they either participated in the action or negligently allowed it to occur. This does not mean that the general partners are completely insulated from the misdoings of other general partners; all the general partners may be forced to share in any loss of partnership capital in accordance with the partnership agreement's predetermined allocation of profits and losses. Further, limited partners should be aware that there is no requirement that the general partner(s) in a limited partnership be an individual; it is perfectly permissible for the general partners to deal with the liability inherent in their position by appointing corporate entities to serve as the general partner(s). While the corporate general partner(s) will owe a fiduciary duty to the limited partners, the shareholders of the corporation will typically not be personally liable for the debts of the partnership and the shareholders, officers and directors of the corporate general partner may also serve as limited partners in the partnership without losing their limited liability.

General Partnership

The formation of a general partnership in New Jersey does not require an official filing. Furthermore, there is no requirement that the formation of the partnership be evidenced by writing. Therefore, a general partnership may be formed simply by an oral agreement. Accordingly, real estate investors should make sure that adequate protections are in place in order to prevent a relationship as being characterized as a legal general partnership where that is not the intent of the parties. It should be noted however that a general partnership has some of the attributes of a legal entity separate from the owner and can be regarded as a form of co-ownership by several persons. Also, as in the case with a LLC and LP as discussed above, the general partners do not have to codify their agreement in writing; however, it is important to note that during the negotiation process in establishing the general partnership, the terms of the agreement between the parties, including the purpose of the enterprise along with the partner's respective rights and liabilities, should be codified within an agreement prior to formation in order to reduce the potential for problems in the future. Accordingly, in order to avoid any specific misunderstandings regarding the business terms and conditions including capital requirements, special allocations, distributions, approval rights and control issues, the parties should enter into a partnership agreement that sets forth the appropriate business terms agreed upon by the parties.

When investors acquire title to real estate as a partnership, each general partner has equal right to participate in management and control of the asset. From a practical standpoint, this means determining the manner in which disagreements arising in the ordinary course of business will be handled is of preeminent importance. One of the most important aspects of the partnership form of entity is the relationship it creates between the partners. By becoming partners at law, the members of the partnership have agreed to carry out the business of the entity with the highest good faith and fair dealing toward each other, and have assumed the fiduciary duties of due care and loyalty to the partnership and each other personally.

General Partnerships permit a large amount of flexibility to allocate profits, losses along with rights and liabilities among partners. However, it should be noted that the operational flexibility is accompanied with large exposure to personal liability. Generally, the general partnership form of entity carries with it liability for each general partner of the partnership as the law treats the partners as jointly and severally liable for the obligations of the business of the partnership. As a result, even though the partners may agree among themselves to disproportional allocation of losses and debts, those internal negotiations are not binding on the rights of creditors and other claimants who may be entitled to recover in full from any one or more of the partners in a general partnership. Therefore, it is extremely important for investors in real estate to carefully consider the people that will serve as general partners in the partnership and determine whether or not their relationship is both substantial enough and secure enough to risk the personal liability inherent in the general partnership structure. Further, the risk of liability is exacerbated by the fact that generally each general partner is also deemed to be the agent of the partnership in dealings with third persons when acting in the ordinary course of business as defined by the

courts, so that each partner may be further jointly and severally liable for liabilities to third parties incurred by a co-partner acting in the ordinary course of partnership business.

Corporations

As in the case with the business entities which were discussed above, corporations are legal entities separate and distinct from the person(s) who created it and from the shareholders who own it. As distinct entities, corporations have the power to act on their own behalf in any way permitted by the law including the ability to contract, to own and convey property, maintain civil causes of action, and may be accused of both civil and criminal wrongdoing in its own name. The existence of a New Jersey corporation begins upon the filing of a certificate of formation pursuant to the Public Records Filing for New Business Entity with the New Jersey Department of Treasury, Division of Revenue & Enterprise Services.[3] Generally, absent a personal guaranty, the liabilities and obligations of the corporation remain separate from the shareholders so long as the shareholders adhere to legal corporate formalities and do not engage in activities that would other permit a piercing of the corporate veil. It should be noted that as with LLC, LP and GP as discussed above, the shareholders do not have to codify their agreement in writing; however, it is important to note that during the negotiation process in establishing the corporation, the terms of the agreement between the parties, including the purpose of the enterprise along with the member's respective rights and liabilities, should be codified within an agreement prior to formation in order to reduce the potential for problems in the future. Accordingly, in order to avoid any specific misunderstandings regarding the business terms and conditions including

[3] N.J.S.A. 42:2C

capital requirements, special allocations, distributions, approval rights and control issues, the parties should enter into a shareholder agreement that sets forth the appropriate business terms agreed upon by the parties.

Since personal liability that exceeds the investor's capital contribution is a key concern for a real estate investor the corporate form of business allows shareholders a limitation on personal liability similar to that under the LLC or LP, in that shareholders may only be held liable for the amount invested, without recourse to any additional personal assets absent specific agreements made by the investor to the contrary such as personal guaranties or personal indemnifications which are often required by financial institutions. Although typically loan requirements contained in a commercial real estate transaction are non-recourse subject to standard carveout provisions, lenders often require personal guaranties and indemnities from private individuals that serve as principals in the transaction.[4]

Real Estate Investment Trust

As a result of the complex compliance issues associated with the organization, operation, and distribution associated with establishing a real estate investment trust ("REIT'), investors are extremely deliberate in selecting this form of ownership. Specifically, a REIT must be formed in one of the 50 states or the District of Columbia as an entity taxable for federal purposes as a corporation. It must be governed by directors or trustees and its shares must be transferable. Beginning with its second taxable year, a REIT must meet two ownership tests: it must have at

[4] Standard carveout provisions which places personal liability in an otherwise non-recourse loan include such acts or omissions as waste, bad faith dealings and environmental contamination.

least 100 shareholders (the 100 Shareholder Test) and five or fewer individuals cannot own more than 50 percent of the value of the REIT's stock during the last half of its taxable year (the 5/50 Test).[5]

A REIT must satisfy two annual income tests and a number of quarterly asset tests to ensure the majority of the REIT's income and assets are derived from real estate sources.

At least 75 percent of the REIT's annual gross income must be from real estate-related income such as rents from real property and interest on obligations secured by mortgages on real property. An additional 20 percent of the REIT's gross income must be from the above-listed sources or other forms of income such as dividends and interest from non-real estate sources (like bank deposit interest). No more than 5 percent of a REIT's income can be from non-qualifying sources, such as service fees or a non-real estate business.

Quarterly, at least 75 percent of a REIT's assets must consist of real estate assets such as real property or loans secured by real property. A REIT cannot own, directly or indirectly, more than 10 percent of the voting securities of any corporation other than another REIT, a taxable REIT subsidiary (TRS) or a qualified REIT subsidiary (QRS). Nor can a REIT own stock in a corporation (other than a REIT, TRS or QRS) in which the value of the stock comprises more than 5 percent of a REIT's assets. Finally, the value of the stock of all of a REIT's TRSs cannot comprise more than 25 percent of the value of the REIT's assets. In order to qualify as a REIT,

[5] National Association of Real Estate Investment Trust web site

the REIT must distribute at least 90 percent of the sum of its taxable income. To the extent that the REIT retains income, it must pay taxes on such income just like any other corporation.[6]

The selection of the proper business entity utilized by an investor in order to acquire, develop, manage and hold title to their real estate investments can prove extremely challenging since the underlying complication does not lie in determining what entities are available, but rather the difficulty lies in the fact that there is typically no one best approach when it comes to finding an entity that will meet the investors objectives. Accordingly, the process is best viewed as determining which of the investor's objectives are of primary importance, and selecting a choice of entity that best fits those objectives.

Major Considerations

Regardless of the business entity selected by the parties, there are several business terms that should be included in the underlying agreement codifying the understanding between the parties. These business terms include the economics of the JV including each parties return requirements, control and management rights and obligations including issues such as approval rights, the treatment of each parties equity including whether the equity will be treated on a pari-passu basis or whether a parties equity will have a priority, and the term of the JV including termination and transfer rights of the parties.

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[6] Id.

JV Economics

During the process of analyzing the economics of the JV, each party will attempt to negotiate an agreement that benefits them. Accordingly, it is important that the agreement contains the economic conditions that allow for enough incentive to make the transaction a benefit and not a burden for either party. For example, the Operating Party might focus on economic aspects which include (1) what is the preferred return the Capital Party will want on its equity; (2) is this return reasonable for this project; (3) will the Operating Party be given the same preferred return as the Capital Party; (4) what is the priority of the equity of the Operating Party as compared with the Capital Party; and (5) is there a promote provision contained within the agreement and if so, does the promote provision allow for a suitable incentive for the Operating Party.[7] Tax considerations will also impact the economics associated with the JV. Accordingly, income allocation, depreciation allocation, transfer restrictions and lock-out periods on debt repayment may result in tax ramifications if the JV agreement is not structured properly.

An essential economic provision contained in the JV agreement is the distribution clause (often referred to as the "waterfall provision"). Specifically, the distribution clause or waterfall provision outlines the manner in which the profits from the JV will be distributed to the parties. It should be noted that the members may not be all compensated equally. For example, some parties may be compensated for a greater contribution of their time as commonly contained in a promote structure while passive members may require that they receive a priority on

[7]A promote provision is a structure that entitles the Operating Party (developer) with a share in the cash flow distribution that is not proportional to his or her cash investment in the project.

distributions since they placed the largest upfront investment and therefore, were exposed to the largest risk.

Another important provision associated with the economics of the JV is the capital contribution clause. Specifically, the capital contribution clause establishes the requirements of the parties to make future capital contributions to the JV. It is important that the JV agreement specify the exact amount of capital contribution expected from each member and the specific conditions that would trigger a capital call along with the specific timing associated with the capital call. Additionally, the JV agreement should specify the remedy associated with a party's failure to participate in the capital call. For example, if the parties are unable to agree on the specific conditions of a capital call, a "squeeze down" provision may be considered. Specifically, a squeeze down provision provides that a party's capital investment is diluted proportionally upon failure to participate in a capital call.

Management and Control

Generally, the operation and governance of the JV reflects a structure whereby the daily management affairs affecting the operation of the underlying property are handled by the Operating Party with the Capital Party having control rights in connection with major decisions that affect the JV including making capital improvements, budgeting, major leasing decisions, refinancing, acquisition of additional assets and disposition of the JV. Since these areas may involve varying opinions as to the degree "major decision" and are often subject to an intense negotiation on the level of approval rights that should be held by the Capital Party, the control

provisions are a heavily negotiated in the JV agreement. Specifically, the Capital Party will often propose a lengthy and detailed list of major decisions in the interest of protecting its investment, and not surprisingly the Operating Party will generally resist these demands on the basis that they are considered excessive and may be regarded as a limitation on its ability to effectively operate the JV. As a result, establishing a workable and sustainable balance between these competing interests can prove exceptionally challenging. It should be noted that the parties in these transactions are generally very sophisticated and highly experienced; therefore, a compromise is often reached in order to proceed with the deal. However, in the event the parties are unable to reach an agreement, it is critical that the agreement contain a deadlock resolution mechanism that permits each party sufficient protection while supporting the continued operation of the real estate project.

Accordingly, in those situations where the parties are unable to agree on major decisions affecting the JV, the agreement should contain a buy-sell clause which is triggered by deadlock between the parties. Generally, a buy-sell clause provides that one or both parties may have a right to trigger a process whereby one party will buy the other out of their interest in the JV. The party triggering the buy-sell is often required to provide an offer that simultaneously acts as an offer to either buy the other party's interest in the JV or, alternatively, sell the triggering party's interest in the JV. This process incentives the triggering party to make a fair offer and provides for some flexibility to exit the JV.

Other Considerations

In addition to the provisions associated with the JV economics and those provisions associated with the management and control of the JV, there are other provisions that are commonly contained in the JV agreement. For example, a right of first offer consist of a clause where one or each party may have a right to trigger a process whereby one party has a right to first make an offer to buy either the real estate asset or the other party's interest in the JV. The other party may then seek a third-party buyer. If a third-party offers an equal or lesser price than the other party's offer, the asset or interest must be sold to the party that made the offer at that party's prior offer price.

Another clause commonly contained in the JV agreement is a right of first refusal in which one or either party may have a right to trigger a process whereby one party has a right to subsequently match any third-party offer to buy either the real estate asset or the other party's interest in the JV.

A "drag-along rights" clause provides that one party may have the right to "drag" the other parties into a sale of the interests in the JV such that the other party would also be required to sell its interest in the JV on the same terms that the triggering party that is selling its interests. The drag-along right is a mechanism to allow the party who can trigger same to be able to cause a transfer of all of the interests (i.e. including the interest of the other parties who are being

"dragged") in the JV (and results in the monetization of the investment) without the consent of the "dragged" party.

Generally, a "tag-along rights" clause provides that a party may have the right to "tag" the other party so as to be able to elect to participate in a sale of the interests in the JV such that the tagging member would also have the right to sell its interest in the JV on the same terms that the triggering party is selling its interests.[8]

Another example of a clause which may be of consideration in JV agreement is a "put" right. A put right permits the party exercising the put to require the other party to buy the putting party's interest in the JV. Also, the JV agreement may contain a "call" right. When the JV agreement contains a call right a party may have a right to require the other party to sell its interest in the JV to the calling member pursuant to previously agreed terms.

As indicated above, although these provisions are heavily negotiated, the parties are generally highly sophisticated and each party will have an idea of their limitations (deal points) on these issues. Therefore, the challenge of the attorney involved in drafting these provisions is to identify the appropriate deal points and ensure that they are included in the JV agreement. Specifically, some of the ways in which attorneys can add value to the process include (1) identify what provisions that may be important to the client that are currently missing from the draft; and (2) suggesting provisions that might be unique in addressing the deal points based on certain characteristics of the deal or structure which should be addressed in the JV agreement.

[8] As the inverse to a "drag," the "tag" allows the member with the right to "tag" to get the benefit of the sale of interests in the asset at the price that the other member was able to obtain and to protect itself from having a new partner with whom it does not want to continue the transaction.

An attorney that has a thorough understanding of her or his client's investment objectives associated with the transaction is in a good position to draft the legal documents necessary to support those investment objectives.

Fiduciary Duty

As discussed above, there are several business entity models from which the parties may select; however, it should be noted that each party will have a fiduciary duty to the other party which requires each party to exercise reasonable care in all of the activities connected with the JV. Specifically, the fiduciary duty requires that each of the parties exercise due care and that each party (1) cooperate with the other parties in order to reach their stated business goals; (2) utilize the appropriate degree of skill and care when performing individual tasks; (3) avoid disrupting or thwarting the aims of the joint venture; (4) inform the parties of business opportunities and important decisions of interest to the joint venture; (5) exercise diligence and prudence when investing shared funds; and (6) avoid actions which are motivated by personal gain and hurt the joint venture. It should be noted that each party's responsibility as a fiduciary commences at the formation of the JV and continues until the completion of the JV or otherwise stated, "until the affairs of the JV are "wound-up."

Pursuant to its fiduciary duty, each party has a duty to disclose information that may be necessary for the project. Specifically, a breach of the duty to disclose as a fiduciary occurs when one party fails to share material information concerning the project with the other party.

For example, *Triple Five of Minnesota, Inc. v. Simon,* 280 F. Supp. 2d 895 (D. Minn. 2003), is a case involving a JV formed to participate in the ownership and operation of the Mall of America located in Bloomington, Minnesota. Specifically, Triple Five of Minnesota, Inc. ("Triple Five") entered into a JV with Melvin Simon and Associates ("Simon") to act as the Operating Party in connection with the development and management of the Mall of America while holding a 45 percent ownership position in the project. The remaining 55 percent of ownership in the Mall of America was held by Teachers Insurance and Annuity Association ("TIAA") who effectively acted as the Capital Party. TIAA sold half of its ownership position to Simon. Subsequently, Triple Five sued Simon for breach of its fiduciary duty for failing to disclose the acquisition of the portion of TIAA ownership interest. The court examined Simon's duty to disclose by evaluating its actions during the negotiations with TIAA along with Simon's actions in sharing the details of the transaction with Triple Five. The court held that Simon breached its duty to disclose by failing disclose its negotiations with TIAA. *Id.* at 903. Additionally, the court held that Simon breached its duty to disclose as a result of its failure to share with Triple Five the material terms of the transaction with TIAA. *Id.* at 904.

It should be noted that attempts to limit a party's exposure to the other parties in the JV does not diminish a party's fiduciary duty. For example, in *Triple Five*, Simon argued that the limitations on a party's liability were not met by the actions alleged by the plaintiff.[9] However, the court

[9] The Triple Five – Simon partnership agreement provided that a party was only liable in the event of its gross negligence.

reasoned that although the parties are free to construct many aspects of their relationship, they cannot alter their fiduciary duty.[10] *Triple Five* at 901.

Accordingly, the establishment of a JV results in a fiduciary duty between the parties in the JV which requires fair dealing and loyalty between the parties with respect to the JV.

[10] In quoting the holding in Appletree Square I Ltd. Partnership v. Investmark, Inc., 494 N.W.2d 889, 893 (Minn. App.1993) (quoting Saballus v. Timke, 122 Ill.App.3d 109, 77 Ill.Dec. 451, 460 N.E.2d 755, 760 (1983)) the court stated "While `partners are free to vary many aspects of their relationship ... they are not free to destroy its fiduciary character."