REAL ESTATE JOINT VENTURES BUILDING SOLID FOUNDATIONS : KEY ISSUES TO ADDRESS IN JOINT VENTURE AGREEMENTS

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In a context where real estate investors are required to take on greater risks to secure transactions and attractive returns, corporate joint ventures and co-investment schemes (JVs) are becoming ever more attractive to institutional investors across Europe. In addition to legal, regulatory and tax structuring considerations which are decisive to the choice of the JV vehicle and investment structure, key issues need to be adequately addressed and specific contractual remedies provided for in joint venture agreements (JVAs). Successful real estate joint ventures require indeed, like a building, solid foundations.

Corporate Governance

In our experience, corporate governance matters often give rise to lengthy discussions due to a lack of understanding from the JV partners of their respective objectives, constraints (e.g. commercial, tax or accounting consolidation constraints) and roles within the context of such partnership. Getting the JV partners to agree upon their objectives and respective contributions to the JV is therefore critical.

In most JVs (excluding 50/50 JVs with strict joint control of both JV partners), one of the JV partners is usually in charge of the day-to-day management of the JV, subject however to certain reserved matters or major decisions, which require the approval of the other JV partner(s). The list of reserved matters is usually very detailed and includes typically the main business decisions to be made by the JV (e.g. buying or selling all or part of the properties owned by the JV, modifying the agreed business plan, leasing, fi-

nancing, etc.). The list of reserved matters is obviously critical for both JV partners and should be tailored to the transaction at hand and include appropriate materiality thresholds.

Corporate governance provisions should, however, avoid two obstacles: ambiguity and unnecessary complexity. There should, for instance, be no ambiguity as to whether a proposed decision of the JV qualifies as a reserved matter or as to which person is entitled to represent and bind the JV towards third parties. Similarly, keeping a clear, simple and straightforward corporate governance structure for the JV is also crucial. A JV cannot operate effectively if the decision making process of the JV is subject to excessive hurdles (e.g. consultation of various committees, board or compliance with excessively strict deadlines, prior notices, etc.).

Conflict of interest situations should also be addressed, in particular in JVs where one of the JV partner is acting, whether directly or indirectly through any affiliates, as local operating partner (e.g. asset manager or developer) or when one JV partner has been selling to the JV some of its assets. Each JV partner should be required to disclose to the other JV partners the occurrence of any potential conflict of interest and its nominees as JV manager and/or director, as the case may be, should not take part in any vote in relation to such matter.

Deadlock

Regardless of the agreed corporate governance, adequate deadlock provisions should be included in the JVA in order to deal with potential disputes or deadlock situations between the JV partners. Prevention is indeed better than cure, and providing for specific contractual remedies upon occurrence of a deadlock event is, in our view, strongly recommended rather than immediately referring such disputed matter to Court or arbitration. Any Court or arbitration proceedings between JV partners is very likely to impair the JV partners' relationships and ultimately the functioning of the venture.

Deadlock provisions may significantly vary depending on the configuration of the JV or the nature of the underlying investments carried out by the JV. Broadly speaking, three elements should be addressed in the JVA:

- The concept of "deadlock event" should be precisely defined and should not apply to minor disagreements between the JV partners; appropriate materiality thresholds or wording should be included in the JVA in that respect;

- A detailed escalation process should be included in order to enable the JV partners and their respective management to further discuss the disputed matters and use all reasonable endeavours to resolve it; we usually recommend the JV partners to exchange written memoranda summarising their understanding of the deadlock event and the solutions that they would be willing to consider and for the relevant representatives of the JV partners to meet in person at least once during such escalation process; and

- To the extent relevant, a deadlock resolution mechanism should be provided for if no agreement is reached during the escalation process; there are many different types of deadlock resolution mechanisms (referral to third party determination, put and call options, buy or sell mechanism, etc.) and the JV partners should tailor such deadlock resolution mechanism to their specific needs and to the specific configuration of their partnership.

Funding and Financing

The JVA should clearly define the funding and financing obligations of the JV partners. To the extent possible, we usually recommend to expressly specify in the JVA:

- The initial mandatory equity commitment of each JV partner and any potential additional funding which may be required by the JV from time to time (e.g. in case of emergency funding shortfall);

- The main terms and conditions of any anticipated external financing (e.g. anticipated amount, interest rate, duration, any applicable maximum LTV / LTC ratios, etc.) as the JV will be, in most cases, leveraged with third party debt;

- The terms and conditions according to which the JV management may make any capital calls, including in particular the structure of such funding (e.g. shareholder loans, capital increase and in such case the valuation of the JV and real estate assets to be used for such purposes, etc.); and

- The consequences of any funding default by any of the JV partners; in most real estate JVs, any funding default usually triggers the following remedies: the ability for the non-defaulting JV partner to fund in lieu of the defaulting JV partner by (i) making a preferred shareholder loan (which bear interest at a premium interest rate and rank in priority to the standard shareholder loans) and/or (ii) subscribing to a capital

increase of the JV and diluting the defaulting shareholder (such dilution being often punitive, i.e. based on a discounted valuation of the JV). In addition to the above remedies, such funding default may also trigger (in most cases subject to reaching certain materiality thresholds) the default provisions of the JVA and enable the non-defaulting partner to buy out the defaulting JV partner at a discounted price (see paragraph "Default" below).

Distributions - Waterfall – Preferred Return / Promote

The distribution policy and waterfall provisions are important business provisions of a JVA. In real estate JVs where one of the JV partners contributes its expertise (e.g. asset or development management expertise), such JV partner may also be entitled to receive a preferred return / promote fee subject to achieving certain performance criteria (e.g. IRR hurdles). Such technical provisions should be carefully drafted in order to avoid any dispute related to the (i) triggering event(s) of such preferred return, (ii) the date upon which the latter becomes due and payable, (iii) its quantum and/or (iv) whether or not the latter may be subject to any claw-back mechanism.

Transfer Restrictions – Liquidity

Transfer restrictions applicable to JV interests and liquidity considerations are obviously key issues which need to be addressed in great details in JVAs as this one of the areas where the respective objectives, interests and constraints of the JV partners may differ significantly.

Typically and in order to ensure a certain stability to the JV, a lock up period is usually agreed between the JV partners during which the JV partners are prevented from transferring their JV interest or to initiate a sale process of part or all of the assets owned by the JV. The duration of such lock up period may vary depending on the configuration or purpose of the JV or the nature of the assets owned by the JV. For real estate JVs including development and/or refurbishment projects of real estate assets, the duration of such lock up period may be, for instance, based on the time period required to develop and stabilise the real estate assets under development (e.g. duration required for the completion of the construction or refurbishment works and/or for reaching a minimum level of letting or pre-letting of the said assets).

Standard exceptions to lock up periods usually include intragroup transfers by the JV partners to affiliated entities provided that the latter agree to adhere to the JVA (i.e. agree to be bound by the terms of the JVA as the transferring JV partner). In that respect, the notion of "affiliate" should be precisely and strictly defined in the JVA to avoid any circumvention of the lock up period.

After the lock-up period, various transfer restrictions and exit mechanisms may still apply. Typically, in most real estate JVs, the JV partners may not transfer their JV interests without being subject to a right of preference of the other JV partners. Depending on the configuration of the JV, such right of preference may be structured as either a right of first offer (ROFO), a right of first refusal (ROFR) or a pre-emption right (the latter being the one impacting the most the liquidity of the selling JV partner).

Also, the minority JV partner may have a tag-along right under certain conditions in case of exit of the majority JV partner (i.e. the right to sell all or part of its JV interest simultaneously and under the same terms and conditions as the majority JV partner). Conversely, the majority JV partner may have a drag-along right against the minority JV partner (i.e. the right to oblige the minority JV partner to exit simultaneously and under the same terms and conditions as the majority JV partner). The exercise of such drag-along right is, however, very often subject to certain hurdles (e.g. multiples, IRR or other valuation hurdles).

In addition to the above transfer restrictions, JVAs may also provide for a specific liquidity mechanism pursuant to which either JV partner or the majority JV partner, as the case may be, may after a certain period of time trigger a 100% sale process of the JV or the assets owned by the JV. In certain markets and subject to the nature of the venture, an IPO may also be a viable alternative liquidity mechanism for real estate JVs.

Defaults and Cross-Defaults

To ensure the legal efficiency of JVAs, the latter usually include default provisions. In real estate JVs, typical events of default may include inter alia the following: (i) material violation of the JVA, (ii) any fraudulent act or criminal conduct, (iii) any change of control of any JV partner, (iv) the occurrence of any insolvency event at the level of the JV partners and (v) for JVs having JV partners acting also as local operating partner (whether directly or indirectly through any of its affiliates), termination for cause of the relevant management agreement(s). Similarly, a "key men" event under a management agreement may also qualify as a default under the JVA when the involvement of such key person was one of the main reason justifying the setting up of the partnership. In our experience, this "cross-default" concept between the JVA and the management agreement(s) entered into with one of the JV partners is

very often heavily discussed, in particular if the relevant JV partner acting also as local operating partner is not only a minority JV partner with a very limited equity stake in the JV.

Typical sanctions upon occurrence of an event of default which, if capable of remedy, is not duly remedied during the relevant remedy period may include inter alia the following: (i) removal of the JV manager(s) and/or director(s), as the case may be, appointed upon proposal of the defaulting JV partner, (ii) suspension of the voting rights and/or financial rights of the defaulting JV partner (including frequently the loss of any preferred return / promote), (iii) termination of any management agreement (if any) entered into with the defaulting JV partner (or any of its affiliates) and/or (iv) the right for the non-defaulting JV partner(s) to buy out the defaulting JV partner at a discounted price (this is usually structured as a default call option of the non-defaulting JV partner).

While negotiating such default provisions, one should keep in mind that such default provisions may however apply to both JV partners (at least the ones not related to the local operating partner). Also, it should be mentioned that the implementation of such default provisions (like the implementation of a buy-or-sell mechanism) is, fortunately, extremely rare in practice.

Protective Covenants

Protective covenants in JVAs have become over the last fifteen years much more sophisticated and comprehensive, in particular for international JVs. Transfers of JV interests are typically subject to satisfactory completion of "know your client" (KYC) procedures and reputation conditions. Most JVAs also include, nowadays, detailed and extensive anti-money laundering, anti-corruption and anti-bribery policies and require from the JV partners as well as their nominees as JV manager(s) and/or director(s) compliance with strict ethical standards. In recent JVAs, we have also noticed a fast growing concern of institutional investors for sustainable real estate investments and, within the context of real estate JVs, various requests to provide for compliance by the JV with sustainability criteria for its real estate investments. Non-compete provisions (e.g. prohibition for the JV partners to acquire or develop a similar property or platform in the vicinity of the JV properties) may also be discussed on a case-by-case basis and included in a JVA. More frequently, JV partners may agree to grant to the JV a "right of first look" at any future investment opportunity which would match the investment criteria of the JV.

Additional Consideration For International JVs

Within the context of international real estate JVs having JV partners based and/or JV properties located in different jurisdictions, specific consideration shall be given to the choice of the governing law of the JVA and the applicable jurisdiction in case of dispute. From our experience, arbitration proceedings are usually recommended for international JVs above a certain size.

Conclusion

The above should not be viewed as being a comprehensive list of all issues which JV partners may face when setting up a real estate JV. Any joint venture arrangement will have its own specificities and should be specifically tailored to the partnership and collaboration at hand. However, successful real estate JVs usually address most of the issues mentioned above, not to cover all risks as this cannot be reasonably done but rather to ensure effectiveness of the JV, avoid unclear roles, slow and complex decision making process and the inability for the JV partners to resolve disputes. With solid and sound foundations, a JV should be able, like a building, to face hazards and to adapt to evolving scenarios, which cannot be excluded given the risks inherent to the late cycle of the European real estate market.