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Commentary

Navigating A Buy/Sell Provision In A JV

DECEMBER 21, 2016 | BY FRANCIS MASTROIANNI

BOSTON—Buy/sells can be adversarial, friendly and/or negotiated, but the goal is always a fair and equitable partner separation, writes attorney Francis Mastroianni in this EXCLUSIVE commentary.

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REPRINTS



“Buy/sell provisions in JV agreements are critical in ensuring an efficient, equitable and often amicable breaking of a deadlock and dissolution of a JV,” writes Mastroianni.

BOSTON—Often a client will notify me that it has either exercised a buy/sell right in a joint venture agreement or has received a buy/sell notice from its JV partner. The reasons for exercising a buy/sell provision in a JV agreement vary and may include: an irreconcilable dispute between the partners, a change in one partner’s investment goals with respect to the asset the JV owns, or as a way to provide liquidity to a withdrawing partner in an organized manner prior to, or in connection with, a refinancing.

Buy/sells can be adversarial, friendly and/or negotiated, but in each case the goal is a fair and equitable partner separation. Assuming each partner is of comparable financial strength, the terms of a well-drafted buy/sell should produce an equitable result by eliminating each partner’s ability to unilaterally buy out the other.

I strongly counsel clients contemplating a JV to include one or more “break-up” or “exit” provisions in the venture’s limited liability company operating agreement. A buy/sell is one exit



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mechanism that provides fairness and certainty. It is difficult for clients to address the possibility of a major disagreement and “divorce” scenario at the point in a deal where they are “getting married” but including a practical exit provision has saved clients endless amounts of headache, time, litigation and legal fees.

A typical buy/sell provision allows either partner to propose a price at which it will buy out the non-proposing partner. The non-proposing partner then has a period of time to elect whether to be a buyer or a seller at the proposed price. Upon notice of such election to the proposing partner, the proposing partner knows whether it will be a seller of its interest or a buyer of its partner’s interest.

A buy/sell is triggered by one partner’s delivery to the other of a buy/sell election notice setting forth a proposed value for the real estate asset owned by the JV and the amount of the selling partner’s share of proceeds upon a hypothetical arms-length sale of the asset to a third party buyer. The recipient partner of a buy/sell election notice typically has 30 days to respond to the triggering partner and elect whether to be a buyer of the triggering partner’s interest at the price stated in the election notice or a seller of its interest at such price. The decision whether to be a buyer or seller often hinges on the recipient partner’s investment goals, available cash to consummate a buy, and the ability to either restructure the existing loan on the asset or secure new financing quickly.

A well drafted buy/sell provision typically is very detailed and specifies the mechanics the parties must follow from the triggering of the buy/sell through closing. Typical provisions read like an abbreviated real estate purchase and sale agreement and include: posting of a good faith deposit, a closing date, reconciliations and adjustments to the purchase price, allocation of closing costs, assumption of the existing loan or securing of a new one and consequences of a buyer or seller default. Sometimes a buy/sell provision requires the parties execute a purchase & sale agreement memorializing the deal terms, but this usually adds unnecessary time and expense if the buy/sell is well drafted and the parties act in good faith.

Pitfalls to Address

Valuation: To ensure a smooth closing under a buy/sell, the JV agreement should address certain terms to avoid disputes over what is ostensibly the dispute resolution provision itself. For example, a recipient of a buy/sell election notice may wish to seek an appraisal of the asset to determine that a market rate sale price forms the basis for the buy/sell price. This is important when the recipient is contemplating being a seller and/or may be an investor partner not as familiar with the local market in which the asset is located. Similarly, because one partner in a buy/sell is often the “out-of-town money partner” and not the sponsor or “on-the ground” partner, the Buy/Sell provisions should include an obligation on the part of both partners to be transparent, deal in good faith, and provide access to the asset’s books and records.

Representations and Warranties: Representations and warranties are limited in a buy/sell transaction since both partners already own the asset. However, the buying partner should be obligated to maintain the asset in the ordinary course and not incur extraordinary expenses or perform new capital or tenant improvements from the trigger date through closing. The goal is to avoid negative impacts on the net proceeds to the selling partner. A selling partner should state in its election notice that the sale of its interest is contingent on “business as usual” through closing.

Cash-on-Hand: Another important yet often overlooked item is how to account for “cash-on-hand” which, while not technically real estate, should be factored into the net sales price payable at closing. Determining cash-on-hand precisely can be challenging but it can be a significant amount (especially if cash distributions have accrued and not been made). Cash-on-hand should be discussed and calculated in advance of the closing date to prevent last minute disagreements. Likewise, the parties should address post-closing reconciliations or “true-ups” of delinquent rents, released lender reserves, and taxes. The parties should execute a settlement statement at closing incorporating these amounts and indicating the net sale proceeds.



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Tax Considerations: Depending on tax and other considerations, often a buy/sell provision permits the buying or selling party to elect whether to structure the sale as a sale of a membership interest or a sale of the real estate asset itself. Such considerations are typically specific to the concerns of the partners. As a result, tax and/or lender requirements often drive the election to consummate the buy/sell as an interest sale or an asset sale.

Debt Assumption: Coordinating an existing or new lender in the context of a buy/sell can be one of the biggest challenges to a successful closing. Well-drafted buy/sell provisions will state that if an existing lender is to remain and the buying partner is not a guarantor of the debt, in order to assume the debt the buying partner must find an acceptable replacement guarantor. In the event the buying partner is unable to do so, the buy/sell may provide that the buying partner indemnify the existing guarantors in the event of a call under the guaranty. Alternatively, the buying partner may terminate the consummation of the buy/sell without penalty in which case the seller partner may elect to become the buying partner or either party may invoke a forced sale of the asset to a third party. Loan documents should also address this guarantor issue so the lender understands upfront the issues raised when a borrower's JV agreement contains a buy/sell provision. Ideally, the loan documents should expressly state that the assumption of the loan in this context will not trigger prepayment penalties or assumption fees.

New Debt: If new debt is procured to replace the existing debt and consummate the buy/sell, who pays any prepayment penalties on the existing debt should be addressed in the buy/sell provisions or, at a minimum, factored into the valuation. Similarly, a new loan most likely will necessitate a transfer of the asset, as any new lender will want to secure its loan with a new mortgage on the real estate. A new lender will also likely require that a new single purpose entity take title in order not to subject itself to any existing liabilities of the joint venture. Coordination and attention to transaction deadlines are critical if new debt will be used in closing a buy/sell.

A well-drafted buy/sell provision should also address what happens if either the buyer or seller defaults. Typically, if a buyer fails to close a buy/sell transaction, the seller either may keep the buyer's good faith deposit or elect to become the buyer and close the purchase under the buy/sell at a 5% to 10% discount to the initial agreed-upon valuation in the initial buy/sell election notice, or both. Conversely, if a seller defaults, buyer typically can sue for specific performance and costs of enforcement.

Buy/sell provisions in JV agreements are critical in ensuring an efficient, equitable and often amicable breaking of a deadlock and dissolution of a JV due to an irreconcilable partner disagreement. Before entering into a JV, such a deadlock provision should be drafted into the agreement and it must be sufficiently detailed to be equitable, avoid misinterpretation and effectuate the intent of the parties. Although it is challenging to address terms of a break-up at the time a partnership is being created, planning for such a scenario spares both partners a significant amount of time and money if a dispute arises and mitigates risk for a project's sponsor, investor and lender.

The counsel of a sophisticated attorney with experience both drafting buy/sell provisions for sponsors and investors and one with experience consummating the actual exercise and closing of a buy/sell can be invaluable in achieving a successful project.

Francis Mastroianni is co-founder and partner of Trilogy Law LLC, based in Boston. He may be contacted at fran@trilogylaw.com. The views expressed here are the author's own.

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Commentary

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