law.com™

New York Law Journal

MONDAY, MARCH 25, 2002

REAL ESTATE AND TITLE INSURANCE TRENDS

Joint Venture Exit Mechanisms Allow Partners to 'Cash Out'

BY MITCHELL L. BERG,
PETER E. FISCH
AND MARCI I. GORDON

THE PARTNERS of a real estate joint venture generally seek to balance their desire to maintain an unfettered right to transfer their joint venture interests with their desire not to saddle the venture with troublesome or undercapitalized partners.[1] A prior article examined the extent to which certain mechanisms commonly employed by joint venture partners to exit real estate joint ventures — rights of first refusal, rights of first offer, drag along rights and tag along rights — achieve this balance.[2] This article examines other exit mechanisms used in real estate joint venture agreements. In particular, this article analyzes exit mechanisms that enable partners to "cash out" of a joint venture without the negotiation of a third party sale.

The "put" and "call" provision is one example of this type of exit mechanism. A put right provides a partner (the "selling partner") with the right to sell its interest in the joint venture to the other partner. In a put and call provision, the put right is coupled with a call right which entitles the other partner to acquire the selling partner's interest at a price equal to or greater than the price at which the put may be exercised. A put right may be present in a joint venture agreement without a corresponding call right, but often the call right is the quid pro quo necessary for the selling partner to obtain the put.

The put provision provides an effective exit mechanism for minority partners with minimal management rights, who may encounter difficulty in finding a third party buyer for their interests and who may wish to dispose of their interests without waiting for the majority partner to sell the underlying assets. While the call provision is not a true exit mechanism, since it cannot be triggered by the partner who wishes to transfer its interest, it may indirectly facilitate an exercising partner's exit by giving that partner complete control over the sale of the entire asset.

Mitchell L. Berg *and* **Peter E. Fisch** *are partners at Paul, Weiss, Rifkind, Wharton & Garrison*. **Marci I. Gordon** *is an associate at the firm.*

The put and call provision may also be appropriate in the case of a partner who had a pre-existing interest in the real estate held by the joint venture, and who chose not to sell the real estate outright but elected instead to retain a passive interest in the asset for a period of time in order to defer capital gains or other tax consequences or to participate in appreciation of the asset. In such a case, the put and call can serve as a means of cashing out that partner (either at its own election or at the election of its co-venturer) once the requisite period of time has expired.

The put provision provides an effective exit mechanism for minority partners with minimal management rights, who may encounter difficulty in finding a third party buyer for their interests and who may wish to dispose of their interests without waiting for the majority partner to sell the underlying assets.

Although the put provision assures a partner the right to transfer its interest in the joint venture, this exit mechanism raises issues that must be addressed by the co-venturers and their counsel.

Pricing Issues

A major concern raised by the put and call provision is the price at which the venture interests will be transferred. Unlike rights of first refusal and rights of first offer, the price is not based on a third party offer — which would provide a reflection of market conditions — or on a venturer's perception of market conditions.

Put and call provisions often price venture interests at a price set forth in the joint venture agreement or determined by a formula (e.g., based on a target rate of return or discounted cash flows) or by an appraisal. It is not possible for partners to predict accurately in a joint venture agreement what market prices will be at the date of the exercise of the put or call. If the partners state a fixed price or set forth a formula for determining the price in the joint venture agreement, a selling partner may be forced to sell its interest at a below-market price when the selling partner needs to dispose of its interest in order to raise cash or when the other partner decides to exercise the call. Conversely, the non-exiting partner is at risk that the selling partner will exercise its put right at a time when the price set by the joint venture agreement is above the market price.

Pricing joint venture interests by appraisal (or a formula similar to an appraisal) helps to insure that the selling partner will receive fair value for its interests. However, valuing interests by appraisal presents different issues relating to the cyclical nature of the real estate market. For example, the selling partner will be at risk of being cashed out of the venture at an unduly low price if the other partner exercises its call right at a point when the market is depressed, and the non-exiting partner will be at risk of being forced to purchase the selling partner's interest at a premium if the selling partner exercises its put right when the market is booming. The partners may reduce this risk by negotiating for the right to defer the appraisal date, with the hope that the market will be more in balance at the deferred date.

A put or call provision that includes an appraisal mechanism must also contemplate whether the appraisal will value the partner's interest in the venture or the partner's share of the assets held by the venture. Minority interests in a venture will often be appraised at a value lower than the minority partner's share of the value of the venture's real estate in order to account for the partner's lack of control. The joint venture agreement should also specify the length of time within which an appraisal must be completed, the mechanism for selecting appraiser(s), the allocation of the costs of the appraisal, and the factors to be considered by an appraiser in valuing the joint venture assets or the interest of the exiting venturer.

Non-Cash Consideration

Another risk inherent in the use of a put provision is the possibility that the non-exiting partner will not have sufficient cash to acquire the selling partner's interest in the venture. This risk can be addressed by providing for a promissory note as payment for all or a portion of the selling partner's interest. However, in agreeing to defer the purchase price by accepting a promissory note, the selling partner compromises its objective of selling its interest in order to raise immediately available cash and, in addition, assumes the risk of collection from the non-selling partner (a risk that can be somewhat mitigated by taking a security interest in the transferred interest or other collateral).

Accepting a promissory note from the non-exiting partner may also result in the selling partner's receiving a lower return on its investment than if it had retained its joint venture interest. From the selling partner's perspective, the promissory note should provide a higher interest rate than the rate of return on the selling partner's investment in the venture, but it is often difficult for the parties to predict accurately the appropriate rates of return.

The use of non-cash consideration as payment for the selling partner's interest raises special issues in joint ventures in which one partner (the "publicly traded company") is a publicly traded real estate investment trust or other public company, or an entity with interests that are convertible into shares of a publicly traded company. In such a joint venture, the publicly traded company may have the right or obligation to exchange its shares for all or a portion of the selling partner's interest in the venture. This mechanism creates the risk that the selling partner will be subject to a call when shares of the publicly traded company are trading at the high end of their range, and that the publicly traded company will be subject to a put when shares are trading at the low end of their range.

The use of caps, collars, floors and other techniques for protecting the parties from fluctuations in share prices is beyond the scope of this article, as is compliance with federal and state securities laws governing the sale of the shares received by the selling partner, but these matters should be considered by the practitioner where publicly traded shares are used as currency for a joint venture interest.

Buy-Sell Provision

A "buy-sell" provision may also be used to allow a partner to exit a joint venture without negotiating a third party sale. A buy-sell mechanism provides that a partner will offer to buy the other partner's interest in the joint venture or to sell its own interest in the venture, in either case at a price based on a valuation of the joint venture's assets specified by the initiating partner or determined pursuant to appraisal or some other mechanism. The responding partner will then have the right to determine whether to sell its interest to the initiating partner or to purchase the initiating partner's interest for the specified price.

Although in real estate joint ventures the buy-sell provision is typically used as a mechanism for dealing with intractable disputes among partners — and therefore may often be triggered only when an impasse has arisen regarding a significant partnership decision — it can also be used purely as an exit mechanism. Its use for this purpose is unreliable, however, because the decision whether to buy or sell lies with the responding partner, and thus the initiating partner may find that it is obligated to buy out its partner rather than to sell its own joint venture interest. Although the initiating partner will, upon buying its co-venturer's interest, own 100 percent of the underlying real estate and will therefore hold a more liquid asset than its former joint venture interest, it will still need to raise the cash in order to meet its purchase obligation.

The use of the buy-sell as an exit mechanism also poses pricing issues. Where the purchase price is based on an amount prescribed by one partner, unfair results may ensue. The initiating partner may fix the price at which the interest will be bought or sold at an artificially low level — and therefore force out its partner at a depressed price — if the initiating partner is aware that the other partner does not have the cash to elect the "buy" option rather than the "sell" option. The responding partner may be protected if it is permitted to tender a promissory note for the venture interest; however, the delivery of a promissory note raises the previously discussed problems relating to the deferral of receipt of cash, applicable rate of return and enforcement of payment. Another technique that will help a less financially able responding partner to avoid being squeezed out of the venture is an option to extend the period during which it may elect to exercise its right to buy or sell or to close the transaction, enabling it to seek the financing necessary to buy out the initiating partner.

Joint venture partners must also be aware that in cases where the buy-sell was intended exclusively as a means of dispute resolution, one partner may attempt to convert it into an exit mechanism by manufacturing or intentionally prolonging a dispute. Practitioners can reduce the risk of this manipulation of the buy-sell by providing that only disputes with respect to enumerated major decisions under the joint venture agreement will trigger the buy-sell or that the buy-sell will be available only after a specified period of time or after the parties have attempted to resolve their dispute in some other fashion.

Other Considerations

In addition to the points already addressed in this article, practitioners should consider whether exit mechanisms such as the buy-sell or put and call should only be available to partners after the expiration of a lockout period during which the partners may not transfer their interests. A lockout period should be long enough to achieve the objectives that require the continued participation of the initial partners — for example, the completion of construction or stabilization of a project, the completion of an acquisition that involves multiple parcels of real estate, or an agreed-upon period of tax deferral.

The joint venture agreement should also provide that any arrangements that are associated with a partner's interest in the joint venture will terminate upon the exit of that partner. The non-exiting partner must have the right, for example, to terminate management or other agreements with affiliates of the selling partner. Likewise, the parties may wish to provide that neither partner will be subject to any exclusivity or other limits on competition once it or the other partner exits the venture.

(1) References in this article to "partners" apply equally to members of limited liability companies, with respect to joint ventures that are limited liability companies.

(2) Mitchell L. Berg and Peter E. Fisch, "Options Vary on Exiting Joint Ventures," *New York Law Journal*, *Real Estate Board of New York* special section, at S12, Jan. 8, 2002.