

TRANSACTIONAL REAL ESTATE

Defining Control In Transfer Restrictions



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One of the most heavily negotiated provisions in any real estate transaction agreement is the transfer provision. Transfer restrictions are a significant focus in documenting joint ventures, loans and even dispositions of real estate.

The typical real estate joint venture consists of an operating partner that provides management services and expertise and a financial partner that provides most or all of the equity. The parties care deeply about the identity of their respective partners—the financial partner is invested in the experience, skills and integrity of its operating partner and the persons who control it, and the operating partner is relying not only on the resources of its financial partner but also, in many cases, on the financial partner's perceived reasonableness and responsiveness in granting or withholding consents and approvals.

Similarly, a real estate lender assesses the merits of a potential loan based not only on the projected economics of the financed property, but also on the experience, wherewithal and reputation of the borrower and its principals. Even in the disposition context, a seller is often concerned that a buyer will “flip” a contract to an unaffiliated third party for a profit and wants a restriction as a way to share in that profit. Thus, while each party to a transaction wants the utmost flexibility to assign its own position, that party will generally want to limit the other parties' ability to freely assign their interests.

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Most real estate transaction agreements rely on the concept of “control” in restricting or permitting transfers of the counterparty's interest or the transfer of direct or indirect interests in the counterparty. Thus, a transfer to an “affiliate”—which is often defined as an entity controlled by, controlling, or under common control with the counterparty—is often permitted. By the same token, a change in control of a party—such that it is no longer controlled by the same individuals or entities which controlled the party at the inception of the transaction—is often prohibited. “Control” is not always defined in the agreement, and when it is, it is typically defined by reference to the power to direct the management and policies of an entity or the right to elect a majority of the directors (or individuals acting in a similar capacity) of an entity. Even where the agreement contains a definition of “control,” issues can arise as to who controls an entity and, consequently, whether a particular transfer will be permitted.

The Continuum of Control

The degree of control in a real estate joint venture rests on a continuum, with total control by one joint venture member on one end and 50-50 control, where all decisions must be agreed on by the venturers, on the other. Even at the extreme ends of this continuum, however, without a detailed definition of control, there can be uncertainty as to who controls an entity for purposes of a provision restricting assignment. For example, in a joint venture with shared control, what happens when one party buys the interest of the other party pursuant to a buy-sell provision or otherwise? Does such an acquisition of the interest of a partner with

whom control was shared constitute a change of control? A more common example demonstrating the difficulty of determining the controlling party occurs when a party enters into a joint venture with a financial partner and grants that partner veto rights, or even affirmative control, over certain major decisions. How much control, and over what kinds of decisions can that financial partner exercise before a transfer of its interest constitutes a change in control for which the consent of a lender or other counterparty would be required?

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Legal Framework

There is very little case law involving disputes over the definition of “control,” whether in the real estate joint venture context or otherwise. Nevertheless, when confronted with a dispute regarding “control,” courts can be expected to first look at the provisions of the applicable documentation.

Based on the limited case law that exists, courts will look primarily to what the parties provide in the agreement, but will also consider the specific factual circumstances of the case. In *Beverage Distributors v. Miller Brewing*, the defendant, MillerCoors, argued that the “Court should decide all factual issues...concerning

who has 'real control' of its operations based on the language of the... agreements, and nothing else."¹ The court disagreed, deciding that discovery would be required to determine "the real world operations of [MillerCoors] and not just the way its operations are defined on paper."² While the facts of the *Beverage Distributors* case are not directly on point,³ the case demonstrates that the control issue can become quite complicated and may require a detailed inquiry into the operations and management of the entity in question. In determining the scope of discovery for the issue of who had control over MillerCoors, the *Beverage Distributors* court considered both day-to-day management control as well as control over strategic decision-making to be relevant.⁴

Ultimately, case law does not provide significant guidance as to the meaning of "control" in the real estate joint venture context, in part because it is such a fact-specific determination and in part because there are surprisingly few reported cases in this area. In the case of many corporations, the entity's structure provides fairly clear indicia of control because one can look to the ownership of voting shares and the control of the board of directors (although issues can arise even in the corporate context where no single shareholder or related group of shareholders own a majority of the voting shares).⁵

However, real estate joint ventures and other real estate owners are typically limited liability companies and partnerships that are governed by contracts, and those contracts can be heavily negotiated—and therefore fairly complex—as they relate to the management of the entity and the parties' decision-making rights. For example, the operating partner may have the right to manage the day-to-day affairs of the entity, but only in accordance with budgets and operating plans approved by the financial partner. In addition, the financial partner typically has approval rights over such major decisions as sales, financings, and major leases and other contracts.

The financial partner may also have the right to initiate actions on behalf of the joint venture entity (for example sales and financings), whether or not these actions are proposed by the operating partner and whether the operating partner agrees or objects. There is no prototypical joint venture in this respect, and the permutations are numerous given the many possible economic structures and the particular requirements of different counterparties based in part on their level of investment. In view of these varying degrees of control, defining control in real estate joint venture agreements and loan agreements can be a nuanced and fact-intensive endeavor.

The lack of clarity in this area is a vexing problem for investors, as the stakes for violating a transfer provision are often high. In the context of a joint venture, it can mean loss of management rights; in the context of a disposition, it can mean termination of the contract and loss of the deposit; and in the context of a loan, it can mean not only an event of default, but also full springing recourse for loan guarantors.

How much control, and over what kinds of decisions can that financial partner exercise before a transfer of its interest constitutes a change in control for which the consent of a lender or other counterparty would be required?

Practice Tips

Since the case law does not provide guidance regarding what control means when it is not clearly defined in an agreement, it is all the more important to consider this question beforehand. A more specific transfer provision provides greater guidance for the courts, and more importantly, is more likely to lead to amicable resolutions of disputes.

Parties often negotiate to have buy-sell or other rights pursuant to which one partner may purchase the interest of another recognized (and permitted) by lenders or other transaction counterparties. This is particularly important for a minority operating partner; the operating partner would be acquiring a majority interest in a buy-sell and would be more likely to violate a transfer restriction than the financial partner buying a minority interest. The integrity of a buy-sell is compromised if one of the two partners is unable to be the buyer, and thus it is essential to preserve the operating partner's right to purchase the financial partner's interest. Similarly, a financial partner needs to have the right to exercise its buy-sell rights without violating a transfer restriction that is predicated on joint control or on the operating partner's day-to-day management of the venture.

Parties often attempt to draft transfer restrictions to make it clear that the right to exercise veto rights over major decisions does not constitute control, though lenders are often resistant to making this accommodation without the opportunity to evaluate the scope of the veto rights. In a common iteration of a transfer provision in a loan agreement (which is typical in commercial mortgage backed securities (CMBS) loans), a lender will permit the transfer of up

to a 49 percent interest in a borrower so long as the original principals continue to control. Very few investors would be willing to acquire a 49 percent interest in a venture without at least some consent rights over major decisions.

Given this business reality, it would be difficult for a lender to argue that an express provision permitting the 49 percent investment did not imply some level of major decision rights. The difficulty for the principals, in the face of default and full springing recourse, is becoming comfortable that the level of investor consent rights in a particular transaction does not negate the control held by the 51 percent equity owners. If possible, it is prudent to at least make a distinction in the transfer restriction between day-to-day operations, which is more likely to stay with the existing principals, and major venture actions and decisions.

In addition, parties can attempt to draft a transfer provision to allow for consent rights over major decisions that are generally, taken as a whole, consistent with the market for similar investments. With these two clarifications, it is easier to structure a joint venture—and to permit transfers of interests in the joint venture—with some comfort that transfer restrictions in a loan agreement are not being violated.

Because the case law does not provide a clear understanding of what "control" means in the joint venture context but rather suggests that it is a fact-specific, case-by-case determination, enhanced clarity in drafting transfer restrictions in transaction agreements would seem to benefit all parties involved. However, the counterparty in favor of which the restriction runs, such as a lender, may refuse to accept such clarification given that the uncertainty is likely to inhibit a party's willingness to effect transfers without seeking the counterparty's consent. Consequently, the parties should seriously consider what benefits and risks accrue by defining "control" with specificity and should act accordingly.



1. 2009 WL 1542730, at *4 (S.D. Ohio).

2. *Id.*

3. The court was interpreting the term "successor manufacturer" under an Ohio statute. *Id.* at *2. The factual issue of control was relevant because MillerCoors could not be a "successor manufacturer" if there was no real change in control after MillerCoors was formed by two joint venture partners. *Id.*

4. See *id.* at *1, *6 ("[I]n the Court's view, the most relevant discovery is that which focuses on the day-to-day operations and decision-making at MillerCoors").

5. See *In re Adelpia Commc'ns*, 287 B.R. 605, 615 (Bankr. S.D.N.Y. 2003) (suggesting that the ability to exercise "voting power in connection with the membership of [the] board of directors" is an important element of control).