ISSUES TO CONSIDER IN PROGRAMMATIC JOINT VENTURES

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In a customary real estate joint venture, an operator/developer (the Operator) and an investor (the Investor) form a joint venture for a single transaction, with no obligations to each other beyond that transaction. Sometimes, though, the Operator and the Investor will form a joint venture for the purpose of investing together in multiple real estate transactions over a period of time. This type of joint venture is commonly known as a "programmatic joint venture."

There are various issues that arise in programmatic joint ventures that do not typically arise in other types of real estate joint ventures. This article identifies some of those issues, discusses the ways parties often address them, and offers some possible resolutions.

EXCLUSIVITY

In programmatic joint ventures, the Operator is typically restricted from investing (directly or through an affiliate) in certain types of deals outside the relevant joint venture between the Operator and the Investor (the Joint Venture). This "exclusivity" requirement raises several issues for negotiation.

First, the parties must determine what types of deals are subject to the exclusivity requirement. Often, there are specific investment parameters for the Joint Venture, and these can serve as the basis for the exclusivity requirements. Investment parameters may include categories such as the type of property (e.g., multi-family, industrial, and office); geographic location; projected returns; minimum and maximum equity requirements per deal; and projected hold period to accomplish the business plan.

Additionally, the parties need to determine the time period of the exclusivity requirement. The exclusivity period is often a fixed period of time (based on the expected period to invest the capital allocated to property acquisitions for the Joint Venture) but can end early based on various factors, including:

- The Joint Venture deploying (or being committed to deploy) all of the capital allocated by the Investor to the Joint Venture;
- The Operator being removed as manager/managing member/general partner (as applicable) of the Joint Venture;
- The Investor defaulting on its capital contribution obligations; and
- The Investor disapproving of a certain number of deals for the Joint Venture (discussed in the next paragraph).

The Operator will typically resist being bound by an exclusivity requirement if the Investor repeatedly rejects deals for the Joint Venture. Thus, the Operator will often negotiate to end the exclusivity requirement early if the Investor rejects a specified number of deals over a specified time period. (This is sometimes referred to as an "X strikes and you're out" provision.) This period may be the entire exclusivity period or some shorter defined period (which the Investor may push for to be allowed to "restart the clock"). In any case, the Investor will want to be clear that for a rejected deal to count for purposes of this test, that deal must at least meet the specified investment parameters of the Joint Venture (and sometimes even narrower parameters). The Investor may also take the position that a deal that meets the investment parameters will not constitute a "strike" if the Investor rejects the deal because of certain defects (e.g., environmental issues or title defects). If a potential deal consists of a portfolio of properties, the parties will need to negotiate whether a rejection of that portfolio collectively counts as a single "strike" for purposes of the above-described test.

The Operator will also want the right to invest in a rejected deal outside the Joint Venture. The Investor may reject this position altogether (as the Investor may want the Operator's sole focus to be on the Joint Venture for the exclusivity period) or may agree to this only if the Investor rejects more than a specified number of deals. The Investor may also want to restrict the Operator from doing deals that are competitive with a Joint Venture property, regardless of how many deals the Investor rejects and regardless of whether the exclusivity period remains in effect. Because the Operator needs to be able to also conduct its ordinary business outside of the Joint Venture, the Operator will typically push for as few restrictions as possible on its ability to invest in rejected deals outside the Joint Venture.

In any event, the Operator will need to exclude its existing deals from the exclusivity requirements, including any potential add-on investments to those deals. The Operator may also seek to exclude passive investments (e.g., buying publicly traded REIT stocks or investing in a fund managed by a third party) from the exclusivity requirement.

It is uncommon—but not unheard of—for the Investor to be restricted from making investments outside the Joint Venture. Sometimes, the Operator will insist on this because the Operator does not want the Investor funding a competitive business (particularly before the Investor has made a significant investment in the Joint Venture). But Investors will often resist any such restriction.

Given its importance to both the Operator (which wants to be able to conduct its business with as few restrictions as possible) and the Investor (which wants the Operator to be focused as much as possible on the Joint Venture)—and the potential misalignment of these interests—the exclusivity requirement is a key issue that needs to be carefully negotiated by each party to a programmatic joint venture.

INVESTOR DISCRETION TO APPROVE DEALS

Another key issue in a programmatic joint venture is whether the Investor will have the right to approve new acquisitions by the Joint Venture. The Investor typically will have such an approval right, particularly because one of the attractive features of a programmatic joint venture, compared to a typical real estate fund, is the right for the Investor to have discretion over the deals in which it invests. However, in some cases, the Operator will have the unilateral right on behalf of the Joint Venture to make acquisitions that meet defined criteria.

If an Investor does have the right to approve new deals, then there are various mechanical issues that must be addressed. First, the parties need to determine at what point in the process such approval will be required, what the approval will cover, and whether one or more additional approvals will be required before the ultimate closing. For example, the parties need to address:

- Whether the Operator will have the right, without the Investor's consent, to pursue a deal and incur costs (pursuit costs) on behalf of the Joint Venture in connection with such pursuit;
- Whether the Operator will be permitted, without the Investor's consent, to execute a "soft" contract (i.e., one that can be terminated for any reason during a due diligence period) on behalf of the Joint Venture and post a deposit in connection therewith;
- Whether the Operator will be permitted, without the Investor's consent, to execute a "hard" contract (i.e., one that does not have a free

termination right) and post a non-refundable contract on behalf of the Joint Venture; and

- If the Investor approves the execution by the Joint Venture of a binding contract for the acquisition of a deal, whether the Investor will also have the right to subsequently approve the closing of such deal.

Also, if the Operator has the right to incur pursuit costs on behalf of the Joint Venture without the Investor's consent, then the parties will need to address any limits on such right (including per-deal limits, time-period limits, and aggregate limits) and whether pursuit costs will be funded pro-rata based on the Operator's and Investor's respective percentage interests in the Joint Venture. Sometimes, to ensure that the Operator is not spending money imprudently, the Investor will require that the Operator bear a disproportionate amount of pursuit costs if the Investor does not ultimately approve the deal.

The parties will also need to address the timing and other mechanics of the approval process itself. Programmatic joint venture agreements often address:

- What materials need to be submitted to the Investor at the time its approval is requested;
- The time period for the Investor to respond;
- Deemed rejection or approval if the Investor does not respond within such time period (assuming all required materials have been delivered to the Investor); and
- The obligation of the Operator to update the information package before the final closing.

Some programmatic joint venture agreements go into great detail with respect to the approval process. However, given that every deal has a different dynamic and timing, it is often not practical for the Operator to comply with all the approval process requirements, and the parties need to be flexible to allow for the agreement to work in the real world.

GUARANTIES

In practically every real estate joint venture agreement, the parties need to determine whether creditworthy affiliates of the Operator, the Investor, or both, will be the guarantor under required deal guaranties (e.g., guaranties to lenders, ground lessors, and franchisors in hospitality deals). In a typical real estate joint venture, the joint venture entity itself has no net worth beyond its interest in a particular deal, so it is not an option for the joint venture entity to post such guaranties. But in a programmatic joint venture that acquires multiple deals with separate financings, it may be possible for the Joint Venture entity to ultimately be the guarantor (given that it should have net worth beyond its interest in any given deal).

As such, in a programmatic joint venture the parties may want to utilize a structure where: (i) they attempt to get the applicable counterparties to accept the Joint Venture entity as the guarantor; and (ii) if they are not successful, to have a designated party as a fallback guarantor. This may be of particular importance to the Operator, as it is the party that is typically required to furnish the required guaranties.

Some counterparties may accept the Joint Venture entity as the guarantor, but only after the Joint Venture entity achieves specified net worth and liquidity requirements. This is particularly challenging for the first few deals by the Joint Venture (before it has accumulated significant net worth). To address this, a structure can be created where the fallback guarantor executes the initial guaranties, but the Joint Venture has the right to replace such fallback guarantor on such guaranties with the Joint Venture entity itself once the Joint Venture satisfies the minimum financial requirements. There can also be a structure where the Joint Venture entity executes the guaranties initially but provides additional collateral (e.g., a collateral assignment of capital contribution obligations, cash collateral, or letter of credit) until the minimum financial requirements are satisfied. Under this structure, the Joint Venture entity may have a specified period of time to satisfy the minimum financial requirements (failing which, a replacement guarantor would be required).

If the Joint Venture entity is a guarantor, the same issues will arise as the Joint Venture approaches the end of its life and is selling off assets. In such instances, the Joint Venture entity will likely be required to provide a substitute guarantor or additional collateral or face a default situation.

In any instance where a party (or an affiliate of a party) to the programmatic joint venture agreement executes a guaranty, that party will want an appropriate indemnification agreement from the Joint Venture for liability under that guaranty (excluding certain "bad boy" liabilities that are triggered by that guarantor or its affiliate). But, for the reasons mentioned above, that may not be sufficient until the Joint Venture accumulates adequate net worth beyond the deal for which such guaranty is delivered. In those instances, the guarantor may insist that a creditworthy affiliate of the other party to the programmatic joint venture indemnify the guarantor for such other party's proportionate share of guaranty liability (again, excluding certain "bad boy" liabilities that are triggered by that guarantor or its affiliate).

ECONOMIC CROSSING/POOLING

In a typical real estate joint venture, the Operator will receive a disproportionate share of the profits (called a promote) after the Investor has received back all of its invested capital and a specified return on that capital. In a programmatic joint venture, the parties need to determine whether a promote will be calculated and paid on a deal-by-deal basis (as if each deal were a standalone investment), on the basis of multiple investments (but not the entirety of the Joint Venture's investments), or on the basis of the Joint Venture's aggregate investments over its life. A situation where a promote is tied to the performance of multiple investments is typically referred to as a "crossing" of that promote among those investments.

The Operator would of course prefer that the promote be calculated and paid on an investment-by-investment basis, so that, if any individual Joint Venture investment is successful, the Operator will receive a promote from that investment regardless of how the other investments by the Joint Venture perform. The Operator may argue that, in the absence of a programmatic joint venture, it would earn a promote on an investment-by-investment basis, given that there would likely be a separate joint venture agreement for each investment (and thus, by having any "crossing," the Operator is in a worse position). Conversely, the Investor would prefer to have the promote calculated based on the Investor's cumulative returns from the Joint Venture's aggregate investments over its life. This would protect the Investor from a situation where some of its profits from a good deal are paid to the Operator as a promote even when a Joint Venture's portfolio did not perform to a minimum standard.

A common compromise, particularly in a programmatic joint venture that is expected to acquire a large number of investments, is for the promote to be calculated and paid based on separate discrete pools of investments acquired by the Joint Venture. For example, in a Joint Venture that is expected to invest $300 million of equity over its life, the investments made with each incremental $100 million of Joint Venture equity would constitute a single pool (so that, upon investment of all the $300 million of allocated equity, there would be three separate pools). The Investor may want additional parameters to be satisfied before a new pool is created (e.g., a minimum number of separate investments in each pool, so that a single large investment does not comprise an entire pool). In a pooling scenario, the promote for all the investments in a particular pool would be crossed (i.e., the minimum thresholds to earn a promote would be calculated on an aggregate basis for all investments solely in that pool), but no pool would be crossed with another pool. Thus, if any particular pool is successful enough to generate a promote, the Operator would earn and be paid that promote regardless of the performance of all the other pools; so, there could be a situation where the Operator is paid a promote from one or more pools even though the overall returns from the Joint Venture do not achieve the minimum thresholds. In effect, under this type of arrangement, each pool is treated as a separate joint venture for purposes of calculating and paying a promote.

There can also a structure where a promote is calculated and paid on a pool-by-pool (or investment-by-investment basis), but if the Joint Venture's cumulative returns on its aggregate investments do not meet a certain minimum threshold, some or all of the promote must be repaid.

In a programmatic joint venture where there is any form of promote crossing, the Investor will likely want to be protected from a situation where the first few deals within the relevant pool perform well enough to generate a promote but there is still a possibility that the promote will not be earned on an overall basis (because there are other investments still held by the Joint Venture that are part of the same pool). For example, there could be a scenario where there are four investments in a promote pool and the first two are sold for a large enough profit for the Operator to earn a promote, but the second two investments perform poorly enough for the Operator not to earn a promote on an overall basis within that pool. At a minimum, the Investor will want the Operator to be obligated to return any promotes that ultimately are not earned (sometimes referred to as a claw-back obligation). The Investor may also want that claw-back obligation to be secured, whether by a personal guaranty from the Operator principals, an escrow of part of the promote that would otherwise be paid, or both. In addition, if, with respect to any pool, a capital contribution is required after any promote has been paid for that pool, the Investor may want that capital contribution to be funded on a "reverse waterfall" basis. This means that in addition to funding its typical pro-rata share of that capital contribution, the Operator must also return a portion of the applicable promote previously paid, so that the capital contribution is funded in the same proportion as the last distribution was made to Operator and Investor.

DEFAULT CROSSING

In a typical real estate joint venture, the Investor will have the right to remove the Operator as the day-to-day manager/managing member (the Manage) of the Joint Venture for cause. Cause usually includes bad acts by the Operator and its affiliates (e.g., fraud, gross negligence, willful misconduct, or criminal acts) but sometimes also includes, among other things:

- Breach of "key man" provisions (which are described below);
- Failure by the Operator to make a required capital contribution;
- Other ordinary defaults beyond notice and cure (sometimes with a materiality threshold); or
- Failure to achieve performance hurdles.

The consequences of such removal is often a loss of the Operator's promote (i.e., distributions of available cash to the Operator and the Investor revert to being based solely on the respective capital contributions made by the Operator and the Investor) and the right of the Investor to terminate Operator affiliate agreements (e.g., development agreements, asset management agreements, property management agreements), thereby resulting in a loss of future fees to the Operator and its affiliates.

The Investor's right to remove the Operator as the Manager of a programmatic joint venture raises several additional issues to consider. First is whether the removal is applicable across the Joint Venture's entire portfolio or only as to the specific properties to which the action giving rise to the removal right related. If the cause event is a "bad act," then the Operator will typically be removed as the Manager for the entire portfolio. If the cause event is something short of a bad act, the Operator may negotiate for the right to remain as Manager (or at least keep in place the fee earning Operator affiliate agreements) for the properties that were not the subject of the cause event.

The same issue arises with respect to the Operator's promote and whether such promote is lost for the entire portfolio after the Operator is removed as Manager for cause. It is particularly punitive for the Operator to forfeit its promote for an entire portfolio, especially if, because of the exclusivity requirements, the Operator is not permitted to conduct business outside of the programmatic joint venture during the exclusivity period. It is not uncommon for the Operator to lose its entire promote for the portfolio if the relevant cause event is a bad act (or at least one of the more egregious bad acts). But the Operator will often try to negotiate compromises short of a full promote loss in other cause event situations. These include:

- Loss of only a certain percentage of the promote (e.g., 50 percent);
- The calculation and "freezing" of the promote at the time of removal (based on the fair market value of the portfolio at the time of the cause event), with the Operator becoming entitled to that promote (as so calculated) upon a future capital event;
- A vesting of the promote over time (e.g., 25 percent per year), so that only the unvested portion of the promote (at the time of removal) is lost; and
- The right of the Operator to "crystalize" the promote after a certain period of time (i.e., the right of the Operator to determine what the promote would be at the time of crystallization, assuming the portfolio were liquated for a price equal to the then fair market value of the portfolio at the time), with no loss of that crystallized promote if there is a future cause event.

These compromises are negotiated on a case-by-case basis, with the outcome varying depending on many factors.

FEES

The Operator in a programmatic joint venture typically receives fees that are customary for all real estate joint ventures (e.g., as applicable development management fees, property management fees, and construction management fees). But in a programmatic joint venture, there may be a few fee categories that are beyond the typical real estate joint venture fees.

First, the Operator may request an "exclusivity" fee as consideration for its obligation to present all deals to the Joint Venture (and its other exclusivity obligations to the Joint Venture). The appropriateness of this fee depends on various factors, including the length of the exclusivity period, whether the Operator can invest in deals outside of the Joint Venture that the Investor rejects for the Joint Venture, and the nature of the other fees. The exclusivity fee is sometimes a percentage of the unused capital allocation for the Joint Venture (on the theory that the Operator will be compensated through other fees as investments are made), but it may also be a fixed fee. In any event, it is typically payable only during the exclusivity period.

Also, the Operator may have a better case to receive an asset management fee because of all the infrastructure that will be required to manage the Joint Venture's investments. These fees are sometimes based on: (i) a percentage of invested capital in the Joint Venture; (ii) a percentage of the net asset value of the Joint Venture's portfolio; or (iii) a percentage of gross receipts of the Joint Venture.

In addition to (or in lieu of) an asset management fee, the Operator may receive an accounting fee or similar fee to compensate it for the infrastructure that will be required to manage the accounting and other bookkeeping aspects of the Joint Venture.

Finally, because of the volume of deals and infrastructure needed to support acquisitions and dispositions, the Operator may negotiate for an acquisition fee for each purchase and a disposition fee for each sale. These are typically a fixed percentage of the purchase or sale price, as applicable.

Although there are sometimes asset management, accounting, acquisition, and disposition fees in ordinary real estate joint ventures, the Operator may have a better case for these fees in a programmatic joint venture, given the extensive time and infrastructure the Operator must commit to the Joint Venture to the exclusion of its other business and because of the potential downside to the Operator in crossing its promote across the entire Joint

Venture (or across pools) rather than being entitled to a promote on a deal-by-deal basis.

KEY PERSONS

A key person provision (i.e., a requirement that one or more key individuals be actively involved in the joint venture) is often included in ordinary real estate joint venture agreements, as the Investor wants to make sure that the individual(s) the Investor is relying on to oversee and manage the investment are appropriately involved in doing so. This can be of particular importance in a programmatic joint venture, given the substantial capital allocation of the Investor to the Joint Venture and the potential extended life of the Joint Venture as a result of it making multiple investments.

This can raise a number of issues to negotiate, including:

- Whether the key person requirement applies for the life of the Joint Venture or only during the exclusivity period or some other period (and, if there are multiple key persons, whether the key person requirement can be satisfied if less than all the key persons remain involved);
- What the consequences are if the key person requirement is breached (e.g., removal as Manager and/or loss of promote);
- Whether there is a distinction in the consequences between a breach of the key person provision due to death, disability, or retirement of the key person(s) and a breach, for example, for leaving to work for a competitor); and
- Whether the Operator will have a right to replace any key person with a substitute that is approved by the Investor (and, if so, what the standards are that apply to such approval).

DISPUTE RESOLUTION AND EXIT RIGHTS

Dispute resolution and exit rights are key concepts that need to be negotiated in any real estate joint venture agreement, and there are several important considerations for these in programmatic joint ventures.

Many joint venture agreements contain a buy-sell provision to break deadlocks and effectuate a “divorce” between the partners. A buy-sell provision is a mechanism that allows the implementing party (the “initiator”) to set a value for the joint venture’s assets. The other party must elect to either: (i) sell its entire interest in the joint venture to the initiator; or (ii) buy the entire interest of the initiator in the joint venture, at a price based on the value set by the initiator. This is designed to keep the initiating party honest, as it does not know if it is going to have to sell or buy at a price based on the value it sets.

However, for various reasons, a buy-sell provision may not work in a programmatic joint venture. It may be unworkable to the Operator because the Operator may not have access to the level of capital it would need to buy out the Investor, leading to a situation where the Investor can game the system by initiating the buy-sell provision and setting an artificially low price (knowing that the Operator will need to be a seller). This is a potential issue in every joint venture agreement, but it is exacerbated in a programmatic joint venture because of the potential scale of the Joint Venture’s assets and the amount of capital the Operator would require to effectively buy all those assets at the same time. A buy-sell provision may also be unworkable to the Investor. The Investor may not have access to the necessary funds to buy out the Operator because the Investor may be an investment fund that will be near the end of its life at some point during the Joint Venture (thus not allowing it to call capital at that point). Also, the asset class may be such that the Investor cannot own it by itself, or the Investor might be concerned that it could have a difficult time procuring an adequate replacement operator.

A forced sale provision is another mechanism in real estate joint ventures that is sometimes used to resolve disputes and/or allow a party to exit the joint venture. A forced sale provision allows a party (usually after a set “lock out” period) to sell the joint venture’s assets (usually a single property) to a third party without the consent of the other party (but sometimes with a right of first offer in favor of the other party). This can be more difficult to implement in a programmatic joint venture because the Joint Venture likely owns multiple assets. Thus, the parties need to determine whether the forced sale will apply: (i) only to a sale of all the assets in a single sale; (ii) on a property-by-property basis with multiple potential sales; or (iii) only to certain groupings of properties (e.g., properties in a single geographic location) that must be sold together. As part of this analysis, the parties need to consider whether the Joint Venture's assets could be worth more if sold as a single portfolio (rather than through a series of individual sales); whether the portfolio is too large to attract enough competition to maximize value; and whether there are other similar considerations. The parties also need to determine what an appropriate lock out date will be for the forced sale provision, given that the Joint Venture's assets will likely be acquired over an extended period.

CONCLUSION

Although this article is not intended to address every possible issue that will need to be negotiated in a programmatic joint venture, it is a summary of the issues that the author frequently encounters in these types of joint ventures. For the reasons discussed in this article, these issues require careful thought and attention to make them work for both the Operator and Investor, often resulting in a lengthier and more difficult negotiation than a typical real estate joint venture.