STRUCTURING COMMERCIAL REAL ESTATE JOINT VENTURES DURING COVID-19

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As a result of the COVID-19 pandemic, real estate investors are experiencing several challenges which serve to adversely affect real estate projects including reduced liquidity, increased cost, and decision bottlenecks during an unavoidable and unforeseen environment.Therefore, real estate investors are forced to pay additional attention to the structure of their joint venture (“JV”) with particular emphasis on those clauses outlining such provisions including governance, financial obligations and exit strategies. This essay will explore various (i) entities used to establish a JV (ii)governance considerations; (iii) economic considerations and (iv) fiduciary duty obligations. Additionally, the essay will highlight factors affecting JVs during the pandemic.

Real Estate JV Entity Structures

A Real Estate JV is a business arrangement in which two or more parties agree to combine their resources in order to develop or acquire a real estate project or portfolio. There are several considerations involved in structuring a JV which include the entity selection, management and control, capital obligations and distribution priorities. Additionally, each party should have a firm understanding of the fiduciary relationship between the parties which is established upon the creation of the JV. 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 consists 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. Generally, the entity types that are considered for a commercial real estate project include, limitedliability company (“LLC”), limited partnership (“LP”), general partnership (“GP”),corporation and REIT. In determining which entity to select the partiesshould consider anumber of factors including taxconsiderations, 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, ownership and operation of a single real estate project). If the JV obtains debt financing, the lender will generally require that the JV is a SPE.

Limited Liability Company

The predominant JV structure used by real estate investors in New Jersey in order to develop, own, operate and maintain their real estate asset is the LLC. In September of 2012, New Jersey enacted new laws governing New Jersey LLCs, and onMarch 1, 2014, the New Jersey Limited Liability Company Act was repealed[1] and replaced by the New Jersey Revised Uniform Limited Liability Company Act ("NJRULLCA") which serves to govern all LLCs in New Jersey.[2]The existence of a New Jersey LLC begins upon the filing of a certificate of formation containing the requisite content including (1) name of the limited liability company, which complies with Sec. 8 of the NJRULLCA; and (2) street and mailing addresses of the initial registered office and the name of the initial agent at that office for service of process of the company.[3] The certificate of formation must be filed with the New Jersey Department of Treasury, Division of Revenue & Enterprise Services.[4]

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

Limited Partnership

[1]P.L. 2013, c.276, §10 (providing the that the date of repeal is March 1, 2014); P.L. 2012, c.50 §95 (repealed).
[2]N.J.S.A. 42:2C-91(b).
[3]N.J.S.A. 42:2C-18
[4] N.J.S.A. 42:2C-22

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. Also, 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 limited partnership pursuant to the statutory requirements including (a) name of the limited partnership; (b) general character of its business; (c) address, including the actual location as well as postal designation, if different, of the original registered office and the name and address of the original registered agent for service of process required to be maintained;[5](d) name and business address or place of residence of each general partner; (e) aggregate amount of cash and a description and statement of the agreed value of the other propertyor services contributed by all partners and which allpartners have agreed to contribute in the future; (f) times at which or events of the happening of which an additional contributions agreed to be made by any partner or partners are to be made; (g) any power of a limited partner to grant the right to become a limited partner to an assignee of any part of his partnership interest, and the terms and conditions of the power; (h) if agreed upon, the time at which or the events on the happening of which a partner may terminate his membership in the limited partnership and the amount of , or the method of determining, the distribution to which he may be entitled respecting his partnership interest, and the terms and conditions of the termination and distribution; (i) any right of a partner to receive distributions of the property, including cash from the limited partnership; (j) any right of a partner to receive, or of a general partner to make, distributions to a partner which include a return of all or any part of the partner's contribution; any time at which or events upon the happening of which the limited partnership is to be dissolved and its affairs wound up; (k) any right of the remaining general partners to continue the business on the happening of an event of withdrawal of a general partner; any other matters the partners determine to include and (n) address of the principal office, which need not be in the State of New Jersey.[6]The certificate of limited partnership must be filed in the office of the New Jersey Secretary of State.[7]

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.

The limited partnership entity is generally regarded as an accepted 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 a limited partner protects them from incurring liabilities in excess of their initial capital contributions. It is important to note that

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[5]P.L. 1983, c. 489 (C. 42:2A-8).
[6]N.J.S.A. 42:2A-14.
[7]N.J.S.A. 42:2A-21.

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 activities 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 a limited partner in the partnership without losing their limited liability.[8]

General Partnership

The formation of a general partnership in New Jersey does not require an official filing since two or more persons who establish a business constitutes the formation of a partnership whether or not the parties intend to form a partnership.[9] 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 agreementor by the actions of the parties by establishing a business for profit.[10] 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 agreedupon by the parties.

When investors acquire title to real estate as a partnership, each general partner has an equal right to participate in management and control of the asset. From a practical standpoint,

[8]See, N.J.S.A. 42:2A-2-5f (defining a limited partner as any person admitted to a limited partnership as a limited partner); N.J.S.A. 14A:3-5(2) enabling corporations to provide indemnification to officers, directors and employees acting on behalf of the corporation).
[9]N.J.S.A. 42:1A-10a.
[10]Id.

this means determining the manner in which disagreements arising in the ordinary course of business will be handled is of preeminent importance.Oneof 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 careand 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.[11] As a result, even though the partners may agree among themselves to a 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 incorporation which must include (a) name of the corporation; (b) purpose of the corporation; (c) aggregate number of shares which the corporation has authority to issue; (d) if there are different classes of shares, the designation of each class and series, the number of shares in each class or series, and to the extent determined, the relative rights, preferences and limitations of the shares in each class or series; (e) statement of authority vested in the board to divide the shares into classes or series and to determine manner in which the designation, number, rights, preferences and limitations are to be changed if the shares are divided; (f) any provisions inconsistent with the act; (g) address of the corporation's registered office and name of the registered agent; (h) number of directors constituting the board along with their address; (i) names and addresses of

[11] N.J.S.A. 42:1A-18.

the incorporators; and (j) duration of the corporation if it is less than perpetual.[12]The certificate of incorporation must be filed with the New Jersey Department of State.[13]

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 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 typicallyloan requirements provided in a commercial real estate transaction contain an exculpation clause providing that the liability of the borrower is non-recourse subject to standard carveout provisions, lenders often require personal guaranties and indemnities from private individuals that serve as principals in the transaction.[14]

Real Estate Investment Trust

As a result of the complex compliance issues associated with the organization, operation, and distribution in connection 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 fifty 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 least 100 shareholders (the 100 Shareholder Test) and five or fewer individuals cannot own more than fifrty percent of the value of the REIT's stock during the last half of its taxable year (the 5/50Test).[15]

[12]N.J.S.A. 14A:2-7(1).

[13]N.J.S.A. 14A:2-7(2).

[14]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.

[15]National Association of Real Estate Investment Trust web site.

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 seventy-five 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 twenty 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 five percent of a REIT's income can be from non-qualifying sources, such as service fees or a non-real estate business.[16]

Quarterly, at least seventy-five 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 ten 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 five percent of a REIT's assets. Finally, the value of the stock of all of a REIT's TRSs cannot comprise more than twenty-five percent of the value of the REIT's assets.In order to qualify as a REIT, the REIT must distribute at least ninety 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.[17]

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.

Structuring Considerations

Particularly during this pandemic, 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. Governance provisions including control and management rights, approval rights, and transfer rightscan be a decisive factor in navigating and adjudicating disputes that may arise between the parties.Also, the economics of the JV including capital funding obligations and return requirements are regarded as critical considerations in structuring a JV agreement.

JV Governance

Since JV is a strategic arrangement that brings parties together in order to develop, own and operate a real estate project, often there are diverging interest driven by each party's investment backed expectation; therefore, the JV is particularly vulnerable to disruptions during

[16] Id.
[17] Id.

the pandemic which can result in financial instability and governance indecision that can challenge the viability of the real estate project. Accordingly, the parties should strategically structure the necessary governance provisions in order to ensure a proper balance between handling the short term challenges present during a pandemic along with the long-term gains of the real estate project. 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 interest driven by the investment backed expectation of each party, governance provisions are often subject to an intense negotiation.

Management and Control

A key element in structuring governance provisions is the decision-making authority regarding the management and control of the project.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. In recognizing the unforeseen magnitude of the pandemic and acknowledging the upside potential after the crisis has diminished, some JVs have established temporary operational structures employing working groups and committees in order to alter their decision-making process instead of exercising deadlock resolution mechanismssince under the circumstances resulting from the pandemic these provisions may prove to be overly punitive. Also,it should be noted that when a term contained in the operating agreement is challenged the court shall determine whether the term is manifestly unreasonable. Specifically,the NJRULLCA provides that the court shall decide if a term contained in an operating agreement is manifestly unreasonable.[18] Accordingly, in deciding whether a clause involving governance is manifestly unreasonable, the court will examine the circumstances in existence during the time the provision was incorporated in to the operating agreement.[19]

Exit Strategies

Notwithstanding the careful and cautious approach that investors may have used in structuring the JV, the challenges resulting from the pandemic may result in the inescapable conclusion that a party must divest its interest in the project. As a result, provisions involving transfer and termination will come into play. In order to provide stability, JV agreements often

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[18] N.J.S.A. 42:2C-11(h)
[19] Id.

contain a lock-up provision which restricts the parties from either transferring their interest or to cause a sale of the JV or a portion of its assets for a specified period of time.[20]Once the lock up period expires, often operational experience, net worth test and reputational vetting are examples of conditions that can be required in order to permit a party to transfer its interest.[21] Additionally, in structuring transfer and termination provisions, there are several clauses that are often contained in JV agreements including a right of first offer ("ROFO") and a right of first refusal ("ROFR"). Generally, a ROFOprovides that 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.

Generally, a ROFRprovides that 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.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.

JV Economics

Although the economics of the JV serves as a critical and fundamental component of any JV agreement, it is certainly regarded as paramount during a pandemic where liquidity is unexpectedly restricted and access to capital is uncharacteristically restrained. As a result, each party will attempt to negotiate an agreement that best fits their investment backed expectations. 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. Therefore, it is incumbent upon investors to have a complete understanding of all of the economics contained in the JV agreement including capital obligations and income distributions. With respect to capital obligations, the parties should not limit their understanding of the capital call structure

[20]Note that inter-party transfers between affiliates of a party are typically exempt.

[21] Although the duration of the lock-up period may vary, generally, it remains effective during the lease up period and until such time that the parties estimate that the project will achieve stabilization.

(pro rata, disproportionate obligation with a cap, deferred obligation for preferred equity position, etc.), but the parties should have an understanding of possible sources available to fulfill capital obligations including each party's financial capacity, rights to add investors or leverage enhancement. With respect to distributions, 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. Tax considerations will also impact the economics associated with the JV. Accordingly, income allocation, depreciation allocation, transfer restrictions and lock-out periods on debt repaymentmay result in tax ramifications if the JV agreement is not structured properly.

Capital Funding Obligations

It is extremely important that during the pandemic, and arguably during any environment, that investors pay close attention to provisions governing capital obligation (capital call) requirements. Specifically, the capital obligation 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 proportion of capital contribution expected from each party and the specific conditions that would trigger a capital call. Additionally, the JV agreement should specify the remedy associated with a party's failure to participate in the capital call.There are several examples of capital call provisions used in structuring a JV. For example, some agreements provide thata party (typically the Capital Party) has a unilateral right to either provide the fundsor veto a capital call.However, some agreements provide that both parties must agree upon a capital call. Generally, once the capital call is made, the parties contribute the capital on a pro rata basis pursuant to their respective ownership interests in the JV. However, the agreement may specify a target amount (cap)in order to limit their capital exposure of a party. Another example, is where the agreement provides a disproportionate allocationof specific capital calls such as cost overruns. A further example is whenthe agreement provides for a reverse waterfall contribution upon the achievement of specified promote targets.

Once the method of establishing the issuance of a capital call along with allocating the contribution obligation to each party, the question becomes whether each party is willing and able to fulfill their funding obligation. Accordingly, the agreement should specify the consequences resulting from a party's failure to fulfill its funding obligation in connection with a capital call.As a result, there are several provisions investors might consider in order to address the failure of a party to providing funding in connection with a capital call including inter-party loans, preferred equity, squeeze down, removal, and clawbacks,An inter-party loan permits a party to loan the JV funds in order to cover the non-performing party's funding obligation. In return for the loan, the lending party receives a priority over distributions, and the funding partner becomes a lender to the JV.[22]In a preferred equity contribution, the funding party provides the necessary funds and in exchange receives a preferred return for a specified rate.[23]In the case of a dilution (squeeze down) provision, the party that funds the non-performing party's capital obligation receives an increase in equity, which in return results in the dilution of the non-performing party's equity in the JV.[24]Also as a consequence, the agreement may provide that a party's failure to fund a capital call willtrigger an event of default event which can lead to a party's removal as the operator, and may also result in a loss or a portion of its promote.[25] Another consideration is a provisionenabling the performing party to recover(clawback) fees previously paid to the non-performing party in connection with services provided to the JV.

Distributions

An essential economic provision contained in the JV agreement is the distribution clause (often referred to as the "waterfall provision"). Specifically, the waterfall provision outlines the manner in which the profits from the JV will be distributed to the parties. Some examples of waterfall distribution provisions include distributions which are paid to the parties on the basis of pro-rata distributions, investor priority, preferred returns, and promote structures. A pro-rata distribution is where the payments are made to each party based on its ownership interest in the JV. With respect to a priority distribution, often the Capital Party might require that it receive distributions until a specified hurdle is reached, then distributions are paid to the Operating Party until another hurdle is reached and then on a pro-rata basis. A preferred distribution is often provided if one party (usually the Capital Party) covers short falls resulting from operating deficits or capital call obligations and provides that the party covering such short falls receives a preferential distribution. Typically, a promote structure provides that initially distributionsare made to the parties on a pro-rata basis until a certain internal rate of return is achieved (commonly referred to as the IRR hurdle), then distributions are allocated to a party (typically the Operating Party) which is referred to as the promote interest, and then the balance is distributed to the parties on a pro-rata basis.[26]

Fiduciary Duty

TheNJRULLCA places a fiduciary duty of loyalty in a member managed LLC[27]; however, does not impose a duty of loyalty in a non-member managed LLC.[28]Similarly, the

[22] Although this is sometimes structured as a loan to the non-performing party secured by its JV interest, investors should use caution since it may result to an imbalance in the interest and incentives between the parties within the JV.
[23] Generally, the preferred rate of interest received by the party making the preferred capital contribution exceeds that of a loan or equity accrual which may result in a dilution of the non-performing party's interest in the JV.
[24]Some may provide that the capital accounts along with unreturned capital contributions of the non-performing party are also diluted, resulting in an immediate economic loss to the non-performing party.
[25] The use of this provision is the result of the Capital Party's concern of the Operating Party's ability to fund capital calls.
[26] Consideration should be given as to how the IRR hurdle is drafted in order to specify the thresholds required to distribute the special allocation and the hurdles required in order to terminate the special allocation.
[27]N.J.S.A. 42:2C-39(a) and (b).
[28]N.J.S.A. 42:2C-39 (i).

NJRULLCA imposes a fiduciary duty of care on in a member management LLC[29]; however, a duty of care is not imposed on a non-member managed LLC.[30]Additionally, the NJRULLCA provides that the duty of loyalty and the duty of care for members can belimited or eliminated so long as the agreement shifts the responsibility to another member(s).[31] Accordingly, it is critical to properly draft the operating agreement in order to reflect the desired exposure of each party as it relates to the duty of loyalty and the duty of care.

Duty of Loyalty

Pursuant to the NJRULLCA, provides that the duty of loyalty consists of (1) to account to the company and to hold as trustee for it any property, profit, or benefit derived by the member:(a) in the conduct or winding up of the company's activities;(b) from a use by the member of the company's property; or(c) from the appropriation of a company opportunity;(2) to refrain from dealing with the company in the conduct or winding up of the company's activities as or on behalf of a person having an interest adverse to the company; and (3) to refrain from competing with the company in the conduct of the company's activities before the dissolution of the company.[32] It should be noted that when a term contained in the operating agreement is challenged,the court shall determine whether the term is manifestly unreasonable. Specifically, the NJRULLCA provides that the court shall decide any claim that a term of an operating agreement is manifestly unreasonable.[33] Accordingly, in deciding whether a restriction or the elimination of a fiduciary duty is manifestly unreasonable, the court will examine the circumstances in existence during the time the provision was incorporated in to the operating agreement.

Although there is limited guidance based on the lack of case law in New Jersey for LLCs, other states have adjudicated the issue of alleged breaches of the duty of loyalty. For example, Marcus v. Antell, is a New York case involving two members holding equal interest in a New York LLC. A dispute between the parties arose and Marcus sued Antell alleging a breach of fiduciary duty and Antell asserted that he did not have a fiduciary duty since Marcus was the managing member of the LLC. In denying the motion for summary judgement, the court held that both parties were managing members and held a fiduciary duty to each other. The court reasoned that since the operating agreement provided that the overall business decisions were vested in both members and required unanimous consent, both members were effectively managing members even if both members were not active in managing the LLC.[34]

Additionally, an example of a breach of fiduciary duty action involving a real estate JV is Triple Five of Minnesota v. Simon.[35] In that case, Triple Five and Simon formed a JV to

[29]N.J.S.A. 42:2C-39(a) and (b).
[30]N.J.S.A. 42:2C-39(i).
[31]N.J.S.A. 42:2C-11(f)
[32] N.J.S.A 42:2C-39(b).
[33]N.J.S.A. 42:2C-11(h)
[34] 2018 WL 4849375 (N.Y. Sup. Ct. October 3, 2018)
[35]Triple Five of Minnesota v. Simon, 280 F. Supp. 2d 895 (D. Minn. 2003).

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 forty-five percent ownership position in the project. The remaining fifty-five 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 to disclose its negotiations with TIAA.[36] 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.[37] 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. However, the court reasoned that although the parties are free to construct many aspects of their relationship, they cannot alter their fiduciary duty.[38]

Duty of Care

The NJRULLCAestablishes a very low standard for members of an LLC in order to determine if a member is in breach of its duty of care. Specifically, theNJRULLCA provides thatThe duty of care of a member of a member-managed limited liability company in the conduct and winding up of the company's activities is to refrain from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.[39] Specifically, pursuant to the NJRULLCA, since members are only liable for a lack of sufficient care only when their actions constitute "grossly negligent or reckless conduct, intentional misconduct, or willful violation of the law," unless otherwise specified in the LLC operating agreement, a member might be liable pursuant to general negligence principles and not be exposed for a breach of the fiduciary duty of care. Additionally, the NJRULLCA imposes a fiduciary duty of care in a member management LLC[40]; however, a duty of care is not imposed on a non-member managed LLC.[41]It should be noted that when a term contained in the operating agreement is challenged the court shall determine whether the term is manifestly unreasonable.[42]Accordingly, in deciding whether a restriction or the elimination of a fiduciary duty is manifestly unreasonable, the court

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[36]Id. at 903.
[37] Id. at 904.
[38]Id. at 901.
[39] N.J.S.A.42:2C-39(c).
[40] N.J.S.A. 42:2C-39(a) and (b).
[41]N.J.S.A. 42:2C-11(f)
[42] N.J.S.A. 42:2C-11(h)

will examine the circumstances in existence during the time the provision was incorporated in to the operating agreement.

Conclusion

The pandemic has required investors within a JV to collaborate in order to explore new operational structures, examine the JV decision making process, prepare for operating short falls and institute protective measures in connection with capital funding obligations in structuring the JV agreement. These innovative concepts are necessary in order for investors to revised budgets and potential deadlocks in decision making. Notwithstanding the uncertainties and challenges that have evolved during the pandemic, investors can properly position themselves in order to handle these challenges through structuring a balanced operating agreement which establishes a workable and sustainable balance between the immediate pandemic related obstacles with the long-term viability of the project.