

# Management and Governance of Real Estate Joint Ventures

## Avoiding Surprises and Resolving Conflict in Tough Times

By Richard R. Spore III



Efficient and effective management is obviously important to the success of any real estate joint venture (meaning any entity formed for co-investment by multiple parties, including general partnerships, limited partnerships, and limited liability companies) at any time. The current recession, however, poses unique short- and long-term challenges that make good management essential not only for the success but also for the survival of many joint ventures. The management of any real estate joint venture should therefore be structured to achieve the following goals:

- empower the appropriate joint venture partners (as used in this article, “partners” refers to the holders of interests in any type of joint venture entity) or managers with the clear-cut authority to manage the joint venture in a way that will achieve its economic goals;
- place appropriate checks on that authority to protect the interests of the partners, particularly minority partners;
- avoid bad surprises and conflict in the area of joint venture management;

- replace management that fails to perform to certain agreed-on standards; and
- resolve conflicts among the partners and managers in a manner that minimizes the economic harm to the joint venture.

This article will discuss structuring joint venture agreements to achieve these objectives.

### Granting and Limiting Management Authority

The partners must decide both who will manage and lease the joint venture’s properties on a day-to-day basis and who will make longer-term strategic decisions on behalf of the joint venture. Longer-term decisions include the joint venture’s capital structure, that is, the composition of its debt and equity capital stack; disposition or acquisition of properties; and the appointment, supervision, and, if necessary, replacement of managers. The key elements of an effective grant of management authority—both for day-to-day decisions and for long-term oversight—include the following:

- the scope of authority granted, and limitations on that authority, must be clear;
- management accountability for the achievement of joint venture objectives (including specific

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management deliverables, when applicable) must be clearly set forth and consistent with the grant of authority; and

- there must be a mechanism for correcting, and if necessary replacing, management that is off-course.

Typically, the easiest way to achieve these objectives is by delegating centralized management control to a manager—whether a manager or managing member of an LLC or a general partner of a limited partnership—or a board of managers or directors. Centralizing



management authority can help avoid confusion regarding who is responsible and accountable for achieving key joint venture objectives. Key management decisions and actions are less likely to “fall between the cracks” with a centralized management structure that includes well-defined processes and responsibilities, as compared with decentralized management (such as management by multiple members of a member-managed LLC). A centralized management structure also can allow the joint venture to act more rapidly to take advantage of opportunities before they disappear and address problems before they become crises.

The manager of the joint venture can in turn have the authority or obligation to delegate certain functions (for example, day-to-day property management or leasing) to independent contractors under management and leasing agreements. With such delegation,

the joint venture management must effectively monitor and manage these independent outside management services providers. The joint venture management should remain responsible and accountable for subcontracted management functions unless the other partners have dictated the choice of these management subcontractors.

Regardless of the exact management structure used, at least some management authority checks and balances should ordinarily be incorporated into the joint venture agreement to protect the interests of the partners who do not control management (typically minority owners or passive investors such as limited partners). This often is done by including in the joint venture agreement a list of management actions that require approval of a majority of the partners before they can be taken by the manager. If the goal is to protect the interests of minority partners, then “supermajority” or even unanimous partner approval can be required for the joint venture to take certain fundamental actions. For example, actions requiring explicit partner approval might include:

- deviating from the approved joint venture budget by more than a certain amount (more on this below);
- amending, terminating, or entering into management, leasing, or franchise agreements;
- amending, terminating, or entering into leases outside of certain previously agreed-on leasing parameters;
- paying any fees (for example, management, leasing, or construction management fees) outside of certain previously agreed-on guidelines;
- issuing capital calls;
- amending the joint venture’s organizational documents;
- changing the joint venture’s tax reporting or accounting practices;
- changing the joint venture’s insurance coverages or insurance carriers outside of certain agreed-on parameters;
- approving conflict of interest

transactions with the manager or any partners in the joint venture;

- borrowing money in excess of a certain amount (except for ordinary course, unsecured trade debt), providing joint venture guarantees of third-party debt, or pledging or mortgaging joint venture assets;
- selling or buying real estate;
- making capital expenditures in excess of a certain amount except under an approved budget;
- dissolving the joint venture, filing bankruptcy, appointing a receiver, or confessing a judgment against the joint venture;
- permitting a default to occur under key joint venture agreements (for example, loan documents, key leases, or franchise agreements); or
- establishing or modifying cash reserves except as provided in an approved budget.

Including these kinds of voting requirements in the joint venture agreement limits the manager’s authority and should not be adopted without careful consideration. If the manager is not controlled by the principal investors in the joint venture, those investors will usually want more extensive management authority limitations. Conversely, if the principal investors control the manager, and these voting requirements are intended to protect minority investors, the principal investors will likely want to require minority partner approval only for the most critical decisions.

### **Avoiding Bad Surprises and Conflicts**

#### **Budgets**

The principal way that joint venture partners can avoid bad surprises and conflicts in day-to-day joint venture operations is to adopt a budget that serves as a roadmap for operating expenses and foreseeable capital expenditures. In general, the managers of the joint venture should be able to project annual joint venture costs with reasonable accuracy, barring unforeseen events like casualty losses. The managers also

should be able to forecast annual revenues, but revenue forecasts are often less accurate than cost forecasts because revenues can vary depending on the nature of the joint venture's property, its tenant mix, lease expiration dates, and the state of the general economy. For example, in the current recession partners may have trouble forecasting revenues accurately because the depth and length of the recession and its ultimate effect on rent rolls are difficult to predict.

The budget's line items should be reasonably detailed and narrow enough for the partners to evaluate and establish controls over specific categories of expenses. For example, instead of a budget line item simply showing a "Fee to Manager" of 10% of gross revenues, it would be more useful to break that gross fee down into its component parts, such as property management, leasing, construction management, and accounting fees. A carefully prepared and reasonably detailed budget should provide the partners with a good idea of the joint venture's expenses and projected cash flow for the upcoming year.

Typically there is an annual budget approval process, with the joint venture managers required to propose a budget for review and adoption by the partners. The joint venture agreement can provide that if the partners fail to approve the proposed budget, the prior year's budget rolls forward, perhaps with a price-index adjustment to the prior year's budgeted costs or with uncontrollable costs (such as taxes) automatically resetting at the prior year's actual amount for those costs. The partners also can consider adopting a mediation/arbitration process to resolve budget conflicts. Traditional arbitration of budget disputes, however, may be impractical for many joint ventures because of the time and expense involved and because questions regarding appropriate budget amounts typically involve business rather than legal issues.

The approved budget should generally be binding on the joint venture's managers. The partners, however, should consider including some flexibility in the budget to ensure that it

functions as a road map rather than a straightjacket. For example, the budget could permit percentage variances from budgeted amounts for controllable expenses. Such permitted variances could apply on an aggregate and a line-item basis. It also can be appropriate to exclude uncontrollable expenses such as taxes or bona fide emergency expenses from the mandatory provisions of the approved budget.

### **Transparency and Conflicts of Interest in Management**

The joint venture will not be able to function without a reasonable level of trust among the partners and the joint venture management. Establishing and maintaining this trust requires clear delineation and limitation of management authority, as described above. It also requires transparency in joint venture management and compensation, with a satisfactory process for either avoiding or resolving conflicts of interest after full disclosure to the partners.

First, there should be no hidden or "buried" fees. All fees to managers, partners, or their affiliates should be fully disclosed and approved in writing by the disinterested partners in the initial joint venture agreement or subsequent partner resolutions or joint venture budgets. Most state law business entity acts include statutory requirements along these lines for "sanitizing" conflict transactions, and the affected partners should be careful to comply with these statutory requirements. The partners may want to re-price these fees periodically to ensure that they continue to be in line with market values. If repricing is desirable, a mechanism or process for that re-pricing should be set forth in the applicable agreements.

The joint venture agreement also should set forth in detail (or disclaim if applicable) any noncompete obligations of the partners or managers. Many state partnership and LLC acts impose noncompete obligations on owners as part of their statutory fiduciary duties. See, e.g., Del. Code Ann. tit. 6, § 15-404(b) (3). These statutory duties apply unless they are expressly waived in the joint venture agreement. Conversely, if partners or managers are intended to have

noncompete obligations of any kind, those obligations should be clearly articulated in the joint venture agreement; the partners should not have to rely on potentially less precise and less robust state law fiduciary duties.

### **Replacing Nonperforming Management**

The partners should decide at the outset what events will justify a management change. For example, should the joint venture's failure to meet certain economic objectives allow partners to replace a manager who is otherwise performing in accordance with its

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contractual obligations? Or should the manager be terminable only on some showing of neglect of duty or misconduct? The answers to these questions will probably turn on a number of factors such as the manager's financial stake in the joint venture (including both its invested capital and exposure on joint venture credit enhancements like loan guarantees) and the amount of its contingent compensation or "promote" interest in the joint venture. A manager with a significant investment in the enterprise and a sizeable "promote" interest at stake will argue that the other partners should not be able to terminate its management authority solely because financial results are not as good as originally hoped for, which may be due to reasons having nothing to do with the manager's performance.

In any case the partners should certainly have the power to terminate a manager guilty of intentional misconduct, fraud, willful breach, or other sorts of bad acts. What constitutes a

reasonable “for cause” basis for replacing a manager, however, can be subject to debate. For example, few would argue against the replacement of a manager who commits fraud or steals from the joint venture or willfully commits a material breach of the joint venture agreement. But consider a manager who allows the joint venture to default under its loan documents or franchise agreement and so jeopardizes the joint venture’s viability. That default could well be beyond the control of the manager if it is caused by joint venture financial performance issues resulting from a general economic downturn of the kind that we are now experienc-

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ing. The default, however, may arise from the manager’s failure to perform covenants that are within its control, such as failing to maintain required insurance or signing leases outside pre-approved leasing guidelines.

Because of the potential for disputes regarding whether a manager has committed bad acts or failed to discharge its contractual obligations to the joint venture, the partners may want to reserve the right to remove the manager without cause, perhaps on a supermajority vote of the partners. Such termination without cause often is coupled with a liquidated damages termination fee to the manager and a buy-sell option for the manager’s interest in the joint venture. These buy-sell provisions protect the manager from having to continue in the joint venture after its removal as manager and also make available an ownership interest in the joint venture to attract and compensate a replacement manager. Inclusion of these sorts of provisions in

the joint venture agreement means that when a manager has clearly committed some bad act, the other partners will proceed under the “for cause” removal provisions of the agreement. But if the manager’s misbehavior is less clear, some negotiated compromise between the “for cause” and “without cause” removal outcomes often will be worked out among the partners and manager.

### **Resolving Conflict**

The two principal contractual means of resolving conflict among partners are inclusion in the joint venture agreement of buy-sell provisions allowing buyouts of (or by) warring parties and alternative dispute resolution provisions allowing the partners to resolve conflicts in a reasonable manner. Without such provisions in the joint venture agreement, the partners must recognize the potential for the joint venture to implode if conflict arises. Typically this occurs when one of the partners seeks judicial dissolution of the joint venture on the basis that it is not practicable for the partners to continue the joint venture’s business in accordance with the joint venture agreement. Such dissolution is permitted under the partnership and limited liability company laws of many states. See, e.g., Del. Code Ann. tit. 6, §§ 17-802, 18-802.

The most commonly used buy-sell provision for resolving conflict among partners is the so-called “Russian roulette” buy-sell. This provision allows any partner to approach another partner or group of partners with an offer to buy its joint venture interests. The other partner or group must then either accept the offer and be bought out of the joint venture or buy the initiating partner out of the joint venture on the same proportionate price and terms offered. The partners should seriously consider including this sort of buy-sell provision in any joint venture when there is the potential for management conflict or deadlock (such as occurs with two 50/50 partners). It is less commonly used with other ownership regimes, but it can be used, with some modifications, in almost any kind of joint venture ownership.

Another buy-sell option for

resolving conflict among partners is a put/call option as to certain partners. Such an option might be based on a formula price, an appraised value price, or perhaps a price determined under a “baseball-type” arbitration. In “baseball” arbitration, each party presents its proposed price to the arbitrator, who must choose one of the two proposals. These buy-sell provisions can provide a mechanism for disaffected partners to exit the joint venture without major disruption of joint venture operations.

It will not be possible, however, to orchestrate buyouts or removals of difficult or unhappy partners in every instance. In those cases, often the best that can be done is to provide an alternative method of resolving disputes that will keep the parties out of court. Once joint venture partners are embroiled in a lawsuit, it will be very difficult for them to conduct joint venture business in a reasonable manner. Accordingly, the parties may want to consider requiring mediation or arbitration (or both) of any dispute that relates to the joint venture or joint venture agreement. But the parties also will want to consider carving out certain kinds of disputes from any mandatory mediation or arbitration. For example, the parties may want to reserve the right to obtain injunctive relief against a threatened breach of a buy-sell provision or some other joint venture agreement provision that could result in irreparable harm to a partner or the joint venture.

### **Conclusion**

The current recession is creating short- and long-term challenges and opportunities in all sectors of the real estate industry. Addressing problems and capitalizing on opportunities in uncertain times require capable and decisive management. A real estate joint venture’s chances of success in this environment are maximized by a management structure that grants managers the necessary authority to do their jobs, limits that authority in appropriate ways, avoids bad surprises and ensures transparency in joint venture operations, and provides joint venture managers and partners with reasonable means to resolve conflict when it arises, short of dissolving the joint venture. ■