

## NOTE FROM THE REAL ESTATE RESTRUCTURING GROUP

### REAL ESTATE JOINT VENTURES: HOT BUTTONS ISSUES EXPOSED BY THE DISTRESSED MARKET

Among the widespread impact of the distressed commercial real estate market has been the tension placed on the partners to the joint ventures which own the real estate investments. In many cases, these partners have been forced to confront issues that were not considered in the original drafting of the joint venture agreement. In some instances, these partners could not foresee the extent to which projected rent rolls would not be realized, available mortgage financing would dry-up and the sales market would capitulate. In other instances, given the speed at which real estate investments needed to be transacted in the late 1990s and early 2000s, as a practical matter, contingencies to address the impact of the distressed real estate market could not be negotiated into the joint venture agreement.

With respect to the negotiation of future joint venture agreements, it is important for real estate investors and their counsel to consider the issues joint venture partners have recently confronted in the face of the distressed real estate market which, in many cases, were not accounted for in the joint venture agreement. Highlighted below are a few of the common hot button issues that joint venture partners have confronted as a result of the deterioration in the real estate market, and related points for consideration for future joint venture arrangements.<sup>1</sup>

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<sup>1</sup> For purposes of this article, we have assumed that the joint venture is in the form of a limited liability company, which is the most commonly used entity for real estate joint ventures, and that there are two members of the limited liability company: the “developer or sponsor partner”, who contributes his knowledge and hands-on development/management of the real estate investment (as well as some of the required equity); and the “equity partner”, who contributes the majority of the required equity for the real estate investment. In addition, we have assumed that the joint venture owns the real estate investment directly, and not through a subsidiary entity(ies) which is often the case for a variety of reasons. The analysis of these issues is substantially the same where a different form of entity is used, there are multiple partners to the joint venture and/or the property is owned by the joint venture through one or more subsidiaries.

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## **Exposure under Loan Guarantees**

In connection with securing debt financing, very often one of the partners to the joint venture (typically the developer/sponsor partner), or its principals, will deliver to the mortgage lender any required guaranties and indemnities, including payment, completion and recourse carveout guaranties and environmental indemnities. Typically, the joint venture agreement will provide that the joint venture indemnifies this partner (or such principals) for any liabilities it incurs under such guaranties/indemnities (unless the liabilities arise from such partner's or its principal's willful acts). However, many operating agreements fail to take into account that in the event any liability is incurred under these guaranties/indemnities, it will likely be the case that the joint venture will not have the financial resources to reimburse such losses.

In this context, the guarantor/indemnitor should consider whether it needs the right under the joint venture agreement to call additional capital contributions in order to cover these losses; and, in connection therewith, whether the other partner has the financial ability to fund these potential additional capital contributions. In addition, the guarantor/indemnitor should consider the need to obtain an indemnity or guarantee from the other partner (or its affiliate or principal, where such other partner does not have sufficient financial resources) to share on a pro rata basis in these losses, and to be responsible for all losses incurred by the guarantor/indemnitor due to the actions of such other partner.

A related point is that the guarantor/indemnitor may have placed itself in the position of being liable for certain actions taking by the joint venture, while the other partner has the unilateral authority to take such actions. For example, the other partner may have the authority to unilaterally submit the joint venture to a voluntary bankruptcy, which could cause the guarantor/indemnitor to incur springing liability for the entire mortgage loan under customary recourse carveout guaranties. In some cases, the guarantor/indemnitor may have sufficient control over these actions under the joint venture agreement, but the agreement may provide for the subsequent transfer of control to one of the partners in the event the real estate project goes into distress (e.g., loss of tenants, mortgage defaults, etc.). Accordingly, the guarantor/indemnitor is well advised to negotiate into the joint venture agreement a limitation on the other partner's authority to cause the joint venture to take actions which would cause the guarantor/indemnitor to incur personal liability.

## **Authority to Deliver Deed in Lieu and Enter Into a Restructuring**

The authority to make major decisions on behalf of the joint venture is almost always considered and negotiated by the partners. In particular, which partner has the authority (and which partner needs to consent) with respect to a sale or refinancing, or to admitting a new partner and amending the joint venture agreement, is rarely disregarded.

But in many cases, the partners fail to consider these transactions in light of distressed circumstances, and the conclusion as to which partner should have the authority (and whether the consent of the other partner should be required) may be different in the context of the decision to give a deed in lieu of foreclosure (or enter into a consensual foreclosure) or enter into a loan restructuring. Similarly, the ability to bring in a new partner to provide new equity (and/or capabilities), and to amend the joint venture agreement in connection therewith, may necessitate a different decision making process in distressed circumstances.

Unless the authority for making these decisions is considered upon entering into the joint venture agreement, frequently the partners end-up clashing over these decisions since they may have conflicting interests. For example, the delivery of a deed in lieu or a loan restructuring may have very different tax consequences to each of the partners, or one of the partners may have a need to take whatever actions are necessary to avoid liability under a personal guaranty in connection with a default under a mortgage loan.

### **Exit Rights**

In order to address a potential irreconcilable dispute between partners, or the fact that the partners may have conflicting goals with respect to the term of ownership of the investment, most sophisticated real estate investors negotiate unilateral rights to “exit” from the joint venture. Common provisions that are negotiated are unilateral sale rights (of the partnership interests or the real estate asset), subject to a right of first offer, right of first refusal or buy/sell option.

However, the devil is in the details in these provisions, and quite often the impact of a distressed real estate market is overlooked in crafting such details which can lead to unintended issues and consequences. One example of failing to consider the impact of a distressed market occurs where a partner has negotiated the right to sell subject to a right of first refusal, only to find that right is not an effective exit strategy in such market. In a poor seller’s market, many purchasers are reluctant to incur the expense of due diligence and negotiation of a contract of sale to simply be subject to the risk of subsequently losing the transaction at the option of the non-selling partner. A second example is where the principal of one partner has given a guaranty to the mortgage lender. In connection with attempting to utilize its negotiated exit right, such partner may have overlooked the necessity of having its principal removed from the guaranty (or, in lieu thereof, having a financially sufficient party indemnify it for losses incurred under such guaranty following the transfer of the property to the other partner). Another example is where, in connection with exercising a right to purchase, the partner may not have considered how much time would be adequate to obtain financing for the purchase in light of the distressed real estate environment.

These are just few illustrations of the joint venture issues partners have confronted as a result of the distressed real estate market. Moving forward, sophisticated real estate investors are well advised to consider the insight gained into these issues in structuring future joint venture arrangements and, with the advice of counsel, make a determination of whether these issues need to be specifically addressed in the joint venture agreement.

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The Real Estate Restructuring Group is comprised of attorneys from several of Tannenbaum Helpert's practice areas, and provides a cohesive, multi-disciplinary, legal team, with a targeted focus on providing strategic advice and effective solutions to the diverse and complex issues which must be addressed in connection with the acquisition, restructuring and disposition of distressed real estate assets. If you have any questions regarding this Note or the Real Estate Restructuring Group, please contact Eric S. Schoenfeld (212.508.6713 or [schoenfeld@thshlaw.com](mailto:schoenfeld@thshlaw.com)). You may also visit our firm's website: [www.thshlaw.com](http://www.thshlaw.com).