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Considerations for programmatic real estate joint ventures

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Commercial real estate joint ventures provide an effective way to join capital with development and operational expertise. A sponsor who identifies a project for acquisition or development enters into a joint venture with an investment partner who brings the necessary capital and investment oversight. Most often, the parties structure such ventures through a single-purpose, limited liability company that owns and operates the project as its sole asset. Once the project is sold, the parties go their separate ways or, if the initial relationship was amicable and profitable, they may explore the possibility of entering into subsequent ventures on similar or different terms.

During recent years, however, the industry has seen an increase in "programmatic" joint ventures intended to create a relationship that spans the course of a number of years and encompasses multiple projects. These ventures provide both sides with tangible benefits. Sponsors obtain a ready source of capital that allows them to move with speed and confidence when searching for new deals or pursuing development opportunities. Investors receive an exclusive pipeline with a trusted developer/operator through which they can deploy capital. Additionally, both sides avoid the need to negotiate new venture documents for each deal and enjoy other efficiencies associated with a streamlined relationship.

A common approach to structuring a programmatic joint venture involves the creation of a holding company structure, under which the holding company will then form a separate subsidiary (usually disregarded for tax purposes) to own and/or develop each project pursued by the venture. In negotiating the holding company venture documents the parties will need to tackle all of the issues common to a single-project joint venture (e.g., capital contribution requirements, major decision rights, fees, division of economic returns, carried interest thresholds, deadlock resolution mechanisms, indemnities, transfer restrictions, cost overruns, and myriad other issues related to the acquisition, development and operation of a real estate project) while also dealing with additional considerations unique to the multiproject structure.

■ **Promoted interests.** Structuring promote, or carried interest, distributions is a central economic issue in programmatic joint ventures. In general, sponsors will prefer that the promote be calculated and paid out on a project-by-project basis. This will entitle the sponsor to earn a promote on successful projects even if the venture is not sufficiently profitable on an aggregate basis. By contrast, investors generally will prefer an aggregate or "crossed" promote structure, such that the promote only becomes payable after the investor has received its required internal rate of return on the aggregate amount of its capital contributions. Compromise positions may include a project-by-project promote with a "clawback" that would require the sponsor to repay excess promote distributions based on an aggregate calculation at the conclusion of the venture (or at other agreed upon times); aggregating the promote for projects purchased during the same calendar year (or other agreed upon period), but treating projects purchased in other calendar years separately; or some mechanism for enabling the sponsor to partially recognize at least a portion of its promote earlier in the life cycle of the joint venture. In addition to negotiating the structure of promote distributions, the parties often engage in extensive discussions about which sponsor defaults can lead to the removal of the sponsor and the loss of all or a portion of the promote. Such negotiations are not unique to programmatic joint ventures but become more critical when the loss of promote will be felt across multiple projects (some of which already may have been completed and sold at the time of removal). For that reason, sponsors often try (with varying degrees of success) to negotiate limitations on a venturewide loss of promote, or to limit the loss of promote to unfinished projects only.

■ **Capital participation.** In a single-project venture the parties generally agree on capital percentages on the front end and make capital contributions in accordance with such agreed upon percentages until the venture ends (subject to dilution and member loan remedies for failures to fund). In a programmatic joint venture, the parties can similarly agree on set capital percentages that will govern all deals consummated by the venture. Alternatively, the parties can vary their capital percentages depending on the type of project pursued. For instance, a sponsor may negotiate the right to selectively elect to contribute additional capital (up to a certain cap) on a deal-by-deal basis, or the parties can specify that for certain projects (e.g., those less risky projects with a cap rate below 6%) the sponsor's co-invest requirement drops to a lower percentage (e.g., 10% to 5%). It is important to note that shifting capital percentages will require the parties to track their capital interests and tax allocations on a project-by-project basis (though separate tracking will need to be done in any event if the parties elect to structure carried interest distributions on a project-by-project, rather than aggregate, basis).

■ **Exclusivity covenants.** A key part of any programmatic joint venture is the exclusivity covenant that requires the sponsor to look for and present deals to the joint venture so as to give the investor the exclusive opportunity to participate in such projects. This covenant can take different forms. The most restrictive exclusivity covenants prevent the sponsor from undertaking any projects outside the venture until the exclusivity period terminates. Such covenants sometimes also require the sponsor's key principals to devote substantially all of their professional time to the venture. Less restrictive exclusivity covenants restrict the sponsor from pursuing a deal that falls within agreed upon investment parameters unless the sponsor first offers such deal to the venture. Projects that fall outside of the investment parameters, or projects that the investor elects not to pursue, can be pursued by the sponsor independently. Investment parameters can be as detailed as the parties determine and can include such varied criteria as geographic locations, investment size, internal rate of return requirements, debt terms, specific asset types, etc.

Exclusivity covenants typically expire after a stated number of years or after a certain amount of capital has been invested. Additionally, sponsors often negotiate early termination clauses if the investor rejects a certain number of deals that fit within the investment parameters, fails to fund required capital contributions in connection with the acquisition of an accepted deal or commits certain "bad acts." Most exclusivity covenants also tie into specific protocols by which the sponsor must present project opportunities to the venture and which set forth the deadlines by which the investor must respond. In all cases, both parties need to make sure that these protocols match their intended mode of transacting business so that they are not hamstrung by an unnecessarily cumbersome or draconian process.

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■ **Exit mechanisms.** In any joint venture, both parties will be focused on the ability to control a sale of the project or to otherwise exit the venture in the event of a dispute or deadlock. The complication in a programmatic joint venture is that any exit strategy will either have to be project specific or will need to encompass the entire venture. For instance, if the parties deadlock with respect to a major decision (e.g., whether to refinance a given project), the venture agreement could provide for a buy-sell mechanism with respect to the parties' interests in the venture as a whole or a more limited buy-sell applicable only to the project at issue. The former mechanism could prove difficult to implement because of the capital required to buy out the other side's interest in the entire venture, whereas the latter may only be a temporary or partial fix if the deadlock has led to a rift in the relationship that may jeopardize the parties' abilities to effectively work together going forward. In addition to resolving deadlocks, each party will want to have some control over the timing of capital events. Sometimes the parties accomplish this by granting one or both parties the right to cause a sale of a project, subject to a right of first offer for the nonselling party. These sale rights can be tailored through the use of lock-out periods and/or return thresholds (e.g., a sale can only be triggered after a two-year holding period and only if it will yield at least a 15% IRR). In those cases where the sponsor has no right to initiate a sale, the sponsor may try to negotiate a right to "crystalize" a portion of its promote through an internal restructuring of the parties' interests after a project has been held by the venture for a given number of years.

In addition to the foregoing (and other issues not specifically discussed), each party also will need to consider and account for how the long life cycle of a programmatic joint venture fits within the unique constraints or peculiarities of such party's upstream ownership structure. For instance, a fund that has to liquidate within the next three years might not be in a position to enter into a programmatic joint venture unless it has the flexibility to fund later projects through a different investment vehicle. Ultimately, in order to recognize the benefits and efficiencies of a programmatic joint venture, and to set the venture up for long-term success, the parties must take extra care on the front end to carefully structure the relationship in a manner that meets each parties' respective business needs while also aligning the parties' incentives as much as possible.▲