NEGOTIATING AND STRUCTURING JOINT VENTURE AND LLC AGREEMENTS

Parties negotiate joint venture agreements in the spirit of optimism. Anxious to combine their resources and skills for certain profit, they are frustrated when the lawyers bog down the process with issues.

Partners may shorten the process of documenting the joint venture by resolving the following issues and outlining their agreement in a term sheet before the lawyers start drafting.

The following discussion assumes the joint venture will be structured as a limited liability company, since that is the entity of choice of late and for good reasons. The same issues arise with any entity structure. The word "partner" is used to mean a member, manager, general or limited partners.

What is the Project's Business Plan:

Before documenting the deal, the parties should reach consensus as to their vision for the project. For instance, they should agree as to the market position for the project, the style and level of design, the degree of leverage, and the long and short term goals for the project. The parties should discuss their relative tolerance of risk and what expertise and connections each brings to the project. If the parties do not have a consistent vision, then disputes are almost inevitable.

Parties:

Are all the parties part of the initial discussion or are you still looking for your capital partner? Will the parties themselves have investors? Which investors need to be signed up prior to closing? Who has the authority to negotiate business terms with new investors and are there limits to that authority.

Purpose:

State the purposes of the joint venture. While many operating agreements contain a broad purpose clause, we recommend a narrow purpose clause such as "The Company is being formed for the purpose of acquiring, developing and leasing the real property common known as 123 Main Street and for related incidental purposes only." This helps to limit the authority of the controlling partners and to establish the appropriate uses for company funds.

Competitive Activities:

May all or any of the partners engage in competitive ventures? Or must they present opportunities to the company before pursuing them on their own?

Capital Contributions:

Identify the contribution of each partner and whether it be cash, property (including intellectual property or contract rights) and/or services. If the contribution is being made over time, state whether it is to be paid at set dates or when called by the controlling partner. Are there mandatory and elective contributions and what are the consequences of a partner failing to make either or both? Dilution? Default and removal? A lending opportunity for other partners? All of the above?

Distributions:

This is a highly negotiated part of a joint venture agreement. The goal is for each party to earn a return appropriate to its risk. You must negotiate the relative value of the respective contributions and the relative certainty (or uncertainty) of gain. A typical sequence for distributions would be as following:

- First repayment of loans or excess capital contributions made by partners, plus a return.
- Then the capital partners receive distributions equal to their capital investment plus a return.
- Then all the partners receive distributions in proportion to their relative ownership of the company.
- At some point in the sequence, the services partner may receive a management fee, promote fee, development fee, leasing fees or other payments or distributions. Sometimes these are paid, at least in part, before any other distribution. Sometimes they are paid upon the company achieving certain milestones such as stabilization. Generally the timing depends on the value of the services being provided relative to the capital provided.

The parties should also consider who has the authority to determine the timing and amount of distributions and reserves. They may want to require that the company make annual distributions that are at least adequate to cover the partners' tax obligations arising from the joint venture.

Profits and Losses:

Determining the allocation of profits and losses (as opposed to cash distributions) involves technical and tax considerations which are beyond the scope of this checklist. Describe to your tax advisor what you wish to accomplish and the advisor should create the technical language to support your plan.

Control:

Our general advice to clients is either (i) to control the project, or (ii) to control when you may get out of the project.

Control is typically broken into two categories: operational and economic, which certainly overlap.

Operational Control is authority to make decisions regarding design, development, construction, leasing, and management of the property. It may include the authority to compensate service providers, including partners and their affiliates. If operational control is held by a party other than the one with financial control, the operational partner usually has the authority to work within a pre-approved budget.

Economic control is the authority to make decisions as to purchases, sales, financing, capital calls, distributions, liquidation, and budgets.

The parties should discuss and articulate which decisions may be made by a single partner, which require the approval of additional key partners, which require majority or super-majority approval of the partners, and which require unanimous approval.

In a larger partnership, all management and economic control is likely to be centralized and held by a single manager or a management committee.

In a partnership with a limited number of sophisticated and active members, one partner may be authorized to perform all management functions within an approved business plan and budget.

In a small partnership, the partners are likely to have a more casual approach in the belief that they will work out their decisions as the need arises. As everyone knows, this approach often fails because the parties hold different assumptions, expectations and “burn marks”. We recommend the parties discuss their assumptions, expectations and burn marks, and even better, document their agreement IN WRITING. The process of writing the agreement is a valuable exercise in itself.

A list of other possible control issues:

- Business plans, budget or permitted expenditures
- Acquisitions, sales, financing, leasing
- Design development
- Joint ventures
- Expenditures over a stated threshold
- Changes in purpose or development goals
- Transfers by or among partners
- Admission of new investors, partners and managers
- Removal of existing partners and managers with or without cause
- Changes in management, including on-the-ground property management
- Contracts with affiliates, fees paid to affiliated parties, conflicts of interests
- Engaging key vendors such as designers, contractors, brokers, lawyers, accountants and property management companies
- Mergers, dissolution, bankruptcy
- Initiating or settling litigation and arbitration
- Land use applications
- Use of or remediation of hazardous materials

As mentioned earlier, if you will not have control over the operational or financial decisions of the company, then negotiate a way to get out of the investment. The right to exit may be triggered by the passage of time, the reaching of a milestone, an impasse, a change in management, a default, even the death of a key player. The price may be pre-negotiated or based upon fair market value. There may be a discount applied because you are selling a minority interest. However, you will appreciate having the ability to cash out of the deal if the need or desire arises.

Transfers Of Interests:

Generally, joint venture agreements restrict the partners' right to sell or transfer their shares except in connection with estate planning transactions or with the consent of all or some of the other partners (plus lenders in some circumstances). Since a blanket restriction against transfer may not be legally enforceable, most operating agreements set out a right of first offer/refusal mechanism which is available to the remaining partners if one partner wishes to sell.

Buy-Sell Provisions:

In most cases, one partner will want to exit the venture before the other partners (or one partner will want to force out another partner). Since such transitions may be contentious, we strongly recommend spelling out the mechanics of this process in the early stages of negotiation. The parties should discuss triggers, pricing, discounts, financings and consent issues.

Possible triggers:

- A stated date or milestone
- Bankruptcy of any partner or the partnership
- Death of a key player
- Defaults by a partner, the partnership or a key third party player such as a tenant
- Impasses and disputes among the partners
- Change in control of a partner entity

Control: Who has the right to force a sale or a purchase? Take into account the relative ability of each party to finance a buy out. Having control over a buy out may be meaningless unless you have the ability to finance and close.

Pricing: The goal of any pricing mechanism is to achieve a fair price, or at least one which is perceived to be fair by the parties so as to discourage litigation and encourage participation in the process. It should also attempt to level the playing field between partners with relatively different cash positions. No method of valuation is perfect, but having a mechanism which requires time and expense may encourage the parties to negotiate a deal among themselves in order to avoid the time and expense.

Consider the following methods:

- Formula
- Negotiation
- Binding appraisal
- Bidding among parties
- "Cut the Cake" (One party sets the price and the other party may either sell out at that price or buy out the other party at the set price)

Formula Pricing: The determination of the purchase price may be as based upon financial measures such as capital accounts, book value, multiples of earnings, cap rate or a combination of the above. While a formula has the advantage of seeming predictability, in practice a formula is never simple to apply. It may also lead to a value which is so unfair that it encourages litigation. Further, because it is generally based upon information about the past, it may encourage a "rush to the door" when times get bad.

Appraisal: If appraisal is to be used, take time to articulate what factors and assumptions the appraiser should take into account in determining market value, including whether the valuation is based upon the market value of the real property asset or the selling partner's fractional interest. Consider whether a minority discount will apply, whether hypothetical transaction costs will be deducted, and what tax consequences will be incurred by each party (e.g.; taxable gain to the seller and reassessment of the property for the buyer). Consider whether each party should have its own appraiser, whether the various appraisals will be averaged, whether a third appraiser will be appointed to arbitrate or choose between competing appraisals.

Spell out whether the purchase price will be paid in cash, in kind, or over time, and if over time how it will be secured.

Check your loan documents. Determine whether lender approval will be required and the effect of the sale on guaranties.

Consider whether the purchase price is to be paid by the company or the remaining partners.

Be Specific:

From time to time, a client asks me to prepare an agreement which is intentionally ambiguous. I recommend against such practice. It invites litigation. And my goal is to keep my clients focused on their businesses and out of court.

The article above was prepared by Helen Sedwick of Bennett Valley Law.

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