June 8, 2020

PERE Insights – Relationship problems? Partner defaults and other termination rights under programmatic real estate joint ventures

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'We must be willing to let go of the life we have planned, so as to have the life that is waiting for us.' – ***E.M. Forster***

In the first Alert of two on programmatic joint ventures in European real estate investment, we focused on some key provisions which are designed to establish relationship harmony and alignment between the capital partner and the operating partner. However, market conditions, business conflicts and human nature can all operate to upset the intended balance of interests and one party or another can therefore fail to meet expectations required of it. It is critically important that joint venture agreements provide for resolving disputes which arise as a result and, ideally, for an equitable parting of ways under the circumstances. Setting out a clear position from the outset on defaults and failure in performance is also another way of creating alignment. The key is balancing a sensible amount of management flexibility with necessary checks and balances, thereby promoting the best interests of the venture. This Alert focuses on some specific provisions which are designed to achieve that balance and on the rights which are consequently available to the performing party where standards are not met. It is also written assuming, again, that the capital partner is providing the significant majority of the venture's equity commitment and is negotiating with a view to best protecting its investment, whilst also taking into account important practical and relationship considerations.

Management Performance – "Cause" and Effect

Management-level default and dissatisfaction

There is a tension between the capital partner's desire to protect its investment and, accordingly, set out relatively strict default parameters and the operating partner's desire to have adequate delegation of authority to the manager and not risk hair triggers of default and, consequently, termination of its manager. Standard defaults for change of control and insolvency of the manager are generally accepted but the definition of "Cause" for operational default purposes is often debated at length. As a general rule, it will be important to focus on events or circumstances which are genuinely indicative of bad management, rather than mere capital partner dissatisfaction. One key element of this is to define what acts or omissions constitute "Bad Acts" of the manager. These might include fraud, gross negligence, criminal acts, dishonesty, wilful misconduct, negligence (to a greater or lesser extent), breach of fiduciary duty or breach of anti-corruption or anti-money-laundering laws. However, the basket and scope of such items is often hotly debated, given the potentially severe consequences which follow from such an event being substantiated. In particular, managers are often at pains to avoid being tripped up by the criminal acts limb and it is therefore not uncommon to see it qualified by convictions, custodial sentences and/or penalty thresholds of varying levels.

General breaches of management obligations are an important limb to this definition. The manager will want to limit these to matters which are not merely trivial in nature, whereas the capital partner/venture will wish to retain flexibility to enforce where it is repeatedly unhappy with the level of management service. Here again, it is important to maintain balance, and partners therefore typically agree that material breaches should trigger a right to terminate only once a sensibly negotiated cure period has expired. To protect the capital partner and the venture further, management agreements can also provide for "Cause" where a manager persistently (but perhaps not materially) breaches its obligations and is notified of the fact. This would, for example, guard against instances of the manager regularly pushing the limits of its delegation but not materially prejudicing the platform each time.

In each of the default circumstances mentioned above, the capital partner's/venture's most readily available remedy will be a right to terminate the manager's appointment under the relevant management agreement(s), though without prejudice to damages and other recovery claims at law. However, those circumstances will potentially have adverse consequences for the operating partner under the equity arrangements with the capital partner – this is discussed in more detail below. A capital partner also needs to consider the remedies it has when it is merely dissatisfied with the level of the manager's performance and the relationship has deteriorated to such an extent that the performance is unlikely to improve. It is possible that none of the management default grounds can be substantiated but the capital partner nevertheless is no longer comfortable with the *status quo* continuing. To cover this scenario, it is not uncommon to see rights to remove the manager 'without cause' on written notice alone. In these cases, the principal points of negotiation will be the length of notice period required and, possibly, the level of any termination fee payable to the manager. In the interests of the relationship a manager may, justifiably, insist on a fee equal to, say, 6–12 months' base management fee. Capital partners may set performance milestones and/or other metrics which need to be achieved, failing which the capital partner/venture will have a right to terminate the manager on notice. There is much debate as to the consequences that should flow from such a termination trigger. On the one hand, the capital partner will argue that a failure to meet business plan targets epitomises the manager's lack of performance and therefore constitutes a *de facto* uncured material breach. On the other, the operating partner will argue there are simply too many external, market factors to contend with to justify that this should be the manager's responsibility alone. This type of termination event can be in a class of its own, thereby carrying longer notice and, perhaps, cure periods, resulting in less penal termination consequences at the equity level, such as a lesser portion of promote being forfeited and/or put or call rights over the operating partner's equity at full fair market value.

Equity-level default

Events of default under the joint venture agreement tend to be somewhat more standardised, commonly including material, uncured default, insolvency events and, as discussed in the previous Alert, failures to pay funds when due. There will also be certain events of default which are specific to the operating partner and/or its management appointment, such as change of control and insolvency events of the manager, 'Bad Acts' of the operating partner, its affiliates, officers etc. and the occurrence of any event of default under the management agreement(s). Including the latter cross-default provision is important to ensure an alignment of the operating partner's management responsibility and the performance of its equity stake because of the potentially severe consequences if this event of default is triggered.

In Europe, it is now also becoming more common that operating partner principals and/or parent companies are asked to stand behind operating partner defaults by way of specific guarantees and indemnities to be entered into alongside the joint venture agreement. The benefit of this for the capital partner is that the actual sources of funding are at risk and there is real 'skin in the game' as a result. On the other side, operating partner executives will be keen to limit the scope of these guarantees and indemnities given the harsh and potentially personal consequences that flow from any claim under them. Therefore, they are often drafted to cover only those breaches which might have the most material monetary impact, including 'Bad Acts' and uncured failure to fund, although it is not uncommon for capital partners to continue to insist on management "Cause" events being included here as well.

Consequences of Default

Whilst the threat of termination at a management level and the backstop afforded by guarantees are important, the most immediate and impactful recourse in the event of default for capital partners will be to the operating partner's equity under the joint venture agreement. The threat of enforcing a sufficiently penal regime here, much like the specific, dilutive consequences flowing from a failure to fund, itself also creates alignment, as the operating partner will be mindful of the significant financial downside. Once an event of default occurs, there will be certain measures which immediately and automatically flow. For example, the voting rights of the operating partner as an investor and of its representatives on the board or similar body of the joint venture company may be suspended or removed, thereby

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allowing the capital partner or its nominee(s) to take control of the venture. Such disenfranchisement of voting rights can, however, offend restrictions under the laws of certain European jurisdictions and it may be necessary to provide for practical workarounds.

The operating partner's entitlement to the promote or carried interest may also be lost following an event of default. This earning power is the cornerstone of the operating partner's investment rationale, so it will fight very hard to limit the application of this default trigger. Discussions that this should apply only to 'Bad Acts' and only to the entitlement to future (and not accrued) promote are therefore relatively common, but capital partners will still fight hard to provide that management "Cause" events also trigger this penalty, as this will more tightly align the manager's appointment to the overall equity performance. It should not be forgotten, however, that accrued promote also shows that the venture has more widely accrued investment success as at the relevant date; a potential justification for the operating partner's retention of its incentive up to that point.

Ordinarily, on the occurrence of an event of default, a non-defaulting partner can elect to exercise a call option, thereby forcing the defaulting partner to transfer its equity interests to it at a pre-agreed discounted price, often by reference to fair market value. The level of that discount is often a contentious point, as the parties attempt to find a balance between the need to provide for a meaningful deterrent and a position which would be inequitable and/or potentially unenforceable at law. From the operating partner's viewpoint, it is also important to consider what effect these equity rights would have on the management appointment and *vice versa* in relation to the occurrence of "Cause" under the management agreement(s). It may be concerned in particular to ensure that it is not bought out from the equity and yet required to continue to manage the platform, as it will have lost its promote incentive and potentially only be paid a management fee. Similarly, if management termination rights are exercised, the operating partner may not want to remain as a passive equity investor only, with no governance rights or promote incentive and with the possibility of suffering adverse valuation effects of mismanagement by a new third-party manager appointed in its place. For these reasons, we have recently seen a number of interesting negotiations around, in certain limited instances, removing the non-defaulting partner's optionality to call for equity or terminate the management engagement and tying these rights together.

Closing Thoughts

Programmatic, platform joint ventures are a relatively long-term capital deployment strategy. For this reason, during their investment life, the markets can shift materially and relationships can become strained between partners for many reasons. It is therefore important to future-proof the venture to ensure that investors can part ways in as efficient and equitable a manner as possible (however that parting of ways arises) and whilst still endeavouring to promote alignment of interests from the outset.

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