Sector Focus

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When real estate joint ventures go bad

KEY POINTS

- Real estate joint ventures are on the increase as a means of financing acquisitions and developments, often proving a structure for overseas investors to work with local property owners or project experts.
- Getting the structure right is vital and requires consideration of the practical issues which may arise should the relationship break down.
- If a joint venture participant or vehicle becomes insolvent an early review of the joint venture agreement and any third party funding arrangements is important for insolvency practitioners or other participants seeking to extract value from the joint venture.

Real estate joint ventures (JVs) are of growing importance. In no small part due to the decreased availability of bank finance and the wave of overseas capital, recent years have seen the real estate industry increasingly turn to JVs as a means of financing acquisitions or development projects. The majority of real estate JVs operate smoothly. However, building the right relationship involves understanding the other party's objectives and expectations, which can be challenging, particularly if they are from another culture. Complexities do, of course, arise if the relationship goes wrong.

As real estate JVs become more common, insolvency practitioners are encountering them with increasing frequency. This year has seen reports of JV vehicles being put into administration, having fixed charge receivers appointed over their assets and being declared bankrupt in a Helsinki court.

REAL ESTATE JVS' STRUCTURE

Real estate JVs may be formed to deal with a single site or development phase or may relate to multiple sites or developments. Whilst they may be purely contractual, many involve the formation of a vehicle for the project. This may be an acquisition vehicle for parties to the JV, or there may be a partial syndication by a property's existing owner. Although no two JVs are structured and operated in the same way, they often involve an investor who provides the capital working with a local operator who supplies expertise or regional knowledge. In particular, we are seeing overseas sovereign wealth funds partnering with UK REITs which own development sites and have the required expertise.

The choice of structure is likely to have been driven by tax, regulatory issues and the importance of limiting liability. Typically, JV vehicles take the form of limited companies (which may be offshore), offshore unit trusts, limited liability partnerships or English limited partnerships. The latter structure has a number of advantages, including tax transparency (which is key for overseas or tax exempt investors), limited liability and flexibility, albeit at a higher cost than a limited company. Part of the cost will be the appointment of a single purpose limited liability company as general partner, to manage and control the business, of whom the JV parties will be shareholders or directors.

The JV relationship may be regulated by a specific JV agreement, a shareholders' agreement or the JV vehicle's articles of association.

EXIT PROVISIONS

Problems can arise if the JV parties did not fully consider the practicalities of the JV's structure. Exit provisions are worth considering very carefully: when a party wants to get out, it wants to do so quickly. Disputes around this can paralyse the JV vehicle and destroy value.

Contractual provision may be made for a voluntary exit, whether by way of a sale of a party's JV interest or the underlying assets. A party's JV interest may extend beyond shares in the JV vehicle to include an interest in associated documentation. The parameters of any sale, and whether the other JV party is to have a right of pre-emption, are important to establish at the outset. For example, the developer maybe looking for a quick exit whereas the overseas fund is making a long term investment. The exit provisions may provide for a right to match any third party offer, "Texas shoot-out" provisions (which involve the submission by the JV parties of sealed bids to buy the other party's interest) or a reference to independent valuation.

The JV parties may not have considered how the exit provisions are to be enforced (say, by the transfer of shares or the removal of directors) should one of the JV parties not to cooperate with their exercise or how that could affect the underlying asset. If the JV vehicle is, say, an Italian company, its directors will be subject to Italian legal duties and procedures and any enforcement of a transfer of shares or the removal of directors is likely to be slow due to the length of the Italian court procedures. If the directors are a mix of nationalities, terminating all of their service contracts and/or enforcing any rights against the directors will take longer and be less straightforward than if they were all the same nationality.

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There may also be jurisdictional issues regarding the disposal of the JV assets on a breakup. If the underlying asset is in a jurisdiction such as Italy this could mean that if there is a default on the investment the assets may be subject to Italian insolvency procedures. Again, there may not be a speedy route out of that situation, leading to an erosion in the value of the JV assets.

GOVERNANCE PROCEDURES

The governance of the JV is a key point to address on formation. A mechanism to deal with conflicts and deadlock is important. There are also likely to be sensible reasons for the imposition of restrictions on what the JV parties can do in competition with the JV vehicle. When it comes to governance provisions clarity of drafting is key.

Most JVs allow for JV parties to appoint directors if the JV vehicle is a limited company: the expectation is that those directors will act in accordance with the JV party's wishes. However, the directors have a duty to act in the best interests of the JV company. It is all too easy for lines to become blurred and careful rationalisation of decisions made at the JV company level is needed.

Every JV is different but certain issues and friction points tend to arise. For instance, one JV party may see trouble ahead and want to limit its investment while the other sees an opportunity and wants to invest. Governance procedures should resolve these problems but they may signal a more fundamental tension in the relationship. The market conditions for, or strategy of, one or both of the JV parties can change dramatically during the life of a JV.

If one of the JV parties is a developer or asset manager it is important to establish at the outset how much autonomous authority that JV party is to have and what matters are reserved to the JV level. The managing JV party may have a vested interest in investment being made in the JV vehicle and may consider that it knows best. The non-managing JV party may be more focused on pure economics. Although the "funding" JV party is expected to be relatively "silent" it is not uncommon for it to become more involved in the project once it is under way; this can lead to friction and slow decision making.

A corporate governance structure is important but the JV parties should consider at the outset whether they realistically have the resources to carry out all the required steps. The practical operation of a JV can be a source of dispute and tension, particularly if there are problems in relation to the project.

While governance procedures are helpful, a JV party may fail to follow them. If a management structure has been adopted there may, for instance, be disputes regarding whether sufficient information is being passed between the JV parties. It is important to provide for a practical and timely means of resolving minor disputes, such as alleged failures to provide documentation, in order to avoid breakdowns in trust which can cause a corrosive atmosphere within the JV.

Careful structuring of the JV and drafting of its regulations can improve a party's position should things go wrong but cannot fully substitute for careful due diligence regarding the project and the other prospective JV parties.

INSOLVENCY OF A JV PARTY

The insolvency of a JV party can have the effect of paralysing the JV. The liquidators, administrators or receivers appointed over a JV party may decide not to progress a project or transaction: what happens then?

JV agreements often contain provisions which seek to circumvent paralysis on insolvency. It is common to see a provision under which a solvent JV party can call for the transfer to it of the insolvent JV party's interest at a predetermined price. This price may be based on a formula or provision may be made for it to be determined by an independent expert. Some JV agreements provide that the insolvency of one JV party is an event of default which automatically leads to a transfer of that JV party's interest to the solvent JV party for no, or only nominal, consideration.

The solvent JV party may be unable to compel the insolvent party to take action, due, for instance, to the moratorium arising on administration. There may also be additional complications due to the party in financial difficulty being subject to another jurisdiction's insolvency procedures: for example, a real estate JV party was recently reported to have filed for bankruptcy protection under the US Chapter 11 regime.

For a number of reasons the provisions in a JV agreement which intend to address a party's insolvency may be ineffective. Transfers triggered by insolvency are vulnerable to being struck down. On a winding up by the court any disposition of a company's property or any transfer of shares made after commencement of the winding up is void, unless the court orders otherwise. An administrator, liquidator or trustee in bankruptcy may apply to court to set aside a prior transfer if it was at an undervalue or if it amounted to a preference. A liquidator or trustee in bankruptcy may seek to disclaim the JV agreement as an onerous contract. Even if the JV parties agree a trigger at an earlier stage, which carries out the disposal in anticipation of impending insolvency, they may not escape the application of these rules. Transactions up to two years, and in some cases longer, prior to insolvency may be set aside.

Any term providing for the acquisition of an insolvent JV party's interest in the JV could fall foul of the "anti-deprivation principle", aimed at protecting creditors by prohibiting the automatic dispersal of a party's assets on insolvency.

One of the more sophisticated options intended to protect a JV party on insolvency is the incorporation in the JV arrangements of registered cross charges over each of the JV parties' participation interests. This may secure loans to the JV vehicle or rights which crystallise on insolvency. The intention would be to give the solvent JV party a secured charge upon

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which it could rely in priority to the unsecured creditors of the insolvent JV party. A practical problem with this is that it may make it more difficult to raise money for the JV from third parties. In addition, in the event of one of the JV parties entering administration, the other may still require a court order to enforce its security.

As well as providing for the insolvency of a JV party, if any of the JV parties are supported by a parent company or other guarantor, it is advisable to expressly provide for the insolvency of that parent or guarantor in the JV agreement.

BUY-OUT PROVISIONS

A JV party's best option to protect it from another JV party's insolvency may be the inclusion of a provision in the JV agreement which states that the non-defaulting JV party may only exercise its right to buy out an insolvent JV party for a genuine arm's length market price with a transparent and fair method of calculating that market price and with no right to counterclaim for loss or damage. There is little risk that such a provision would be set aside by a court.

As a practical matter such provisions may not provide the solvent JV party much by way of additional protection: the solvent JV party may be one of the first parties an insolvency practitioner contacts when looking to dispose of the insolvent JV party's interest. They may also fail to take into account the degree of loss suffered by the solvent JV party.

It is important for a solvent JV party to establish before exercising its buy-out rights whether their operation will trigger an obligation to repay any loans which it may have guaranteed. Such provisions may also be unenforceable if the insolvent JV party granted security over its interest, unless that security was taken subject to the buy out rights.

Buy-out and transfer provisions are not of assistance if the solvent JV party cannot finance a purchase of the insolvent party's interest. Finding funding is likely to be difficult. There may also be liabilities associated with the JV's assets which the solvent JV party is not prepared to take on.

INSOLVENCY OF THE JV VEHICLE

Rather than a JV party, it may be the JV vehicle itself which has become insolvent. The market has seen examples of receivers appointed over properties held by JV vehicles on the maturity of their secured lending. Insolvency is a question of fact determined in accordance with the provisions of the general insolvency law applicable to the structure of the JV.

If the JV vehicle is insolvent it is important for the JV parties to establish whether that insolvency would be deemed a default under any cross-default provisions in their other facilities. Key agreements between the JV vehicle and third parties, such as building contracts and agreements for lease, also need to be reviewed as rights to terminate may have been triggered.

Should a JV vehicle enter administration, the interests of its creditors will have overriding priority. JV parties have no inherent ability to stand in the way of the administrators or to exercise preferential rights equivalent to being secured creditors.

The JV parties may have provided for the insolvency of the JV vehicle in the JV agreement. However, when a JV vehicle is wound up, provisions in the JV agreement forfeiting its interests to the other JV parties may be void. Buy out or transfer provisions do not assist where the JV vehicle itself is insolvent.

LENDERS' RIGHTS

Lenders may have taken a fixed and/or floating charge over the shares in, and the assets and undertakings of, the JV vehicle.

The insolvency of the JV vehicle, or one of the JV parties, may be an event of default giving rise to the lender's powers of enforcement over any secured assets, including the power of sale. The lender may be entitled to appoint a receiver or administrator over the JV vehicle. It may also have step-in rights, allowing a company controlled by the lender to temporarily take over the JV, prior to a later disposal of its interest in the JV to a third party. Such a disposal is likely to include a novation of the JV agreement in favour of the third party purchaser.

PRIORITIES FOR INSOLVENCY PRACTITIONERS ON APPOINTMENT

When appointed in relation to a JV vehicle or JV party, an insolvency practitioner will need to act quickly if the project is to continue. It will be important to establish whether the solvent party wishes to fund a buy-out of the insolvent JV party or the continuation of the project. If the JV was funded by a third party it will be necessary to establish the lender's rights and its willingness to provide additional finance. Consideration should be had to whether the insolvent JV party had been complying with the terms of its JV agreement: for example, an insolvent developer JV party may have fallen behind on the project due to its financial problems.

CONCLUSIONS

The insolvency practitioner's best solution in each case will depend upon the nature of the JV, the stage the project has reached (for example, whether it is self-funding), the quality of the underlying documentation, the security position and the availability of finance.

Should a JV dispute arise, whether or not in an insolvency context, early advice and prompt action are important when multiple jurisdictions are involved as without them a party may find itself at a severe disadvantage. ■