# Recapitalization of Real Estate Joint Ventures

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**From the letter of intent to the liquidation, capital partners who fund the recapitalization of real estate joint ventures must identify, negotiate, and document a host of issues to protect their interests. This article discusses some of the key issues.**

A recapitalization can benefit a real estate joint venture across real estate cycles. In up markets, it can be a ticket to monetize value from successful real estate projects. In down markets, it can be a lifeline for troubled projects. Owners who recapitalize to extract equity from a wildly successful project will be motivated by much different factors than owners who recapitalize to save a project from creditors. But both groups of owners will face many of the same issues.

A joint venture is an entity formed by two or more members to acquire, develop, finance, or operate real estate. The joint venture may own the real estate directly or, more likely, through a subsidiary.[1] A basic joint venture will have one member who is the operating expert and one member who provides the majority of the capital. A recapitalization involves the restructuring of the joint venture's capital structure—by replacing debt with equity, by replacing equity with debt, or likely a combination of both. As this discussion will demonstrate, changing something as fundamental as an entity's capital structure invariably drives other changes, including matters related to ownership of the entity, capital contributions, capital distributions (or return of capital), voting, exit rights, and dispute resolution (among many others).

This discussion proceeds primarily from the perspective of an incoming capital partner (the "Incoming Investor") who is considering an initial capital investment in an entity (the "Joint Venture") that owns a troubled real estate project (the "Project") during a market downturn, with secondary consideration given to an existing capital partner (the "Existing Investor"; together with the Incoming Investor, the "Investors") who is either trying to exit its investment in the Joint Venture or trying to decide the terms on which it would be willing to remain in the Joint Venture with the Incoming Investor

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and the operating partner (the "Sponsor"). Why this focus?

First, although many consider the U.S. commercial real estate sector healthy right now, others predict stresses on this sector in the near future. Real estate projects that are performing now may become distressed in the intermediate future. Second, many commercial real estate professionals are already involved with distressed projects and have been for several years. Even in today's relatively strong U.S. commercial real estate sector, sponsors and investors are dealing with the consequences of deals made in the middle part of the last decade (especially 2007)—at the time enabled by, and now cursed by, easy credit and reckless underwriting. Now that 10-year mortgage loans originated in the middle part of the last decade have come due and, in many cases, been modified and extended to no avail, sponsors, investors, mortgage lenders, and mezzanine lenders are analyzing how best to protect their respective interests and to salvage as much value as possible from these distressed projects.

This article is divided into three parts. The first part presents some of the preliminary questions that must be asked to determine whether a recapitalization is viable. The second part begins by addressing the need (present in virtually every recapitalization of a distressed project) to negotiate forbearance agreements with creditors of the Joint Venture and its affiliates (primarily senior mortgage lenders and mezzanine lenders but also any other persons making claims against either or both the Project or the Joint Venture). While such negotiations are obviously indispensable, they are only a prelude to the main negotiations with creditors: how to achieve intermediate or long-term resolutions of the creditors' claims, either through payoffs or restructurings of existing debt, while preserving the objective of a viable recapitalization. The third part begins by considering the continued role of the Existing Investor in the Joint Venture—because whether this member exits or remains in the Joint Venture significantly changes the members' negotiations and the structure of the amended and restated joint venture agreement (the "A&R JV Agreement") that will govern the Joint Venture post-recapitalization. It then examines some of the key provisions[2] of a joint venture agreement (the "Existing JV Agreement") that must be addressed in the recapitalization of a Joint Venture and considers the competing interests of the members as they negotiate these provisions.

## Is a Recapitalization Viable?

The Incoming Investor will probably begin its analysis with an assessment of the Project.

For example:

- Is the Project's current use still viable? Is it the highest and best use?
- Are the challenges facing the Project confined to the Project itself (e.g., sub-optimal tenant mix, deferred maintenance, passive property management) or are they products of forces affecting the Project's entire market (e.g., the Project is a retail center on the east side of a major highway, and a Walmart-anchored shopping center opened on the west side of the highway six months ago and has been pulling traffic and tenants to the west side)?

- Is there positive cash flow before debt service? After?
- Is there equity in the Project?
- Is the Project's mortgage (and any related mezzanine debt) currently, or about to be, in default? On what terms will the Project's lenders cooperate with any proposed restructuring?

The Incoming Investor will also need to take a careful look at the Sponsor and the Existing Investor. This investigation might include the following items:

- What does the Incoming Investor know about the principals of the Sponsor and Existing Investor? How strong are their balance sheets?
- What is the reputation of the principals? Are they known for fair dealing or sharp dealing?
- Have the principals or their respective affiliates committed loan defaults, been in disputes with equity investors, or been parties to any litigation?
- How many other projects does the Sponsor principal oversee? What is the financial condition of these other projects? If others were to become distressed, does the Sponsor principal's organization have the resources to address those distressed projects while simultaneously maintaining the level of attention that will be necessary to conclude a successful turnaround of the Project?
- Do the Sponsor and its principal have incentives to make *this* Project successful, whether because of cash equity they have invested, a reasonable chance to realize a promoted interest, deferred fee income, guaranty exposure, or reputational concerns? The more projects the Sponsor principal oversees—especially if any of those projects are distressed—the more pressing this question becomes.
- Do the Sponsor and Existing Investor have the ability to contribute additional capital to the Joint Venture?

## Restructuring the Joint Venture's Debt

If a loan default is imminent (or worse, has already occurred), the Sponsor and the Investors (individually a "Member"; collectively, the "Members") must address the debt portion of the capital stack before they discuss restructuring the equity portion. Otherwise, there likely will not be any equity to restructure. In the short-term, this entails securing forbearance agreements to forestall any enforcement actions by mortgage and mezzanine lenders or other claimants against the Project or the Joint Venture (such as mechanic's lien claimants), particularly if they assert rights that could impact the Project in the near term. Once they have bought themselves some time, the Members must focus on structuring a long-term solution to the Joint Venture's debt load and any other claims against the Joint Venture or the Project—either by paying off some or all of that debt (and other claims) or by modifying the debt.

### *Payoff*

Facing a distressed Project, the Members might seek *discounted* payoffs of the Joint Venture's indebtedness. Implicit in any such request is the assumption that no potential takeout lender could justify loaning the Joint

Venture the full payoff amount. The Members might believe this is a valid assumption; but they will have to persuade the lender who is being asked to accept a discount. Perhaps they can demonstrate that the existing loan was underwritten too aggressively, all potential takeout lenders are more conservative, and the market value of the Project has dropped considerably since origination of the existing loan. To make a discounted payoff more palatable to a lender, the Members might offer the lender an equity interest in the recapitalized Joint Venture. This adds another set of issues to the recapitalization, however, and some lenders could not agree to it even if they wanted to.[3]

### *Modification*

If paying off existing indebtedness is not an option, the Members may seek to modify it, perhaps by creating interest-only periods, extending the maturity date, splitting the existing promissory note into separate tranches (e.g., an A note and a B note[4]), decreasing the interest rate, converting a portion of the principal to common or preferred equity in the Joint Venture,[5] or writing down a portion of the principal.

### *Lender Approval Issues Associated with a Recapitalization*

Whether existing indebtedness is refinanced or modified, the Investors should obtain lender approval of the following actions: (i) transfers of interests in the Joint Venture among the Members, (ii) transfers of direct or indirect interests in either of the Investors (subject to certain limits), (iii) any exercise by either or both of the Investors of the right to remove the Sponsor as the managing member and assume management control (whether directly or through an affiliate), and (iv) exercise of exit rights—all without payment of transfer, assumption, or other fees and without triggering a default or Event of Default. The issues referenced in subprovisions (i), (iii), and (iv) are addressed in the next part this article. Regarding the issue referenced in subprovision (ii), the Investors want to be sure that they can take actions at the fund level as may be necessary to maintain tax-exempt status, if applicable, accommodate redemptions by their own investors, and otherwise manage their portfolios. For example, prohibitions in mortgage loan documents on transfers of “direct or indirect interests” in a borrower could be tripped by transfers of non-controlling interests within either Investor, by pledges (and realization on such pledges) of direct or indirect equity interests by an Investor on a portfolio-wide basis, by transfers of stock in an Investor that is a public company, or by mergers involving an Investor. Thus, the Investors must seek assurances, either in a separate agreement with the applicable lender or in the loan documents, that will address all of these issues.

### *Issues Associated with Existing Third-Party Guaranties*

Affiliates of the Sponsor might be, or become, obligated as guarantors of third-party indebtedness.[6] Under certain circumstances, the Sponsor-affiliate guarantors may reasonably expect to be released from liability under those guaranties. Those circumstances include (i) a decision by the Investors to remove the Sponsor as managing member of the Joint Venture based on the Investors’ discretionary election or the Project’s performance (as opposed to based on the Sponsor’s wrongful acts), (ii) a buyout of the Sponsor’s interest in the Joint Venture (whether through exercise of a call right, a buy-sell provision, or otherwise), and (iii) a sale of the Project at the Investor's election. The Sponsor affiliates would prefer that delivery of all applicable guaranty releases be a condition to the exercise of those types of rights. Although this preference is understandable, the Investors should not accommodate it. Obtaining the releases could take weeks or months—and, absent the guarantors having a *right* to releases, they might never be obtained at all. The Investors must be able to act promptly to protect their investments and discharge their fiduciary duties to their own investors. Anything that delays or, worse, stalls their ability to act must be resisted. As a compromise, the Investors will likely agree to use commercially reasonable efforts to obtain all applicable releases and to indemnify the Sponsor affiliates against post-removal liability under the third-party guaranties.

If Sponsor affiliates are to be released under guaranties of indebtedness that will remain outstanding, the lender will of course condition release upon one or more acceptable replacement guarantors assuming liability under the guaranties. In that event, in connection with closing the recapitalization, the Investors and the lender should address as many issues as they can surrounding release-and-replacement. For example, what persons or entities will serve as replacement guarantors? Can the Investors obtain the lender's preapproval of these specific persons or entities? Would the lender agree to parameters that, if satisfied, would qualify a person or entity as a replacement guarantor? Will replacement guarantors be subject to net worth and liquidity covenants? Are the replacement guarantors assuming only post-release liability under the guaranties (and are the existing guarantors retaining only pre-release liability under the guaranties)?

### *No Liability*

Ideally, any lender will acknowledge that no direct or indirect partner, member, shareholder, beneficial interest holder, manager, or agent of the joint venture will have any liability under the loan documents, except for the express obligations of any guarantors under guaranty agreements.

### *How to Address These Issues*

The issues above are often addressed in the loan documents. However, they could be addressed in a new, separate agreement between the lender and the Investors, typically called a "recognition agreement." Such an agreement would establish privity of contract between the lender and the Investors and confirm the lender's express approval of (i) the Investors' position in the capital stack, (ii) transfer rights and exit rights set forth in the A&R JV Agreement, and (iii) the Investors' exercise of remedies under the A&R JV Agreement. Recognition agreements provide that these actions will not require payment of any assumption or transfer fee or result in any default or Event of Default under the loan documents. Although recognition agreements are more commonly seen with preferred equity investments than with joint ventures, nothing says the Investors could not negotiate one with a lender, especially since those parties will already be in active discussions regarding the recapitalization.

## Restructuring the Joint Venture's Equity

### *Preliminary Matters*

A question that should be answered as early as possible in the recapitalization discussions is whether the Existing Investor will remain as a Member in the Joint Venture. If not, the Members need to address issues such as the terms on which the Existing Investor will be bought out of the Joint Venture, any residual liability it may have, and its entitlement to indemnification for any post-exit liabilities. If the Existing Investor is remaining in the Joint Venture, the Members must consider how the Existing Investor will participate in the economics and management of the Joint Venture. The analysis that follows assumes that the Existing Investor will remain in the Joint Venture. It also assumes that the Incoming Investor will have the largest percentage ownership interest in the Joint Venture (sufficient to constitute a simple majority for voting purposes), the Existing Investor will have the next-largest percentage ownership interest (sufficient, when combined with the Incoming Investor's percentage ownership interest, to establish a super-majority among the Members), the Sponsor will have the smallest percentage ownership interest (necessary only for establishing unanimity among the Members), and that the Members' capital contribution and voting percentages both equal their respective ownership percentages. Finally, the analysis assumes that the Joint Venture was formed in Delaware and that the A&R JV Agreement will be governed by the laws of the State of Delaware.

The decisions related to a recapitalization (e.g., incurring new debt, modifying existing debt, admitting the Incoming Investor as a Member) will require at least majority, likely super-majority, and perhaps even unanimous approval under the Existing JV Agreement. Before the Incoming Investor spends time and money on a recapitalization effort, therefore, it should ensure that the Existing Investor and the Sponsor share its vision for the Project's future and for the recapitalization of the Joint Venture. A detailed and carefully drafted term sheet is indispensable.

The Incoming Investor should conduct appropriate due diligence concerning any defaults under the Existing JV Agreement by either the Sponsor or the Existing Investor (and should bolster this due diligence through appropriate representations and warranties from these Members). To the extent defaults exist, the Incoming Investor should require that the Existing Investor and the Sponsor enter into a forbearance agreement to begin with, then, if at all possible, negotiate a final resolution of the defaults as part of the recapitalization. Otherwise, the Members are just postponing a potential problem—which, if it materializes, will place further strain on the already distressed Project.

Because the Incoming Investor comes to the Project and the Joint Venture with an information deficit relative to the Existing Investor and the Sponsor, it should take measures to protect itself against the unknown. These include indemnities in favor of the Incoming Investor for pre-existing liabilities (e.g., income tax, uninsured claims), which indemnities should be made by the Existing Investor and the Sponsor and, ideally, backstopped by a creditworthy affiliate of each indemnitor. The Incoming Investor should also obtain a detailed slate of representations and warranties concerning the Project and the Joint Venture.

Finally, although not discussed herein, the Members must consider the tax consequences of the recapitalization—federal, state, and local—and structure the transaction accordingly.

## *Economic Provisions*

### *Initial Capital Contributions*

Capital is the lifeblood of any real estate joint venture. Therefore, the Members will likely start their discussion of the Joint Venture's economics by deciding who will contribute capital and in what form. Ideally, each Member will contribute capital: doing so creates perhaps the strongest incentive to commit the effort necessary to execute a successful turnaround of the Project. Although cash is surely the most obvious form of capital, it is not the only one: anything of value could be used to capitalize the Joint Venture. For example, perhaps part of the Project's difficulties stem from space constraints. If an affiliate of the Sponsor owns adjacent land, the Sponsor, as its capital contribution, might cause its affiliate to contribute that land to the Joint Venture. (The Members will need to establish the dollar value of this contribution in the A&R JV Agreement.) If the Sponsor is not contributing land or other non-cash property, then it should ideally be obligated to invest a material amount of cash equity as part of the recapitalization (and, subject to limited exceptions, the Sponsor principal should be prohibited from syndicating this equity investment).

If the Sponsor principal is not obligated to contribute capital (whether cash or non-cash), then the Investors must find other ways to ensure that the Sponsor principal is committed to the recapitalization effort. There are at least three possibilities. First, the Sponsor might have a chance to realize a promoted interest (i.e., an interest in the profits of the Joint Venture that is larger than the Sponsor's capital interest in the Joint Venture, often referred to simply as the "promote"). Assuming the Sponsor's ability to realize this interest does not arise until after the Investors have received their required return on, and return of, capital, and assuming the Sponsor believes it has a realistic chance of realizing this interest, aside from (or perhaps along with) a significant capital investment, the promote is probably the strongest motivator for the Sponsor. Second, affiliates of the Sponsor may be obligated on personal guaranties to mortgage lenders (and perhaps mezzanine lenders)—contingent obligations that could become definite obligations if the Project is not successful. If, however, the guaranties are non-recourse carve-out guaranties and no carve-out violations have occurred, the motivational value of these guaranties is limited. Third, affiliates of the Sponsor may have *earned* certain fees (e.g., property management and leasing fees, acquisition fees, development fees, construction management fees) but not yet been *paid* those fees because payment was deferred for one reason or another (e.g., an occupancy percentage target was missed, the Project failed to satisfy performance benchmarks, or the Sponsor was or is in default under the Existing JV Agreement). Although unpaid fees typically do not have the motivational force of a material cash equity investment, a promoted interest, or a personal guaranty, they are another carrot that, when combined with other carrots (such as a promoted interest) and sticks (such as guaranty exposure) can collectively compel the Sponsor principal to commit the requisite time and resources to right a distressed Project. If none of these or similar motivational factors are present, the Existing Investor should analyze its ability to remove the Sponsor from any management role in the Joint Venture before committing to a recapitalization effort and the Incoming Investor should probably analyze other investments.

Once the Members have decided upon who is contributing what capital, they must determine how it will be used. As noted above, non-cash property (such as an adjacent piece of real property owned by a Sponsor affiliate) might be contributed to enhance the value and performance of the Project. Cash contributions might be used to amortize existing debt positions, replace subordinate (high interest) debt with equity, or to fund tenant improvements, leasing commissions, or capital expenditures.

### *Additional Capital Contributions: In General*

The Members should assess the Joint Venture's need for additional capital in the future. They will need to consider a host of issues on this point, including who has the right to determine whether additional capital is needed, who has the right to call that additional capital, what amounts may be called and when, what is each Member's proportionate responsibility for capital calls, how long the Members have to meet the capital calls, whether contribution is optional or mandatory, what happens if a Member fails to fund, credit support for a Member's funding obligations, and how and when additional capital is returned.

### *Additional Capital Contributions: Contribution and Return*

Although the Investors will need to analyze all of these issues surrounding additional capital contributions (and many others), some merit particular attention in the context of a recapitalization. Generally speaking, additional capital is contributed by, and returned to, the members in proportion to their respective initial capital contributions. However, the Investors should consider whether there are certain additional funding obligations for which the Sponsor should bear sole responsibility. The more control the Sponsor has over the occurrence of a particular event, the stronger the argument that the Sponsor should be solely responsible for additional capital needs that relate to that event. Controllable construction cost overruns are a good example. The Investors are relying on the Sponsor to manage construction and ensure that it is performed properly, on time, and within the Project's budget. The Sponsor is compensated for this risk through the promote. If the Sponsor's mismanagement results in a Project that is over budget, the Investors would be reasonable to insist that the Sponsor contribute 100 percent of the additional capital necessary to fund the overage.

If the Members agree that the Sponsor will bear sole responsibility for funding a particular category of additional capital (such as amounts related to controllable construction cost overruns), the Investors will likely require that this capital be returned differently than other capital contributions. Possibilities include the following (from most favorable to the Sponsor to most favorable to the Investors). The additional capital contribution for the controllable construction cost overrun (the "Overrun Contribution") might be credited to the Sponsor's capital account with a corresponding adjustment to the Members' percentage ownership interests in the Joint Venture (meaning that preferred return and promote amounts would be paid to the Sponsor based on its adjusted (higher) percentage ownership interest). Although it is possible the Members could treat the Overrun Contribution in this fashion, it is unlikely. Alternatively, the Overrun Contribution could be credited to the Sponsor's capital account with no corresponding adjustment to the Members' percentage ownership interests in the Joint Venture (meaning that preferred return and promote amounts would be paid to the Sponsor based on its initial percentage ownership interest). Although more likely than the first option, this probably is not the way most joint venture agreements would treat return of an additional capital contribution necessitated by sponsor mismanagement. Instead of either of the foregoing options, the Overrun Contribution might be credited to the Sponsor's capital account with no corresponding adjustment to the Members' percentage ownership interests in the Joint Venture, and either or both the return of and the return on the Overrun Contribution would be subordinated to capital distributions to the Investors. Less favorably to the Sponsor, the Overrun Contribution might result in no capital account credit, no adjustment to the Members' percentage ownership interests in the Joint Venture, and the Sponsor would receive a return of and return on the Overrun Contribution only to the extent of available funds in the terminal distribution from the waterfall.[7] Finally, the Overrun Contribution might result in no capital account credit, no adjustment to the Members' percentage ownership interests in the Joint Venture, and the Sponsor would receive no return of, or return on, the Overrun Contribution, even at a subordinated level; instead, the Overrun Contribution would be paid back solely out of loan proceeds or any remaining budget contingency amounts available after final completion or stabilization of the Project.

### *Additional Capital Contributions: Mandatory or Discretionary?*

The Members should also agree upon whether any additional capital contributions are mandatory. Possible mandatory contributions include expenses integral to the repositioning of the Project (e.g., capital for tenant improvements and leasing commissions) that were identified at the closing of the recapitalization, non-discretionary expenses such as taxes and insurance, emergency expenses, expenses related to health and safety of persons, payments due under approved contracts to which the Joint Venture or any affiliate is a party (including loan documents), and items that are the subject of an approved budget.

Each member of a joint venture should be careful negotiating mandatory capital contributions. The items for which mandatory capital may be called must be limited in number, precisely defined, and subject to aggregate dollar amounts. A member who is contributing the majority of the funding for a recapitalization—and who will have the majority of the responsibility for future funding—should be especially careful. Under any circumstances, but especially in the context of a distressed Project, the Investors may not want to be obligated to make additional capital contributions. The Project and its market may both be in relatively good condition at the time the Investors *promise to fund* mandatory additional capital. But conditions may deteriorate markedly between that time and the time, perhaps months later, when the Investors *must actually fund* mandatory additional capital. The Investors might want to decide in real time whether or not to fund additional capital, with the benefit of knowing the then-existing condition of the Project and its market. The Sponsor's likely counter is certainly understandable: regardless of the Project's condition (indeed, perhaps *especially* if the Project's condition worsens), the Sponsor wants to be sure that it has the capital it needs to execute on the Project's turnaround plan. Failure in this respect exposes the Sponsor principal to reputational risks and possible guaranty liability.

The Investors can make a compelling argument that, in light of the fact that they have committed the majority of the Project's capital, they should have final say as to whether additional capital should be invested in the Project. If the Project's performance is bad enough, the Investors might rather forfeit their initial capital investment than commit additional capital to a doomed investment. If the Sponsor successfully resists the Investors' attempts to retain approval rights over all additional capital contributions, in addition to imposing the parameters set forth in the preceding paragraph,[8] the Investors should make the Sponsor's ability to call mandatory capital subject to certain conditions. These conditions might look a lot like some of the conditions mortgage lenders impose on reserve account disbursements or construction loan draws.

### *Additional Capital Contributions: Failure to Fund*

The consequences of a member's failure to fund additional capital generally depend on whether the failure to fund relates to a discretionary funding obligation or a mandatory funding obligation. For discretionary funding obligations, most joint venture agreements focus on incentives to induce the funding member to advance the non-funding member's portion of the additional capital contribution. These incentives include giving the funding member the option to make loans (to the non-funding member) or loans or advances (to the joint venture) to cover the non-funding member's portion of the additional capital contribution. Funding members who make loans might have the option under the joint venture agreement to convert those loans to equity contributions, which could[9] result in the dilution of the non-contributing member's interest in the joint venture. In the context of failures to fund discretionary additional capital, dilution is usually one-for-one (i.e., a failure to contribute additional capital of 1X results in a straight 1X decrease in the non-funding member's percentage ownership interest in the joint venture). In the context of a discretionary funding failure, dilution will usually be limited to the non-funding member's economic interest and will not affect the member's voting rights. Because the funding obligation is discretionary, a non-funding member is not in default under the joint venture agreement for its failure to fund.

For mandatory funding obligations, most joint venture agreements focus on deterrents that, ideally, prevent a member from failing to fund in the first place but ensure, should a member fail to fund, that the non-funding member will face consequences adverse to its position and that the funding member will have an opportunity to better its position. These deterrents include the use of loans and advances, as discussed above, but with significantly higher interest rates applicable to the loans[10] and enhanced dilution applicable to the advances. Instead of a failure to contribute required capital of 1X resulting in a straight 1X decrease in the non-funding member's percentage ownership interest in the joint venture, it will result in an enhanced decrease of, e.g., 1.25X (or higher). Further, dilution likely will not be limited to the non-funding member's economic interest but will additionally affect the member's voting rights. Because the funding obligation is mandatory, a non-funding member will be in default under the joint venture agreement for its failure to fund.

Whether addressing discretionary or mandatory contributions of additional capital, the Investors need to consider many additional issues as well. For example, dilution of the Sponsor's economic interest in the Joint Venture is a meaningful occurrence only if the Joint Venture is yielding a profit (i.e., if the Project has equity in it). For a distressed Project that is the subject of a recapitalization, that may not be the case—certainly, at least, not in the early or even intermediate stages of the turnaround efforts, which is when it is most crucial that the Sponsor and its principal be fully engaged with the Project. Under these circumstances, loans might be the better option—or, at least, the Investors should consider drafting the A&R JV Agreement so that loans are at least *an* option that the Investors could pursue. In addition, if the Investors want equity contributions by the funding members to dilute the non-funding members, they need to say so in the A&R JV Agreement. Although the Delaware LLC Act permits dilution,[11] it does not require it. If the A&R JV Agreement does not require it, neither will a court.[12] Usury is also an issue in loans by a funding Member to a non-funding Member. Any loan—whether to a non-funding Member or to the Joint Venture itself—should be made subject to a strong usury savings clause to avoid charging or collecting usurious interest.[13]

### *Capital Distributions*

Capital is generally returned to the members of a joint venture in proportion to their respective capital contribution percentages. But that is not always the case. And even when it is the case, it does not mean all capital will be returned without preference between or among the members (i.e., *pari passu* distribution). Rather, one or more members will likely be paid first, with one or more other members having to wait until later (i.e., senior-subordinate distribution).

We have already considered a common exception to the general rule that capital is *contributed* in proportion to the members' respective capital contribution percentages—controllable construction cost overruns. Surely the most common exception to the general rule that capital is *returned* in proportion to the members' respective capital contribution percentages is the Sponsor's promote. To illustrate, consider a two-party joint venture between a sponsor who contributes 10 percent of the capital and a single investor who contributes 90 percent of the capital (with initial distribution percentages based on percentage ownership interests in the joint venture, which equal the members' respective capital contribution percentages). The distribution waterfall for this joint venture provides that available cash will be distributed as follows:

> First, to the members pro rata in accordance with their respective percentage ownership

interests until each member has received a 10 percent return on its invested capital;

Second, to the members pro rata in accordance with their respective percentage ownership interests until each member has received a return of its invested capital;

Third, 80 percent to the investor and 20 percent to the sponsor until the investor has received aggregate distributions sufficient to provide the investor with a 15 percent internal rate of return (IRR) on its aggregate capital contributions; and

Fourth, 60 percent to the investor and 40 percent to the sponsor.

In the top tier of the waterfall, the sponsor, like the investor, is just receiving a return on its invested capital; and in the second tier, the sponsor and investor are each receiving a return of their invested capital. But in the third and fourth tiers, the sponsor is receiving an extra 10 percent and 30 percent, respectively, of distributable cash. The extra 10 percent in the third tier and 30 percent in the fourth tier is the promote.

The four-tier waterfall above is relatively simple for purposes of illustrating the promote. Most joint venture waterfalls will have more than four tiers, and at least some of the distributions will be senior-subordinate, rather than all *pari passu.* Increasing the number of members in a joint venture usually increases the number of tiers in its waterfall. More members also increases the likelihood of senior-subordinate distributions.

One of the first adjustments the Incoming Investor will make to the distribution waterfall in the Existing JV Agreement is to subordinate distributions to the Sponsor and perhaps to the Existing Investor, as well. This subordination might apply only to the Members' return of capital or it might apply both to return of capital and return on capital.

Whether the Existing Investor is *pari passu* with the Incoming Investor or subordinate to the Incoming Investor will likely depend, at least in part, on how much additional capital the Existing Investor is contributing to the recapitalization. If the Existing Investor is contributing a material amount of additional capital, the Investors might agree that the Incoming Investor will receive a specified return on its capital, after which the Existing Investor will receive a specified return on its capital, and only then would the Incoming Investor be entitled to a return of its capital (after which the Existing Investor would be entitled to a return of its capital). Or perhaps the Investors would agree that the Incoming Investor receives both a return on and return of its capital before the Existing Investor receives any distributions but the Existing Investor will be entitled to a higher rate of return on its contributed capital than it would have received had it contributed little or no additional capital in connection with the recapitalization.

### *Fees*

As discussed above, fees payable to affiliates of the Sponsor for services to the Joint Venture or the Project can be another factor motivating the Sponsor principal to commit the resources necessary to turn around a struggling Project. The dollar value of such fees will surely be much smaller than the dollar value of the promote. However, fees, unlike the promote, will be paid currently and, therefore, can provide a much-needed source of income to the Sponsor's organization during turnaround efforts. As long as the amounts of the fees and the terms of the agreements governing them are comparable to what the Joint Venture would pay third parties for similar services, it makes more sense for these revenue streams to benefit the Sponsor's organization than to benefit third parties.

From the Investors' perspective, the A&R JV Agreement should impose at least some conditions on payment of fees. At a minimum, the Investors should insist that no fees are payable while the Sponsor or any of its affiliates involved in the Project is in default.[14] Additionally, payment of fees may be contingent upon the Project satisfying certain benchmarks, whether completion of a specified percentage of construction, obtainment of a minimum percentage occupancy, or satisfaction of various financial tests. If the Project involves a significant construction component, the Investors may impose controls to ensure that the pace of fee disbursement for construction services is commensurate with the pace of construction progress at the Project. Further, the Investors might require carve-outs from fees under certain circumstances. For example, if an affiliate of the Sponsor is the property manager and is compensated based on a percentage of the Project's gross revenue, the Investors might insist on excluding from the definition of "gross revenue" things like CAM fees, tax reimbursements, lease cancellation fees, and other receipts that, though technically "revenue," do not actually add to the Project's value in the way that, e.g., an increase in rents does.

In addition to addressing the fees themselves, the Investors must focus on the underlying contracts that provide for those fees. Whether the contract relates to property management and leasing, development, construction, accounting, or something else, any agreement between the Joint Venture and a Sponsor affiliate merits close scrutiny by the Investors. The Investors should require final approval and primary negotiation rights over (i) all contracts between the Joint Venture and Sponsor affiliates and (ii) the management of all defaults, remedies, and dispute resolution efforts related to those contracts.

### *Clawback*

The Investors should consider including a clawback provision in the A&R JV Agreement. Such a provision allows the Investors to "claw back" promote payments to the Sponsor and any fees paid to Sponsor affiliates to the extent that the Investors do not achieve specified returns on their invested capital. If the Investors include a clawback provision, it should be backstopped in some way (to assure recovery, whether through one or more guaranties or some type of collateral); otherwise, the value of the provision is fairly limited.

### *Guaranties*

The Members will need to agree upon what guaranties will be provided by one or more Members (or their affiliates) in favor of other Members. Most likely, a creditworthy affiliate of the Sponsor will deliver a guaranty to the Investors to backstop the Sponsor's obligations with respect to controllable construction cost overruns (if applicable) and any clawback obligation and to provide a meaningful repayment source for any losses the Investors suffer as a result of the Sponsor's malfeasance (fraud, misapplication of Joint Venture funds, criminal actions, etc.).

Guaranties delivered to third parties (such as mortgage and mezzanine lenders) will require more detailed discussions among the Members and their affiliates. It is important to note that the beneficiary of the guaranty (e.g., a mortgage lender) will have nothing to do with these discussions (and wants nothing to do with them): the beneficiary's claim is against the guarantor, and the beneficiary expects to recover 100 percent of its claim from that guarantor. The questions that arise for the Members are, once the guarantor pays (or becomes obligated to pay) 100 percent of the claim, how will that payment be allocated among the Members, and how will the guarantor's payment be treated in the Joint Venture's capital structure?

It is possible that there will be no allocation of the payment: one Member (or its affiliate) may bear all guaranty exposure, with no claim against the other Members for contribution, reimbursement, or indemnification. More likely, however, the Members will agree to some version of the following: my fault, I pay; your fault, you pay; nobody's fault, each pays in proportion to its percentage ownership interests in the Joint Venture.

Whether or not a guarantor is entitled to contribution, reimbursement, or indemnification for a guaranty payment, the Members should address whether or not the guarantor (or its affiliate Member) will receive capital account credit for that payment. If the guaranty payment is treated as a capital contribution, does it earn a return? At what point in the distribution waterfall is the contribution (and any return) paid back? If the guaranty payment is not treated as a capital contribution, this could be because the guarantor received a guaranty fee in exchange for its delivery of the guaranty or because the guaranty liability was caused entirely by the guarantor (or one of its affiliates).

## ***Management***

### *Managing Member of the Joint Venture*

The sponsor is often the managing member of a joint venture. But investors are increasingly requiring that they assume the managing member position at the outset. Therefore, the Incoming Investor in a recapitalization may require that it be designated as the managing member; it will then designate the Sponsor as the "administrative member" (or some similar title) and delegate to it specifically defined authority with respect to certain day-to-day tasks related to operation of the Project. This structure limits the Sponsor's power and authority to act on behalf of, or to bind, the Joint Venture without the Incoming Investor's prior approval, while empowering the Incoming Investor with general authority to act on behalf of, and to bind, the Joint Venture. The only hard limits on the Incoming Investor's authority would come through a list of "major decisions"—that is, a list of actions that cannot be taken by or on behalf of the Joint Venture without the requisite level of Member approval (with some major decisions being subject to majority approval, others perhaps being subject to super-majority approval, and a few being subject to unanimous approval).[15]

### *Voting and Dispute Resolution among the Members*

If there are three or more members (such as the Sponsor, the Existing Investor, and the Incoming Investor), the joint venture agreement usually provides for voting rights based on each member's percentage ownership interest and specifies whether particular major decisions require majority, super-majority, or unanimous votes. The Investors should resist efforts by the Sponsor to require unanimity on any but the most fundamental major decisions.[16] The Investors will have funded the vast majority of the Joint Venture's capital and, therefore, will bear the vast majority of the financial hit if the Project falters or fails. For this reason, the Investors are both fair and reasonable to insist that they have final say on all but a few matters.

The Sponsor might seek the right to exit the Joint Venture if it is overruled by the Investors on a major decision. From the Sponsor's perspective, it might not want to continue in an enterprise where it has lost *de facto* control and where it no longer agrees with its co-venturers on a matter of major importance to the enterprise. From the Investors' perspective, they might see the Sponsor's request for an exit right as the product of a sincere attempt to resolve a conflict where both sides have legitimate concerns, or they might see it as the product of sour grapes. However they see it, the Investors should take the request seriously. Many investors categorically reject this request from a sponsor, arguing that losing votes—even on matters of critical importance—is part of life in a joint venture, especially when one has contributed only a fraction of the entity's capital. Implementing the will of the majority (or super-majority), these investors say, even if it is different than your own, is part of what you agreed to do when you signed on as the sponsor and became entitled to the promote and fee income (through your affiliates). This argument is solid. But it looks past some important questions that investors should ask themselves when dealing with a sponsor for whom this type of exit right is important. If the sponsor is this concerned *right now* about having to remain in the joint venture after being overruled on a major decision, how disgruntled and resentful might it be if that *actually happens later*? Am I comfortable, an investor should ask, with the possibility that there could come a time when the person who is responsible for managing my investment wants nothing to do with my investment but remains involved in it only because I will not let him or her out?

Many investors would answer that yes, in context, they are comfortable with this possibility because a post-override exit right is disruptive to the joint venture: first the investor would have to deal with the buyout of the sponsor, then it would have to find, vet, and admit a new sponsor. These investors would rather require the sponsor to remain in the joint venture and rely on the (likely considerable) controls the investors have under their joint venture agreements to ensure that the sponsor is doing its job.

Some investors might answer no and, therefore, be willing to give the sponsor a post-override exit right. These investors should be careful about the type of exit right they permit the sponsor to exercise. Any exit right that could allow a sponsor to force an investor to liquidate its interest in the joint venture (e.g., a buy-sell, a forced sale of the project) should be rejected; otherwise, the minority member could force the majority member to liquidate its interest in the joint venture—which is bad in general, and which is especially bad if market conditions or issues within the investor's fund structure make that an inopportune time to liquidate. Any exit right granted under these circumstances should affect only the sponsor's interest in the joint venture (e.g., a put right in favor of the sponsor at a pre-determined price or pursuant to an agreed valuation formula).

Further, any such exit right should be exercisable only under carefully defined circumstances (e.g., if the sponsor is overruled on any one of a small sub-category of major decisions) and unavailable under certain circumstances (e.g., if the sponsor or a sponsor affiliate is in default).

### *Voting and Dispute Resolution between the Investors*

Once the Investors have decided how to address voting and dispute resolution with the Sponsor, they will have to decide how to address these matters between themselves. Possibilities include unanimity on all issues, majority rule on all issues, or more likely some combination of the two (e.g., majority rules on "basic" major decisions and unanimity on "fundamental" major decisions). The agreement the Investors reach on these matters will be driven in part by the amount of capital the Incoming Investor is contributing relative to the Existing Investor, how essential the Incoming Investor is to the success of the turnaround effort, and the level of risk associated with the turnaround effort. If the balance of power is tilted in favor of the Incoming Investor (as it likely will be), the Incoming Investor would likely insist on the right to override the Existing Investor on certain matters and agree that the Existing Investor will have recourse to an exit strategy if the Incoming Investor exercises that override right. The Incoming Investor's concerns regarding an exit right in favor of the Existing Investor will parallel the Incoming Investor's concerns regarding an exit right in favor of the Sponsor: the exit right should cause as little disruption as possible and should affect only the Existing Investor's interest in the Joint Venture, e.g., a right in favor of the Existing Investor to put its interest in the Joint Venture to the Incoming Investor at a pre-determined price or pursuant to a pre-determined formula).

### *Sponsor Involvement*

The Investors should ensure that the Sponsor, the Sponsor principal, and any key employees are obligated to remain involved in the management of the Joint Venture and the operation of the Project on a day-to-day basis. In addition to prohibiting the withdrawal of the Sponsor from the Joint Venture, the A&R JV Agreement should prohibit the resignation of the Sponsor principal and any key employees from involvement in the Project and should require that they be actively involved in the operation of the Project on a day-to-day basis. Removal or replacement of any of these people should require the approval of the Investors. And if any of these people are removed or replaced without the Investors' approval, or if any of them fail to maintain the required level of involvement in the Joint Venture's day-to-day operations, in addition to making such failure a default under the A&R JV Agreement, the Investors should consider including in the A&R JV Agreement a right in favor of the Investors to exit the Joint Venture.

### *Competitive Activities*

Joint venture agreements often contain waivers of restrictions on competitive activities, providing, to a greater or lesser extent, that the members may pursue other investments, even if those investments would compete with the project that is the subject of joint venture agreement. A distressed project that is the subject of nascent turnaround efforts, however, is much more sensitive to competition than a stabilized project. Agreeing to tighter restrictions on competitive activities may be part of the price the Sponsor has to pay to convince the Incoming Investor to commit to the recapitalization and to persuade the Existing Investor to remain in the deal (and, especially, to contribute additional capital). The more unique the Project and the more integral the Sponsor is to its success, the stronger this argument becomes in favor of the Investors. If the nature of the Project is such that competition is an acute concern for the Investors (e.g., the Investors are recapitalizing a limited liability company that owns a distressed Project, the Project is in an asset class that falls in the core focus of the Sponsor's organization, and there are a lot of similar projects for sale within a one-mile radius of the Project), the Investors may require the Sponsor to agree not to operate, own, own interests in, etc. any "Competing Project" within a certain radius or boundary of the Project—not, at least, until the Project has achieved completion, a certain level of occupancy, a certain level of financial performance, or other appropriate benchmark of stabilization.

### *Major Decisions*

This portion of the Existing JV Agreement merits special attention by the Investors as they negotiate the amendment and restatement of this document with the Sponsor. If the Incoming Investor is the managing member of the Joint Venture, it would prefer that the list of major decisions be as short as possible because actions on this list that require more than majority approval (i.e., super-majority or unanimous) will require the Incoming Investor to obtain the consent of either or both the Existing Investor and the Sponsor. Even if the Incoming Investor and the Existing Investor are co-managing members of the Joint Venture, the Incoming Investor will face only a slight variation on this same problem. If the Sponsor is the managing member of the Joint Venture, the Investors must insist on a much longer list of major decisions. Since they will not have the power or authority to act on behalf of, or to bind, the Joint Venture, the list of major decisions will be their principal means of controlling the Joint Venture.

Although the details of specific major decisions are crucial, the Investors must keep the bigger picture in mind. Which Members are entitled to propose actions that constitute major decisions? Joint venture agreements are sometimes (mis)drafted such that only the managing member has the authority to propose actions that constitute major decisions. If the sponsor is the managing member, the investor has negative control by virtue of the fact that the sponsor must obtain the investor's approval to take certain actions, but the investor has no positive control because it has no right to propose actions that constitute major decisions. The A&R JV Agreement should be drafted such that the *Members* have the right to propose major decisions. In addition, the Investors must remember that they do not want the major decisions process to handcuff the Sponsor and thereby risk strangling the Project. The more fluid the Project, the more important nimble management is. To promote it, the Investors must negotiate a major decisions framework that protects themselves but still gives the Sponsor room to maneuver. Quick responses from the Investors to major decisions proposed by the Sponsor are a key component to striking the right balance on this issue.

Sometimes major decisions are divided into subcategories, such as "fundamental," "significant," and "basic." The Investor should seek the right to approve major decisions—certainly, at least, fundamental major decisions—in its sole and absolute discretion (with a "commercially reasonable" standard applying to non-fundamental major decisions).

### *Waiver of Fiduciary Duties*

Under Delaware law, managers and managing members of limited liability companies owe fiduciary duties to the members and to the limited liability company.[17] However, Delaware law provides that these fiduciary duties can be narrowed or eliminated.[18] Regardless of the management structure the Members select—whether, on the one hand, the Incoming Investor is the managing member or the Investors are co-managing members (with, in each case, the Sponsor as the administrative member acting pursuant to authority delegated by [and revocable by] the Incoming Investor or Investors) or, on the other hand, the Sponsor is the managing member—the Investors should ensure that, should either or both of them ever find themselves in a management role post-dispute with the Sponsor (whether because the Sponsor's delegated authority has been revoked or because the Sponsor has been removed as managing member), they will owe fiduciary duties neither to the Sponsor nor to the Joint Venture. Otherwise, the Investors will give a disgruntled Sponsor a platform on which to second-guess the Investors' post-revocation/post-removal actions and to create fact issues that could lead to protracted litigation.

## ***Operation of the Project***

### *Budgets*

Budget overruns are bad for any real estate venture. They are especially bad for a distressed project in the midst of turnaround efforts. Therefore, the Investors should limit the range of permissible variances and should impose other safeguards to increase the likelihood that the budget will stay in balance. To begin with, the Investors should require that any budgets (whether operating budgets or capital budgets) contain detailed line items of proposed expenses, not general categories. For operating budgets, the Investors should limit deviations on both an individual line item basis and an aggregate basis for the overall budget to the lesser of a certain dollar amount and a maximum percentage deviation. For capital budgets, the Investors should eliminate deviations altogether. The Investors must also restrict the shifting of cost savings between line items, making any such shifting subject to the lesser of a certain dollar amount and a percentage of the line item. Finally, the Investors must impose appropriate limits on how the Sponsor uses funds from the budget's contingency line item.

### *Business Plan*

In crafting a business plan for a distressed Project, the Members need to strike a somewhat difficult balance. On the one hand, the Investors should insist on detailed and thoughtful business plans, particularly those that will be implemented in the early stages of the turnaround efforts. Although the business plan must be detailed and thoughtful, it should not be rigid or restrictive. A Project with any element of distress will be a dynamic enterprise. This necessitates a business plan that can accommodate changed circumstances and that accounts for likely contingencies.

Although the components of any good business plan are driven by the particular project, most business plans will address at least the following: proposed maintenance expenses, proposed capital expenditures, financing needs, construction schedules, leasing, and marketing plans.

## *Transfers and Exit Rights*

### *Transfers*

Because the Sponsor will be the driving force behind the turnaround of the Project, the Investors should generally restrict transfers of the Sponsor's interest in the Joint Venture, both direct and indirect. Common exceptions to this general restriction include transfers for estate planning purposes and transfers to affiliates of the Sponsor (each subject to certain conditions).

The Investors will expect the ability to freely transfer their interests in the Joint Venture, both direct and indirect. Because the Sponsor is depending on the Investors for the capital essential to the turnaround effort, the Sponsor might insist that the Investors be prohibited from effecting transfers of their interests in the Joint Venture until they have fully funded their capital commitments. Most investors would agree to this restriction, provided that it is limited to the investors' direct interests in the joint venture. Virtually any investor will require the ability to make upper-tier transfers (which is essential for addressing redemptions of persons and entities who have invested in the investor and other aspects of portfolio management).

### *Exit Rights*

An exit right gives a member the right to dissociate from the joint venture. There are many kinds of exit rights, including buy-sell provisions, forced sales, puts, and calls. Members can have recourse to exit rights for a variety of reasons (usually subject to various restrictions and conditions). One of the most common reasons that joint venture agreements permit initiation of exit rights is as a means of dispute resolution. If, for example, two members cannot agree on a major decision that requires approval by both of them, either or both of those members might have recourse to an exit right that, depending on the mechanism, would result in either or both of them liquidating their interests in the joint venture.

Many joint venture agreements include a buy-sell provision as one of the members' exit rights; in some joint venture agreements, it is the only exit right. If the Existing JV Agreement offers a buy-sell provision as the only way to effect an exit, the Investors should consider replacing this provision or, at least, adding an alternative exit mechanism (and specifying that the alternative mechanism has priority over the buy-sell provision). Under a buy-sell provision, the member initiating the process states a price for the assets of the joint venture and specifies that the price for each member's interest equals the amount that member would receive if the joint venture's assets were sold for the stated price and the sales proceeds were distributed pursuant to the joint venture's waterfall provisions. The other member can then decide whether it wants to buy the initiating member's interest in the joint venture or sell its own.

The theory behind the buy-sell process is that because the initiating member does not know whether it will be the seller or the buyer in the transaction it will name a fair price. This theory does not always hold true in practice. At least two of the exceptions are especially likely to manifest themselves in a down economy. In up markets, high deal volume provides ample comparable sales prices off of which the buy-sell offer price can be calculated. In down markets, low deal volume results in a dearth of comparable sales prices, increasing the chances that the price will have little relationship to the project's true value and, therefore, that one member will profit at the expense of the other using a process that is supposed to generate a fair result.

In addition, the risk of gamesmanship lurks behind the mechanics of the buy-sell process. The initiating member, wanting to acquire the Project at a discount to its market value, might knowingly name an artificially low price, provided it can access capital in time for the buy-sell closing and provided it is relatively confident that the responding member cannot. *So what?*, one might ask. *If the concern is protecting the (presumably cash-rich) investor against the (presumably cash-poor) sponsor, isn't the investor on the good side of this risk?* Not necessarily. Even the largest institutional real estate investors have allocated certain amounts of capital to certain funds, asset classes, geographic regions, and so on. Notwithstanding the fact that the affiliates of an investor might collectively have access to hundreds of millions of dollars of capital, that capital may be practically unavailable to the investor if, for example, the fund that owns the investor is subject to redemptions (and needs to liquidate its holdings, not increase them) or if that fund has reached an allocation limit in the project's asset class (and therefore, the investor cannot increase its interest in the project to 100 percent by being the buyer in the buy-sell process).

Joint venture agreements sometimes give one, some, or all of the members the ability to force a sale of the project, though it is probably most common for this right to be exercisable only by the investor (perhaps subject to a right of first refusal/first offer in favor of the sponsor[19]). This forced-sale right might exist in place of, or alongside, a buy-sell provision.[20] A forced-sale provision eliminates the risk of gamesmanship considered above because the market will actually set a price for the project. But whether that price will bear any meaningful relationship to the project's inherent value is far from guaranteed. That's because buy-sell provisions and forced-sale rights are prone to a common weakness when triggered in a down economy: the dearth of comparable sales data makes it difficult to establish an accurate value for the project. During a time of low sales volume and depressed prices, a seller is likely to have to accept a significant discount to its asking price if it wishes to close a transaction. For this reason, investors in distressed assets are even more likely than investors in non-distressed assets to require that a forced-sale right be exercisable only by the investors. The greater the disparity between the equity investments of the sponsor, on the one hand, and the investor, on the other hand, the more force the investor's argument gains. Under these circumstances, the investor would ask, why should the sponsor be able to force the investor to sell? The member who will bear the brunt of the financial hit, the investor will argue, is the only member who should be able to force a sale.

## *Defaults and Remedies*

### *Defaults*

Defaults can be generally categorized as either "payment defaults" or "performance defaults." Payment defaults typically refer to a member's failure to contribute capital as and when required by the joint venture agreement.[21] Performance defaults cover any other failure to abide by the terms of the joint venture agreement. Defaults can also be categorized based on culpability—with "economic defaults" at one end of the spectrum and "wrongful defaults" at the other end of the spectrum. Economic defaults would include things such as the sponsor failing to reach a certain occupancy percentage or failing to satisfy a financial metric applicable to the project, the death or disability of the sponsor principal or other key person, or capital calls made in excess of a certain level or for certain purposes. Wrongful defaults would include acts such as fraud, misappropriation, voluntary bankruptcy, and criminal misconduct.

The nature of the default—payment vs. performance, economic vs. wrongful—informs provisions for notice, cure, and remedies. Like any contract, the A&R JV Agreement should be precise about what constitutes a default and what notice and cure rights, if any, apply to it. The Investors should consider whether any cure periods should be shortened (or removed entirely), whether materiality qualifiers should be removed, and whether cure rights should be subject to certain conditions. In addition, the Investors should cross-default Sponsor affiliate agreements (property management agreements, development agreements, construction management agreements, etc.) with the A&R JV Agreement. That way, a default by a Sponsor affiliate under an affiliate agreement results in a default by the Sponsor under the A&R JV Agreement.

### *Remedies*

Because there are relatively few opportunities for default by the Investors, and because this discussion proceeds primarily from the perspective of the Investors, the following consideration of remedies focuses on situations in which the Sponsor is the defaulting party. The nature of a remedy available to the Investors depends of course on the nature of the default that precipitates it. If the Sponsor has committed an economic default, it will likely face a less severe set of consequences than if it has committed a wrongful default.

On the less severe end of the spectrum, remedies might include suspension of the Sponsor's economic[22] and voting rights until a certain condition is satisfied (e.g., achieving a certain percentage of occupancy at the Project or completing certain stages of construction). The Sponsor might also be obligated to post collateral or even to make some type of cash payment (e.g., if the Project is beset by controllable construction cost overruns). At the more severe end of the remedial spectrum, the Investors might have the right to terminate contracts between the Joint Venture and Sponsor affiliates.[23] For more serious defaults, the Sponsor may suffer a partial or even complete loss of its promote (meaning that its economic interest in the Joint Venture is reduced to the amount of its percentage ownership interest in the Joint Venture). For particularly egregious defaults, the Investors might have the right to buy out the Sponsor's interest in the Joint Venture at a discount (e.g., a call right in favor of either Investor at 50 percent of the value of the Sponsor's interest in the Joint Venture).

If the Sponsor is the managing member of the Joint Venture, an additional remedy the Investors will surely have is the right to remove the Sponsor from that position. Virtually any joint venture agreement will permit removal based on wrongful defaults, and many will permit it based on economic defaults. It is becoming more common to see joint venture agreements that permit removal at the investor's discretion, even if no default has occurred. Such a right significantly reduces the threat of litigation over removal and provides for a seamless transition of management. Even with a well-drafted joint venture agreement, attempting to remove a recalcitrant sponsor for cause (i.e., an uncured default) can result in lengthy and expensive disputes about whether the "cause" actually occurred. By contrast, a right to remove for any reason or no reason eliminates any debate. The Investors will need to address the Sponsor's concerns regarding loss of the promote, as well perhaps as a request by the Sponsor that if it is removed without cause it should be bought out of the Joint Venture (because it does not want to continue as a member of the Joint Venture after it has been stripped of its management rights and of the promote). Finally, the Sponsor will fairly insist upon it and any of its affiliates being released from guaranties delivered in connection with the Project or, at least, indemnified by a creditworthy affiliate of either Investor.

Unless the Sponsor's removal was at the Investors' discretion and not precipitated by any default on the part of the Sponsor or any of its affiliates, the economic effect of the removal will likely be that the Sponsor loses any claim on the promote and the Sponsor affiliates lose any claim on fee income. In addition, the Sponsor will likely lose all voting rights. The Sponsor's only interest in the Joint Venture will be its percentage ownership interest (entitling it to a return of, and return on, its invested capital). A replacement Sponsor would be admitted to the Joint Venture who would be entitled to the promote (and its affiliates would be entitled to the fee income). The replacement Sponsor would also be entitled to exercise the voting rights of the removed Sponsor.

Before the Investors take the drastic step of removing the Sponsor as managing member of the Joint Venture, they should ask themselves whether doing so will actually solve their problems or just make them worse. The Investors have no authority to bind the Joint Venture until one or both of them or their designees assumes the role of managing member. In conjunction with the management takeover, the Investors have a multitude of questions to answer, just a few of which include the following: Who should receive notice of the takeover? E.g., lenders, third-party property managers, contractors, tenants? Where are the books and records for the Project and for the Joint Venture? What must the Investor do to gain control of cash?

Sponsors sometimes seek to impose a requirement of a final determination of default before triggering the removal of the sponsor as managing member. The Investors should resist any such request. If the Project is deteriorating, the Investors do not want to increase their risk of loss by engaging in a drawn-out battle to attempt to prove that the Sponsor actually committed the act or omission alleged by the Investors. Further, the Investors likely have their own investors to consider (and in connection with that, their fiduciary duties to those investors: Have the

Investors perhaps breached those duties if they agree that the Sponsor can drag the Investors all the way to the state supreme court before the Investors will be able to exercise the removal right?)

The Investors also need to ask how they will address amounts payable to the Sponsor or its affiliates during the pendency of a default by the Sponsor. The answer depends on the nature of the default (Does it result from an economic default or a wrongful default? Have cure periods expired? Will it affect what amounts, if any, are paid to the Sponsor and, further, when they are payable?) Amounts to consider include distributions of current income, distributions from capital events, payment of the promote, and payment of fees. Depending on the nature of the default, all or some of these amounts may be temporarily withheld from the Sponsor and its affiliates or waived altogether. If distributions to the Sponsor or its affiliates are withheld, they will likely be deposited into an escrow account and held until elimination of the condition that caused the default. If distributions to the Sponsor or its affiliates are waived, they will likely be made available to a replacement Sponsor and its affiliates (with the removed Sponsor's interest in the Joint Venture being reduced to its percentage ownership interest).

## Conclusion

Investing new capital in a distressed real estate joint venture can be a satisfying and lucrative challenge. It can also be a frustrating and expensive mistake. To increase their chances of arriving at or near the good end of this continuum, investors who are considering an initial capital investment in a distressed real estate joint venture must plan meticulously and execute methodically. This planning and execution will likely entail, among many other things, a comprehensive business and legal analysis of the project, the joint venture, and its existing members; successful forbearance and modification negotiations with lenders and any other creditors; re-working the joint venture's capital structure; restructuring the joint venture's management (including issues related to voting, sponsor involvement in the day-to-day activities of the joint venture, and major decisions); and negotiating effective default and remedies provisions. With proper attention to these and other issues, a new investor can protect itself and profitably deploy its capital while giving a second chance to a good project that has fallen on hard times.

## NOTES:

[1]Most likely, title to the Project will be held by a wholly-owned subsidiary of the Joint Venture (the "Project Owner"). The Project Owner would be the borrower/obligor on any mortgage debt and the mortgagor under a mortgage, and, if applicable, one or more upstream affiliates of the Project Owner would be the obligors on mezzanine debt and the pledgors under pledge and security agreements. To simplify the presentation herein, the Joint Venture is assumed to own the Project directly and to be the obligor on any applicable debt.

[2]Tax considerations are among the issues not discussed herein—but they absolutely must be considered in the drafting and negotiation of any joint venture agreement (at the federal, state, and local levels).

[3]REMIC trusts, for example, are prohibited from holding anything other than "qualified mortgages" and "permitted investments." Net profits interests, equity kickers, and similar interests do not fit into either of these categories.

[4]The A note would retain priority over all equity investments (whether from the Existing Investor or the Incoming Investor) but the B note might be subordinate to the equity investments.

[5]Again, some lenders could not agree to this even if they wanted to. *See supra* note 2.

[6]It is possible, of course, that either or both of the Investors might guarantee third-party indebtedness.

[7]*See* "Distributions."

[8]*See* "limited in number, precisely defined, and subject to aggregate dollar limits."

[9]*See* discussion regarding the need to provide for dilution in the A&R JV Agreement.

[10]Relative to the interest rates applicable to loans related to discretionary funding obligations.

[11]*See* 6 Del. C. § 18-502(c).

[12]*See Grove v. Brown*, 38 Del. J. Corp. L. 1163, 2013 WL 4041495 (Del. Ch. 2013).

[13]Among other items, the Members might additionally consider the following: credit support for a member's funding obligations, notice and cure rights, timing of dilution and opportunities to reverse it (if any), security for loans made by a funding member, equitable subordination risk with respect to loans, and how any contributions and loans will be repaid (solely from distributions to the non-funding member, or will there be an additional source of repayment (such as a guaranty or collateral (e.g., a letter of credit))?).

[14]The Members will have to agree on the treatment of fees that accrue during the pendency of a default. One common solution is to escrow such fees until the default is cured. If the default is not cured and becomes a defined Event of Default, some joint venture agreements might provide that the fees remain in escrow, whereas others would deem them waived.

[15]The Incoming Investor would of course have to comply with the Delaware Limited Liability Company Act and other applicable law; but these authorities would likely impose few, if any, practical limits on actions the Incoming Investor might wish to take as managing member.

[16]E.g., taking action that would cause a Sponsor affiliate to incur guaranty liability, amending loan documents in a manner that increases guaranty liability for a Sponsor affiliate, conducting transactions with affiliates of the Incoming Investor or the Existing Investor other than in accordance with the terms of the A&R JV Agreement, selling the Project other than in accordance with the terms of the A&R JV Agreement, and changing the purpose of the Joint Venture.

[17]*See* 6 Del. C. § 18-1104.

[18]*See* 6 Del. C. § 18-1101(c).

[19]Many investors are unwilling to grant such preemptive rights to a sponsor, particularly in the context of an investor-driven sale of the project.

[20]If it exists alongside a buy-sell provision, the members should specify in the joint venture agreement which of these two exit rights has priority over the other and, additionally, that no member can initiate either exit right if another member is already in the process of exercising one of the exit rights (though this prohibition might be subject to one or more exceptions in the investor's favor).

[21]And again, note that failure to contribute capital is not always a default.

[22]I.e., the Sponsor's right to the promote and the Sponsor affiliates' right to fee income.

[23]The Investors should think carefully about whether and when to exercise this remedy. Although terminating Sponsor affiliate contracts deprives the Sponsor's organization of fee income, it also deprives the Project of resources necessary for its operation. Because the promote will not be paid, if at all, until the Project's turnaround has succeeded, the Sponsor's organization needs a current income stream to support its operations. Fee income paid to Sponsor affiliates is a big component of that income stream. If the Investors shut off that income stream by terminating Sponsor affiliate contracts, they may hurt themselves as much or more as they hurt the Sponsor. For these reasons, investors typically do not terminate sponsor affiliate contracts unless they have also made the decision to remove the sponsor from any management or operational role.