Law & Accounting

Consider lender concerns in your joint venture agreement

In commercial real estate mortgage loan transactions, potential lenders will only make a loan to a borrower for a fraction of the value of the mortgaged property securing the loan, often around 60%, and will require the borrower to contribute or retain the remaining amount with required equity. With higher interest rates and constrained capital, real estate developers and owners are looking at requirements to solicit greater equity investments in their projects prior to approaching lenders. Often, the developer and an unrelated money partner ("investor member") will form a joint venture to own and control, directly or indirectly, the property. Customarily, the developer will be the "managing member" and control the day-to-day operations and management of the JV (and thus the property), while the investor member will participate in major decisions and otherwise passively expect a favorable return on its investment. These two members enter into a "JV agreement" that outlines the rights and obligations of the members.

Importantly, since the investor member's return will be paid from property revenues and/or proceeds from the sale of the property, the JV agreement outlines remedies if the property is underperforming. Each member's remedies generally include the right to buy out the other member, and gain exclusive control and ownership of the JV. Since the exercise of this remedy can fundamentally change the ownership structure of the borrower that was underwritten by the lender, lenders may closely analyze the JV agreement and impose requirements for the JV agreement based upon issues that conflict with the lender's loan document requirements.

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■ **JV agreement guidelines.** Lenders' primary concerns are the distribution of profits from the property, and each member's right to exercise remedies, particularly when property revenue is sufficient to cover debt service and property expenses (i.e., taxes, insurance and operating costs), but not preferred returns under the JV agreement. Some lenders expressly require that investor members' return be payable only from excess cash flow following payment of debt service and property costs in order to ensure amounts payable under the loan documents are payable prior to any amounts payable under the JV agreement. Relatedly, lenders typically require that preferred returns not be payable on set dates or intervals, as this requires "on-demand" performance of the property and increases the likelihood of a default under the JV agreement. Similarly, lenders will often prohibit a provision in the JV agreement that allows investor member to require the managing member to buy its interest in the JV prior to the maturity date of the loan, as this likely requires a balloon payment from the managing member that may result in a default under the JV agreement or weaken the financial strength of the JV.

That said, lenders appreciate that inadequate returns will give rise to investor member remedies under the JV agreement. The remedy about which lenders generally have the most concern is the right of the investor member to take control of the JV, thus, indirectly, controlling the borrower and the property, particularly if such a remedy is available while there is no default under the loan. Since most loan documents prohibit transfers of control in the borrower and the property (without lender's consent), such takeover may trigger a default under the loan documents without a negotiated takeover right pursuant to the loan documents.

If the loan documents permit a takeover of the JV, lenders will generally require the investor member to designate a guarantor that will replace the existing guarantor upon such takeover, and will underwrite the investor member and replacement guarantor to the same extent as the managing member and existing guarantor. By effectively underwriting each as a potential loan party, the lender hedges against a change in control of the borrower and property beyond the lender's control. Importantly, the loan documents may condition such a takeover on advance notice to the lender and the payment of a fee, new or supplemental opinions, and the borrower's reaffirmation of special purpose entity and other standard "know-your-customer" representations contained in the loan documents.

Beyond the takeover rights, provisions in the JV agreement regarding a forced sale of the property or replacement of the property manager should, generally or specifically, account for any applicable conditions in the loan documents. A forced sale may trigger prepayment fees under the loan documents or be subject to a lockout period. A new property manager may require the lender's review and approval, including of the new management agreement and manager's credit and experience, and the manager's execution of relevant loan documents (such as a subordination agreement). If known in advance of loan closing, it can be helpful to request that the lender preapprove the replacement property manager in the loan documents and for this preapproved manager to review and comment on any applicable loan documents.

Certain JV agreement "defaults" may be red flags for lenders. For example, lenders will not want the investor member to be permitted to exercise remedies in the JV agreement based on the performance (even bad acts) of another entity or property unrelated to lender's loan. Lenders disfavor, and some prohibit, the right of the investor member to exercise remedies simply for the property's failure to meet specific, quantifiable metrics like debt yield or net operating income tests. Note that some agency lenders have strict guidelines and will not make a loan if JV agreements have any unacceptable attributes, many of which are similar to those outlined above.

■ **Conclusion.** The members

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should consider waiting to finalize and execute the JV agreement until the prospective lender has reviewed and approved it. During negotiations, each JV member should recognize that the lender may have comments to the remedy and distribution provisions and perhaps other items that are particular to the underwriting of that particular lender. An investor member that insists on strict payments and remedies for the property's failure to perform in the JV agreement may delay loan negotiations. In addition, each JV member should review the loan documents and try to avoid late stage comments to the loan transfer provisions, which can delay closing. Making the lender aware of proposed takeover rights early in the process will give the lender time to determine how to move forward with transfer rights in the loan documents. In short, accounting for potential lender requirements in the JV agreement will help all parties enter into the loan document negotiations with realistic expectations and smoothly proceed to closing the loan. ▲

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