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OPTIONS VARY ON EXITING JOINT VENTURES

MITCHELL L. BERG - PETER E. FISCH

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An important consideration in forming any real estate joint venture is the ability of the joint venture partners[1]† to exit their respective investments. The identity of the joint venture participants and what each contributes to the joint venture are critical to its success. As a result, many joint venture agreements limit or prohibit transfers of interests by partners, and where transfers are permitted, a non-exiting partner will often seek to control the identity of any new co-venturer, particularly in a situation where the exiting partner has any consent or veto rights over management decisions.

Even with free transferability of interests, the potential difficulty of locating a transferee who will be willing to live within an existing joint venture structure complicates a partner's ability to exit a joint venture (or may, at the very least, result in a discounted price for the joint venture interest). While the unilateral ability to cause a sale of the property will eliminate this complication, joint venture agreements commonly place restrictions on the ability of one partner to cause a sale of the assets of the joint venture.

A variety of exit mechanisms are commonly used to balance the conflicting goals of free transferability at maximum value, and the remaining venturer's wish not to be saddled with a difficult or uncreditworthy partner. Each partner must carefully consider the options. A hard fought exit right may one day be used against its proponent. This article examines several common exit strategies employed in real estate joint ventures.

Right of First Refusal

In many joint ventures, all parties may benefit from deferral of the availability of any exit mechanism. For example, in a development joint venture, the developer partner may wish to require that the "money" partner remain in the venture in order to provide necessary financial muscle in the event of cost overruns or delays. The "money" partner may deem that the developer partner, having construction expertise and familiarity with the project, is critical to bringing the project in on time and on budget.

The parties may also be bound by completion or credit guarantees that further complicate their own exit. Even after completion, it might be in the interest of both parties to defer an exit by either party until the project reaches stabilization. Under these circumstances, the parties will sometimes agree to a 'lock-out' period during which transfers of the joint venture assets or joint venture interests are prohibited without qualification and without the availability of any agreed-upon exit mechanisms.

Perhaps the most common exit mechanism used in real estate joint ventures is the right of first refusal (ROFR) which gives the partner desiring to exit the joint venture the ability to transfer its interest to an identified third-party buyer on terms and conditions specified in any contract, term sheet or letter of intent, subject to the right of the other party to purchase the interest by matching the term of the third-party offer. The ROFR offers the benefit of allowing the non-initiating partner to remain in the joint venture under all circumstances.

The ROFR is not without its infirmities. A partner that expects to be in a selling position should be concerned about the chilling effect the ROFR can have on the marketing of its partnership interest. A prospective purchaser may be reluctant or unwilling to spend resources doing its due diligence investigation and negotiating the acquisition, only to lose the deal after an agreement is reached. A prospective purchaser may require a 'break-up' fee from the exiting partner, which erodes the exiting partner's return unless the agreement permits it to be passed on to the other partner or to the joint venture. The chilling effect may be exacerbated if the time periods for response in the ROFR are too long.

Also, the ROFR confronts the non-selling partner with the choice either to buy the interest being sold (which may not be feasible or desirable) or let it be sold to a third party that might not be an acceptable partner. Often, the non-selling partner will not agree to a blanket transfer right if the ROFR is not exercised, retaining a limited (such as reasonable) approval right over the incoming partner. Alternatively, the parties may agree in advance upon a set of parameters (e.g., relating to the financial status, experience and reputation of the transferee) defining a permitted transferee. However, once these parameters or an approval right are introduced into the procedure, the usefulness of the ROFR as an exit device is compromised.

Interests in a joint venture are generally less marketable than the entirety of the partnership interests or the partnership property itself, and a sale of a portion of the interests is likely to generate fewer proceeds to the exiting partner than its share of the proceeds of an asset sale. In another less common variation on the ROFR, one partner may obtain a bona fide, third party offer for the joint venture property and present it to the other partner. The non-initiating partner then has the right to buy the property from the joint venture on the same terms or buy out the initiating partner at the amount the initiating partner would have received had the property been sold at the offered price and the joint venture liquidated.

This mechanism has the advantage of offering the asset rather than a joint venture interest for sale. Furthermore, by using the liquidation provision to establish the price, existing partner loans, distribution priorities and the like automatically get taken into consideration. However, a property ROFR suffers from the same chilling effect on marketing as the ROFR involving interests. It also forces the non-initiating partner either to buy, which may not be feasible, or to have its interest liquidated when it would not otherwise have desired to do so.

Right of First Offer

A right of first offer (ROFO) avoids the marketing issues present with the ROFR and its variations. The selling partner may deliver a first offer notice to the non-selling partner setting forth the material economic terms upon which the selling partner would sell its interest to the non-selling partner. The non-selling partner has a specified period during which to accept or reject the offer.

If the offer is accepted, the partners proceed to close the sale on the terms set forth in the offer (and as further negotiated between the parties). If the offer is rejected, the selling partner is free to market its interest to third parties on the terms set forth in its offer. To keep the selling partner honest in formulating the terms, the selling partner will be required again to comply with the first offer notice requirement if it does not complete a transaction substantially on the offered terms within a prescribed period of time (e.g., six to 12 months), or if the selling partner can only complete the transaction on terms that are materially more favorable to the buyer than those in the offer notice.

The ROFO allows the selling partner to market its interest virtually unencumbered (except for the prescribed economic parameters), and the chilling effect of the ROFR is avoided. However, because of the lack of a bona fide, third-party offer, the ROFO creates economic uncertainties as to the terms of sale. The selling partner must make a decision as to where to set the price. A low price will likely result in the selling partner leaving some value behind if the ROFO is exercised, while a high price may result in the selling partner being unable to obtain the price required by the ROFO (thus requiring the selling partner once again to request the approval of the non-selling partner after the market sets the price). Moreover, the ROFO offers no cure for the issues relating to the identity of the assignee.

The ROFO may also be implemented with respect to a sale of the joint venture's property rather than a sale of joint venture interests. This eliminates both the "chilling" effect and concerns about the transferee's identity although it does require the non-initiating partner either to purchase or to accept a sale of the property and liquidation of its interest as discussed above.

Drag Along Right

Another exit mechanism is the so-called "drag along" provision. Under this provision, a selling partner can compel the non-selling partner to participate in a joint sale of the parties' partnership interest. The drag along right, which resembles the right to cause a sale of the joint venture property in that it involves the sale of 100 percent of the partnership interests and therefore eliminates any discount for lack of control, can be based on a bona-fide third party offer, as in an ROFR, or without such an offer, in which case it resembles a ROFO. The drag along right is sometimes coupled with a right of the non-selling party to purchase the interest of the selling party on the terms of the third party offer. This effectively is an ROFR, and raises all of the issues raised by the ROFR.

No exit mechanism is a panacea, and the drag along has its drawbacks. When not coupled with a buyout right, it is particularly harsh for the non-selling partner, forcing it to sell its interest on terms that it may not find acceptable without an adequate alternative. Even when a buyout right is present, the non-selling partner is forced as in the case of a sale of the joint venture property coupled with a buyout right, either to buy or to sell, rather than being permitted simply to ride its interest. The non-selling partner may be required to sell at a price it considers too low or at a time that it considers to be inopportune unless it can raise the funds necessary to buy the selling partner's interest.

The "flip side" of a drag along right, and one that often accompanies a drag along right, is a tag along right. The tag along is especially important in partnerships where a minority partner has no other effective means of exit. A tag along requires the selling partner to give notice of any sale of its interest to the non-selling partner. The non-selling partner may participate by including its interest in the transaction. If the buyer is unwilling to buy all of the interests, the selling partner may, under the joint venture agreement, no longer be required to complete the sale, although if it does the tag along right should provide for sale of a ratable share of each partner's interest.

The universe of exit mechanisms in real estate joint ventures is too great for the scope of this article. Other mechanisms include a buy-sell provision (used more often to deal with intractable disputes between partners regarding joint venture governance), put and call rights, and the right of one partner to sell the partnership assets provided that the sale will yield the non-initiating partner a threshold investment return.

Drafting Issues

In drafting agreements providing for ROFRs, ROFOs, and drag along and tag along rights, practitioners should be cognizant of certain issues that repeatedly arise in negotiating these provisions.

Parties must consider appropriate remedies for default by a partner who has exercised its ROFR or ROFO or is being dragged along in a sale. A partner exercising an ROFR or a ROFO may be required or permitted to deliver a deposit to the initiating partner, which will be paid to the other partner as liquidated damages in the event it defaults on its purchase obligation. Other remedies may include the loss of rights of first refusal or first offer with respect to future transactions, loss of management and consent rights in the joint venture and a call right in favor of the non-defaulting partner, perhaps at a discounted price.

The joint venture documentation should make clear that the exit mechanisms are binding on assigns of the original partners. In addition, a common point of negotiation is whether a defaulting partner may exercise its rights under the exit mechanisms, and thought must be given as to the interaction with other provisions of the joint venture agreement, such as a squeeze-down arising from a capital call default.

To the extent the various exit mechanisms provide for determination of the purchase price payable to an exiting partner based on what such partner's distributive share would be in a sale of the partnership assets, it is important to provide for deduction of imputed costs so the interest of the selling partner is not overvalued. For example, a buyout right might provide that a selling partner will receive what it would have received as a liquidating distribution in the event the partnership property were to be sold after deducting imputed brokerage commission, transfer taxes and other closing costs, even when these costs would not otherwise be payable solely on account of the transaction. The non-selling partner will have to incur these expenses in order to realize the value of the partnership asset, and imputing these costs permits the non-selling partner to pass an equitable portion of the costs on to the exiting partner.

On the other hand, in evaluating a third-party offer under an ROFR that involves the payment of brokerage commission, the agreement should recognize that such commission may not be payable if the offeree partner accepts the offer, and an appropriate sharing of the savings should be provided. In addition, the parties must deal with non-cash consideration in third-party offers, either prohibiting offers with non-cash consideration or providing a mechanism for valuing such consideration for purposes of meeting the terms.

Since a sale of both partners' interests pursuant to a drag-along consists of two separate transactions, the partnership agreement should require that each party execute and deliver such assignment and other documents as are necessary to effectuate the sale, and the parties should consider giving the initiating partner a power of attorney for such purpose. In addition, the agreement should provide that expenses of the sale will be paid out of the joint proceeds of the sale of partnership interests.

The parties' respective obligations to make representations and warranties regarding the property and the partnership should also be addressed. If liability for breaches of representations is to be joint and several, as is often the case, the parties may wish to require that a portion of the consideration received by the parties be placed in a reserve in order to satisfy potential claims. In the sale of one party's interest in the joint venture to the other, the parties should address whether, and in what proportion, contingent liabilities of the joint venture at the time of sale are to be shared.

Non-managing venturers must make sure that any agreements between the joint venture and the affiliates of the managing venturer (such as management agreements) are terminable without penalty by the joint venture in the event of a purchase by the non-managing venturer of the managing venturer's interest or the sale of such interest or the property to a third party.

Exit mechanisms in joint venture documentation may be rendered ineffective by covenants in the joint venture's financing agreements. Often, a lender's standard transfer restrictions will prohibit the sale of a joint venture interest pursuant to the operation of a ROFO or an ROFR, and unless the property will be refinanced in connection with the transfer (which could still present a problem in the event of a prepayment lockout or premium), the parties may find that the exercise of their exit or buyout rights under the joint venture agreement is impermissible when the appropriate exceptions have not been included in the financing agreements.

While a lender is unlikely to give the partners carte blanche to bring in any successor partner, the lender may agree to the limited approval rights or parameters for approval discussed above. The lender may also agree to permit one partner to buy out the other unless one of the partners is critical to the operation of the partnership (for example, a developer partner). If a partner or its affiliate has guaranteed the joint venture's debt, the buyout of that partner pursuant to a ROFO or an ROFR will need to be accompanied by a release of the guaranty, if the lender is willing to give one, or an indemnity by the purchasing partner or a creditworthy affiliate in favor of the guarantor.

Mitchell L. Berg and Peter E. Fisch are partners in the New York office of Paul, Weiss, Rifkind, Wharton & Garrison.

FootNotes: [1]

††† References in this article to "partners" apply equally to members of a limited liability company, with respect to joint ventures that are limited liability companies.