New York Law Journal
Real Estate Trends
WWW.NYLJ.COM
An ALM Publication
VOLUME 259—NO. 89
WEDNESDAY, MAY 9, 2018

TRANSACTIONAL REAL ESTATE

Structuring Programmatic Real Estate Joint Ventures


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Programmatic or "platform" joint ventures (JV) are a means of structuring a series of commercial real estate investments between sponsors and capital partners. Rather than one-off pairings between sponsors and institutional equity partners to consummate individual transactions, a programmatic JV creates an infrastructure for two investors with similar goals to build a portfolio of investments. For a sponsor, a programmatic JV can be a reliable way of raising equity for a series of prospective real estate deals, avoiding the time, cost and uncertainty of seeking out separate capital partners for each contemplated project (and the risk of putting up nonrefundable deposits to secure properties without knowing that all equity is in place). From the perspective of a fund or other institutional equity investor, a programmatic JV is an efficient way of putting out equity with a partner that has been fully vetted and provides expertise in a desired asset class or geographical area.

While programmatic JVs can take the form of a less formal strategic alliance with a framework for pursuing individual transactions as they arise, more commonly a sponsor

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and capital partner will enter into a holding company joint venture agreement that lays out the economics and governance for each consummated investment and also defines the investment parameters of the venture. Programmatic JVs raise a unique set of issues that are often extensively negotiated between the parties and their counsel.

Exclusivity Covenants

When a capital partner enters into a programmatic JV, it may reserve a portion of its available equity for investment in the venture. A material consideration for a capital partner in committing that equity—or for entering into the programmatic arrangement in the first place—is a covenant by the sponsor to bring all potential investments that are within agreed investment parameters to the capital partner through the programmatic JV to the exclusion (in whole or in part) of other third-party investors. As a result, it is important to both parties to carefully define the criteria for what constitutes a target investment. These criteria are often quite detailed, taking into account asset class, geography, the amount of required capital contributions, return guidelines and leverage limitations. Clearly defining the parameters of a target investment is critical, as it affects whether the sponsor is required to bring a

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particular opportunity to the venture (rather than pursuing it outside the venture), and, if an asset is not within the parameters, there is typically no consequence to the capital partner for rejecting it.

From a sponsor's standpoint, the joint venture agreement needs to establish both (i) a procedure to ensure that the capital partner provides prompt approval or disapproval of a target investment and, in the latter case, the right to pursue the investment independently and seek a separate equity investor outside of the platform and (ii) a mechanism for termination of exclusivity, usually through some combination of the capital partner's having rejected a certain number of prospective deals (a "three strikes" provision) and a fixed outside date.

A programmatic joint venture agreement typically lays out a detailed process pursuant to which a sponsor can bring a target investment to the capital partner for consideration, including submission of a detailed initial investment memorandum. The agreement usually lays out with some specificity what information must be provided to the capital partner and in what form. In some cases, the agreement may provide for a preliminary approval by the capital partner, authorizing the sponsor to incur pursuit costs at the venture's expense while it is underwriting the asset for final approval. Any such preliminary approval will be followed by a more detailed underwriting from the sponsor prior to final approval of the investment by the capital partner.

A sponsor usually negotiates protections if the capital partner rejects target investments and frustrates the sponsor's ability to consummate transactions. Sponsors often attempt to negotiate the ability to pursue rejected target investments outside the joint venture, and many programmatic JVs permit a sponsor to do so. However, capital partners are sometimes unwilling to allow the sponsor to pursue target investments with third parties. From the capital partner's standpoint, the sponsor should be devoting all of its efforts to finding opportunities and creating value for the joint venture as a quid pro quo for the capital partner making its equity available for the venture. Allowing the sponsor to pursue target investments with third parties may divert the attention and the resources of the sponsor and detract from the venture. To some extent, the willingness of a capital partner to allow rejected target investments to be consummated outside the programmatic JV may depend on the sponsor involved, and a more substantial sponsor with a deeper organization may be more successful in negotiating this right.

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A more common remedy in programmatic joint ventures to protect the sponsor from a capital partner that rejects target investments is a so-called "three strikes" provision. Under a three strikes provision, when the capital partner has rejected a certain number of target investments proposed by the sponsor, usually within a specified time period, the sponsor has the right to terminate the exclusivity covenant. The termination of exclusivity is particularly important where the sponsor is unsuccessful in negotiating the right to pursue rejected investments outside the venture.

Programmatic JVs also tend to prescribe an expiration date upon which the exclusivity period will end, irrespective of the parties' prior track record in agreeing upon prospective projects. This expiration date may be a mutually agreed fixed outside date, and the expiration may also be triggered when an agreed equity sum or a percentage of committed capital has been contributed to the venture's investments. In the event of any such exclusivity termination, barring any separate termination and liquidation of the venture, the sponsor will continue to manage and operate the existing investments of the venture, and may still approach the capital partner regarding potential target investments but will not be obligated to do so.

Calculation and Payment of Promote

Programmatic JVs also present issues relating to the payment of a promote or carried interest to the sponsor, specifically whether to calculate the payment of a promote or carried interest on a deal-by-deal basis or on a portfolio or aggregate basis. If the promote is calculated on a deal-by-deal basis, the sponsor will earn a promote on successful investments, even if the venture incurs an overall loss; by definition, the aggregate promote payable to the sponsor will be the same or higher in a deal-by-deal calculation. The sponsor will also receive promote payments earlier, as early as the sale or refinancing of the first investment. Capital partners will usually require a "clawback" of a sponsor's promote distributions (often secured by a guaranty or an escrow) in the event the sponsor receives more promote in the early distributions than it would have received had the promote been calculated at the end of the venture.

Not surprisingly, most capital partners will insist that the promote be calculated on an aggregate basis for all investments over the life of the joint venture. From a capital partner's standpoint, requiring an agreed IRR on all contributed capital across all investments prior to the payment of any promote is the optimal method for calculating promote. Even if the promote is calculated on an aggregate basis, a clawback may be necessary either if successful investments are realized (either through sale or refinancing) before other less successful investments are acquired or additional capital is otherwise contributed. A compromise position sometimes seen in programmatic joint ventures allows for the payment of promote on an asset-by-asset basis, trued up periodically (as additional assets are sold) to an aggregate calculation, with a clawback (appropriately secured) if at any time the sponsor has received more promote than it would be entitled to receive on an aggregate basis.

Buy-Sell and Forced Sale Mechanics

Another issue that arises in programmatic joint ventures relates to the right of one party to trigger the sale of the assets of the joint venture and the use of a buy-sell mechanism to resolve deadlocks between the sponsor and the capital partner. The implementation of forced sale rights and a buy-sell mechanism can result in complications not present in a single-asset joint venture. In a forced sale provision in a single-asset joint venture, a member can initiate a sale of the asset owned by the venture (usually after some lockout date), and the other member will have the right either to (i) purchase the initiating member's interest in the venture based on the amount the initiating member would receive in distributions if the venture assets were sold at the offering price, or (ii) permit the disposition of the asset to a third party at the offering price (sometimes with some permitted variation) and receive its distributive share of the sale proceeds. In a programmatic joint venture, the non-initiating member cannot buy the interests of the initiating member in a single asset, since all assets are held in subsidiaries of the same joint venture entity, so the provision must be structured to provide for a purchase of the asset by the non-initiating member from the venture (and this can have transfer tax consequences and also require the purchase of a new title insurance policy). A corresponding issue comes up in the exercise of a buy-sell mechanism in the event of a deadlock relating to a specific asset. In a single-asset venture, the triggering of a buy-sell will result in one venture party buying the interest of the other. In the context of a programmatic JV, where the deadlock relates to an individual asset and the parties wish to resort to the buy-sell to deal only with that asset and not the venture as a whole, the buy-sell must be structured so that the purchasing party acquires the asset from the venture.

Tracking Interests

In some programmatic JVs the parties may wish to own varying percentage ownership interests in the underlying properties. This can be accomplished by providing for "tracking interests"—i.e., interests in the upper-tier programmatic JV which "track" the real estate assets separately and which permit a joint venture partner to indirectly hold, for example, 60 percent of asset A and 30 percent of asset B while the other joint venture partner indirectly holds 40 percent of asset A and 70 percent of asset B. Capital contributions and distributions relating to one asset are, under the joint venture agreement, treated separately from those relating to another asset. Contributions for joint venture expenses which do not relate to a particular property can either be allocated among the assets and treated as part of the tracking interests or treated as a separate category and shared by the joint venture partners in accordance with fixed percentages without regard to the partners' indirect interests in the assets. Note that varying ownership interests in the joint venture's investments can be problematic if the investments are subject to a single cross-collateralized financing (where, for example, a partner's larger interest in a successful investment may be at risk in the event of a default relating to a less successful investment in which that partner has a smaller interest).