

**There's More Than One Way to Form a JV:
Alternative Structures for Real Estate Joint Ventures
April 28, 2011**

A. Hypothetical Development Deal

1. Investor proposes to make an investment with Developer for the development and construction of a Project. The investment would be based on the following:

- a. Budget:

Land acquisition	\$36
Hard and soft costs	<u>\$64</u>
Total uses	\$100

- b. Schedule:

2 years to develop/construct the Project
3 year hold after completion of the Project

- c. Investor's objectives:

Invest \$36
Receive 8% annual return
Hold for 5 years
Receive an additional return from profit on sale

2. Consider a variety of structures for the Investor's investment in the Project, and determine how each structure has different implications for state law, tax, bankruptcy and financing purposes.

B. Alternative Investment Structures

1. Structure #1: Equity - Common

- a. Description: Investor and Developer form a limited liability company ("LLC") in which Investor and Developer are the members. Developer is the managing member of the LLC, and Investor has the right to approve specified major decisions. Investor contributes \$36 to the capital of the LLC, and Developer contributes \$4. The LLC obtains a \$60 non-recourse construction loan, and Developer individually provides a non-recourse carveout guaranty to the Mortgage Lender (but no other payment guaranty).

- b. Sources:

Equity
Investor - \$36

Developer - \$4	
Total	\$40
First Mortgage	<u>\$60</u>
Total	\$100

c. Distribution Waterfall for NOI:

- 1- Mortgage Lender
- 2 - 90/10 until 8% return
- 3 - 80/20 thereafter (i.e., Developer gets a 10% promote)

d. State law perspective:

- Investor and Developer's relationship will be governed by LLC operating agreement and applicable state's limited liability company act.
- If Project does not generate sufficient revenue to pay Investor, Investor will generally not have remedies against LLC or Developer (assuming no mismanagement by Developer).

e. Tax perspective:

- For Investor:
 - Assuming 8% return is an internal rate of return, investor will receive return of all contributed cash first, and thereafter an 8% return on its capital.
 - Investor will have taxable income allocations on both tier 2 and tier 3 distributions.
 - Investor will share in JV losses in proportion to either its capital and/or residual interest.
 - Income allocations will typically follow cash flow. To the extent that debt service or other payments reduce cash flow, possibility of taxable income not matched with cash.
- For Developer:
 - Assuming 8% return is an internal rate of return, developer will receive return of all contributed cash first, and thereafter an 8% return on its capital.
 - Developer will have taxable income allocations on both tier 2 and tier 3 distributions.

- Developer will share in JV losses in proportion to either its capital and/or residual interest.
- Income allocations will typically follow cash flow. To the extent that debt service or other payments reduce cash flow, possibility of taxable income not matched with cash.
- Developer's income will have same character as that of the JV. Ability to convert ordinary income to capital gain. Through 3rd tier allocation able to share in JV upside as capital gain rather than ordinary income (assuming not dealer property).

f. Mortgage lender's perspective:

- Very common, safe structure, at least for completed projects. Mortgage lender is the only secured creditor.
- Limiting recourse to carve-out guaranty presents significant risk to construction lender and may not be widely available in the market.

g. Bankruptcy perspective:

- Equity vs. Debt stake is balancing of control against recovery in a bankruptcy
- Equity position provides control of the entity and decision making before and after bankruptcy case begins
- Equity stands behind all debt and will be the last paid in a bankruptcy

2. Structure #2: Equity - Preferred

- a. Description: Consider the same basic legal structure as Structure #1, except that the distribution priorities are modified so that *Investor's 8% return is a priority ahead of the return to Developer*. Investor and Developer form LLC. Investor invests \$36 as a capital contribution to LLC, and Developer invests \$4 as a capital contribution. Investor receives an 8% priority return, ahead of the return to Developer. Developer then receives a 8% "catch-up" return. Investor and Developer share 50/50 any returns thereafter.

b. Sources:

Equity	
Investor - \$36	
Developer - \$4	
Total	\$40
First Mortgage	<u>\$60</u>
Total	\$100

c. Distribution Waterfall for NOI:

- 1- Mortgage Lender
- 2 - Investor until 8% return
- 3 - Developer until 8% return
- 4 - 50/50 thereafter (i.e., Developer gets a 40% promote)

d. State law perspective:

- Same as Structure #1

e. Tax perspective:

- Same as Structure #1
- Might consider Tax Distribution in favor of Developer in cash waterfall because Developer may be allocated taxable income prior to receiving any cash if the Investor's 8% return is an internal rate of return calculation.

f. Mortgage lender's perspective:

- Same as Structure #1

g. Bankruptcy perspective:

- Same as Structure #1, priority between classes of equity will be enforced in bankruptcy

3. Structure #3: Debt - Mezzanine Loan

- a. Description: Instead of Investor and Developer forming the LLC, Developer owns 100% of the LLC and Investor makes a \$36 non-recourse loan. The loan is made to Developer (not the LLC), and is referred to as a Mezzanine Loan. The terms of the Mezzanine Loan are set forth in a loan agreement between Investor and Developer, and provide for 8% interest plus kicker interest of 50% of net cash flow remaining after an 8% return to Developer. The Mezzanine Loan is secured by a pledge of 100% of Developer's ownership interest in the LLC.

b. Sources:

Equity	\$4
Mezz Loan	\$36
First Mortgage	<u>\$60</u>
Total	\$100

c. Distribution Waterfall for NOI:

- 1- Mortgage Lender
- 2 - Mezz Loan until 8% interest

- 3 - Developer until 8% return
- 4 - 50% as kicker interest on Mezz Loan, 50% to Developer

d. State law perspective:

- Relationship between Investor and Developer is now that of creditor/debtor, and applicable state law governing loans applies.
- If Mezzanine Loan is not paid when due, Investor will have right to foreclose on Developer's pledge of the ownership interests in the LLC.

e. Tax perspective:

- Initial inquiry as to whether Investor's Mezz Debt is debt or equity
- If Mezz Debt is respected as debt, then:
 - payments to Investor generate interest income and interest deduction. Also different consequences arise in the event of default on the Mezz Debt.
 - Investor has no capital gain potential if form is respected.
 - Developer has capital gain (assuming not dealer property).
 - Developer can include entire Mortgage and Mezz Debt in basis for purposes of claiming losses. No losses allocable to Investor.
- Likely Mezz Debt is equity given 50% kicker (no cap on upside). Same tax consequences as Structure #2.

f. Mortgage lender's perspective:

- Risk/reward analysis is mixed bag. On one hand, mezz lender is another party in interest who may be incentivized to disrupt mortgage lender's enforcement of its remedies. On other hand, mezz lender is a secondary source of repayment of mortgage debt in distress situation. Risk of disruption can be mitigated through intercreditor agreement.
- Mezz lender is technically not a creditor of the mortgage borrower, so mortgage lender will prefer mezz debt relative to second mortgage debt.

g. Bankruptcy perspective:

- Investor is not a creditor or equity holder of LLC and has no direct rights in LLC bankruptcy
- Bankruptcy remoteness -- will the Developer file?

- Cross-defaults in loan to Developer
- Ability to foreclose on equity in Developer

4. Structure #4: Debt - Hybrid Mezzanine Loan

- a. Description: Consider the same basic legal structure as Structure #3, except that in lieu of receiving kicker interest, Investor receives a 50% carried interest in LLC. The carried interest provides that Investor will receive 50% of net cash flow after Developer receives an 8% return.

- b. Sources:

Equity	\$4
Mezz Loan	\$36
First Mortgage	<u>\$60</u>
Total	\$100

- c. Distribution Waterfall for NOI:

- 1- Mortgage Lender
- 2 - Mezzanine Loan until 8% interest
- 3 - Developer until 8% return
- 4 - 50/50 to equity (Investor and Developer)

- d. State law perspective:

- Same as Structure #3

- e. Tax perspective:

- Initial inquiry as to whether Investor's Mezz Debt is debt or equity
- If Mezz Debt is respected as debt, then:
 - payments to Investor on Mezz Loan generate interest income and interest deduction. Also, different consequences arise in the event of default on the Mezz Debt.
 - Unlike Structure #3, Investor has capital gain potential on its 50% equity interest and Developer has capital gain potential (assuming not dealer property) on its 8% internal rate of return and equity interest.
 - Investor's basis, but not Developer's is increased for the Mortgage and Mezz Debt and for purposes of claiming losses. Developer gets no basis from debt for claiming losses, thus losses limited to capital.
- Risk that Mezz Debt is equity given 50% equity component with no matching capital investment. Same tax consequences as Structure #2.

- f. Mortgage lender's perspective:
 - Same as Structure #3
- g. Bankruptcy perspective:
 - Generally the same as Structure #3
 - Investor not a creditor in LLC bankruptcy, but equity provides opportunity for role in LLC bankruptcy

5. Structure #5: Debt - Subordinate Mortgage Loan

- a. Description: Consider a structure similar to Structure #3, except that Investor's collateral is the Project and not a pledge of the ownership of the LLC. Investor makes a \$36 non-recourse loan to the LLC secured by a mortgage on the Project. The mortgage is expressly subordinate to the mortgage securing the First Mortgage Loan. The subordinate mortgage loan bears interest at 8% and receives kicker interest of 50% of net cash flow after an 8% return to Developer.

- b. Sources:

Equity	\$4
Second Mortgage Loan	\$36
First Mortgage	<u>\$60</u>
Total	\$100

- c. Distribution Waterfall for NOI:

- 1- First Mortgage Lender
- 2 - Second Mortgage Loan until 8% interest
- 3 - Developer until 8% return
- 4 - 50% as kicker interest on Second Mortgage Loan, 50% to Developer

- d. State law perspective:

- As in Structures ##3 and 4, applicable state law regarding creditor/debtor rights will apply.
- If Second Mortgage Loan is not paid when due, Investor will have the right to foreclose upon its mortgage, subject to the First Mortgage.

- e. Tax perspective:

- Same as Structure #3

- f. Mortgage lender's perspective:

- Stop the presses! Senior mortgage enforceability is impaired by presence of another secured creditor. Rating agencies won't rate debt. Risk of cram down in bankruptcy.
- If this structure were to happen, relationship between mortgagees would be prescribed in intercreditor agreement.

g. Bankruptcy perspective:

- Investor now a direct creditor of LLC with greater rights as secured creditor in bankruptcy
- Bifurcation of secured claims
- Secured creditor has protections for value of collateral and ultimate recovery

6. Structure #6: Property Interest - Subordinated Ground Lease

- a. Description: Investor purchases the land on which the Project will be built for \$36 and then ground leases the land to LLC on a non-recourse basis. The Ground Lease provides for base ground rent equal to an 8% return to Investor on the land price. The Ground Lease also provides for participating rent of 50% of net cash flow after an 8% return to Developer. Investor, as ground lessor, subordinates its fee interest in the land to the lien of Mortgage.

b. Sources:

Equity	\$4
First Mortgage	<u>\$60</u>
Total	\$64*

*Land is leased so \$36 land cost is removed from the budget

c. Distribution Waterfall for NOI:

- 1- Mortgage Lender
- 2 - Ground rent until 8% return on \$36 land price
- 3 - Developer until 8% return
- 4 - 50% as participating ground rent, 50% to Developer

d. State law perspective:

- Relationship between Investor and Developer is now that of lessor/lessee, and applicable state law governing leases applies.
- If ground rent is not paid when due, Investor will have right to terminate the Ground Lease and evict LLC.

e. Tax perspective:

- If form is respected:
 - Investor generates ordinary rental income
 - Developer generates ordinary rental deduction. Developer claims depreciation deductions and can claim other losses on its overall investment.
- Risk that based on benefits and burdens of ownership, transaction recast as a joint venture given the 50% net participating ground rent. Could be improved by sharing in % of gross, rather than net rent. Same as Structure #2.

f. Mortgage lender's perspective:

- This scenario has similar risk profile to mortgage lender as if developer and investor partnership owned in fee.
- Some additional risk to mortgage lender due to separation of developer and investor into different real estate interests, but risk is manageable.

g. Bankruptcy perspective:

- Lessors have substantial protections in bankruptcy
 - Debtor required to pay rent
 - Protections for assumption and assignment of rent
- Subordination agreement with third party enforceable
- Right to payment of rent against debt service

7. Structure #7: Property Interest - Unsubordinated Ground Lease

- a. Description: Consider the same structure as Structure #6, except that Investor does not subordinate its fee interest in the land to the lien of the First Mortgage. Given the enhanced security of his position, Investor accepts a reduced base return (say, 6% in lieu of 8%) and reduced kicker (say, 10% in lieu of 50%).

b. Sources:

Equity	\$4
First Mortgage	<u>\$60</u>
Total	\$64*

*Land is leased so \$36 land cost is removed from budget

c. Distribution Waterfall for NOI:

- 1- Mortgage Lender
- 2 - Ground rent until 6% return on \$36 land investment
- 3 - Developer until 8% return
- 4 - 10% as participating ground rent, 90% to Developer

d. Business perspective:

- For the first time, Investor has priority over the Mortgage. Consequently, Investor's returns are decreased to reflect his more secure position.

e. State law perspective:

- Same as Structure #6

f. Tax perspective:

- Same as Structure #6

g. Mortgage lender's perspective:

- Although this structure is common, it increases mortgage lender's risk profile and reduces priority of lien, which would be reflected in pricing. Adequate mortgagee protection provisions in ground lease are critical.

h. Bankruptcy perspective:

- Same as Structure #6

8. Structure #8: Contract - Participation Agreement

- a. Description: Investor advances \$36 to Developer. Developer contractually agrees to provide Investor with an 8% return and a 50% share of the profits.

b. Business perspective:

- Unusual and unique arrangements - e.g., management agreements, employee participation arrangements, public/private partnerships, etc.
- Since Investor's investment is once again subordinate to the Mortgage, its returns are adjusted upwards to reflect the greater risk.

c. State law perspective:

- Relationship between Investor and Developer is now that of contracting parties, and applicable state law governing contracts applies.

- If participation is not paid when due, Investor will have right to sue for damages under state law.

d. Tax perspective:

- If form is respected then Developer has interest deduction and Investor has interest income, and Developer has capital gain potential.
- Because of Investor's 50% participation in upside that is not capped, likely recast as a partnership. Generally, same as Structure #2, except Developer has no 8% internal rate of return before sharing with Investor. Both parties share in losses.

e. Mortgage lender's perspective:

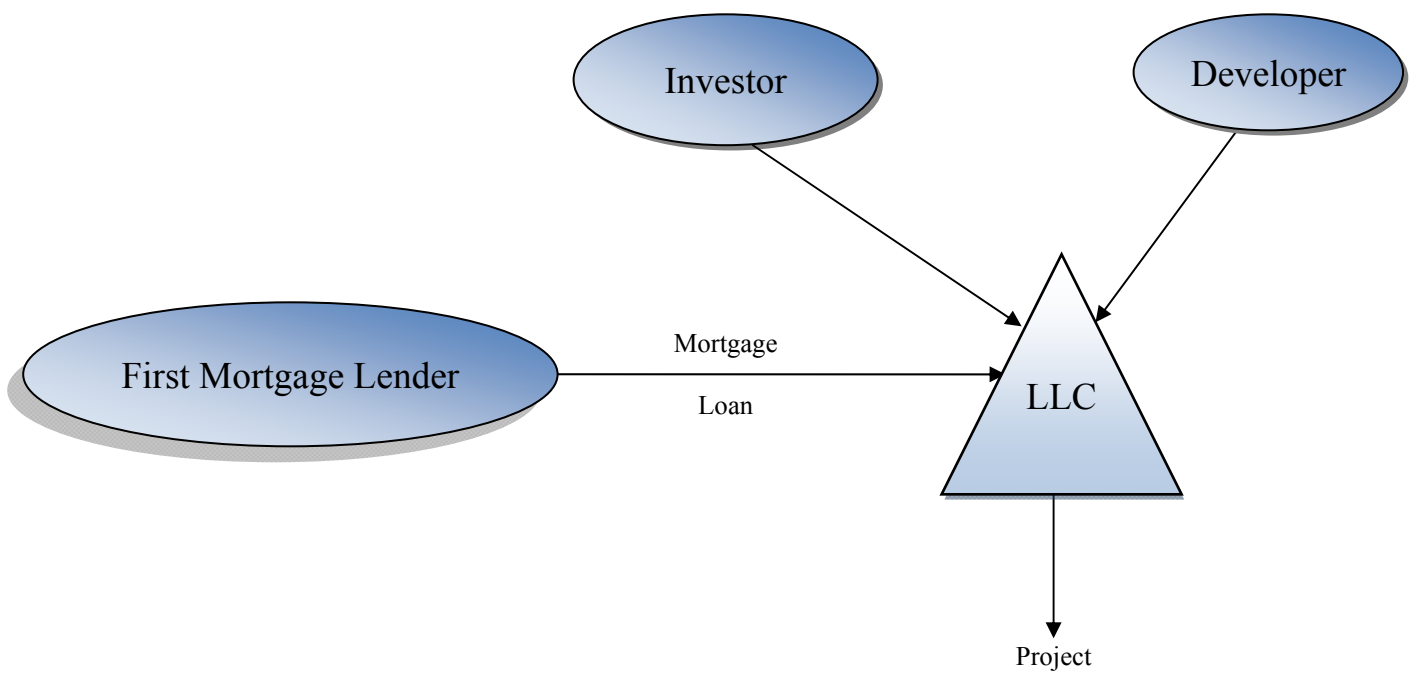
- Mortgage lender's position is secure. Investor will presumably require SNDA to protect its investment.

f. Bankruptcy perspective:

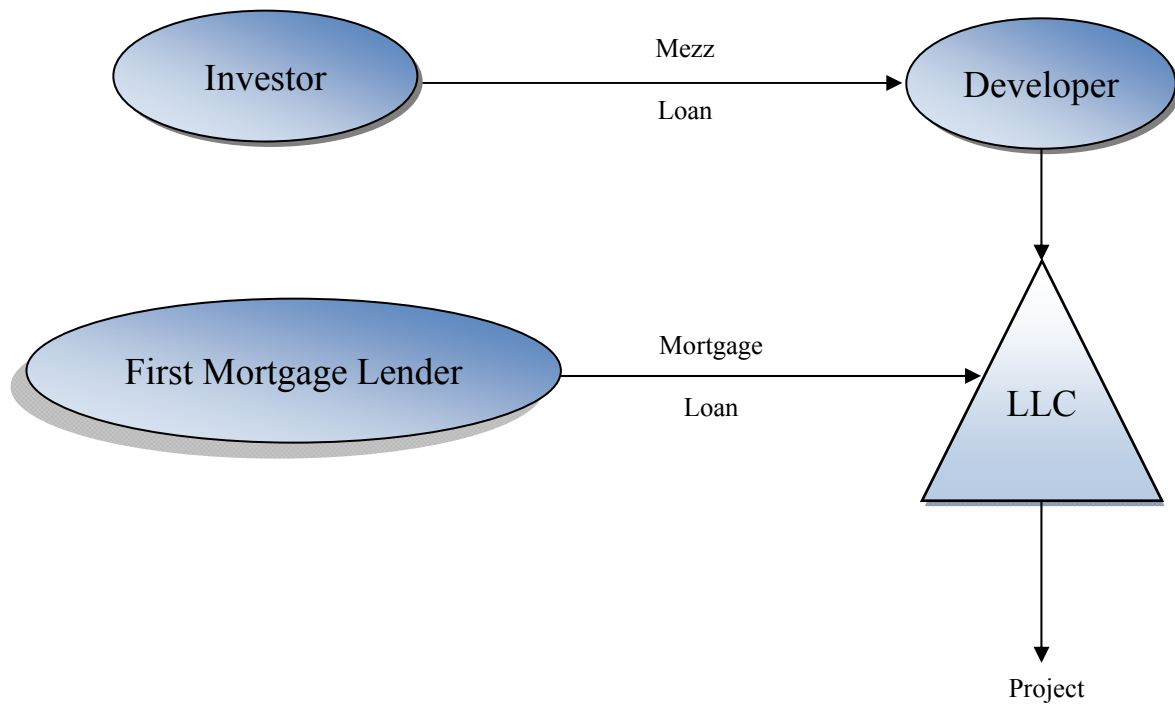
- Investor becomes an unsecured creditor under the contract
- Obligations of debtor and non-debtor continue
- Limits on ability of Investor to enforce contract rights in bankruptcy

Organizational Charts

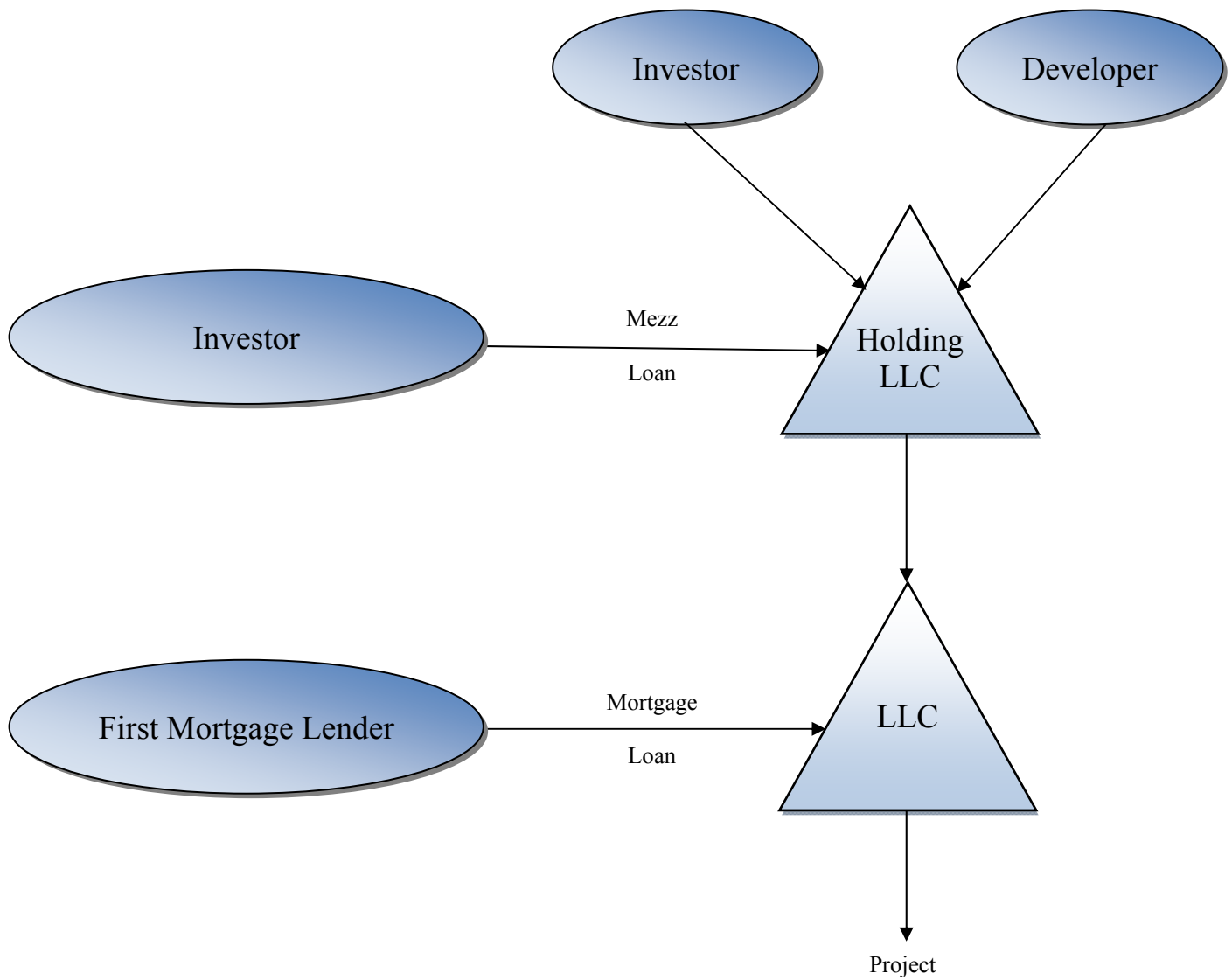
Structure ##1 and 2: Equity



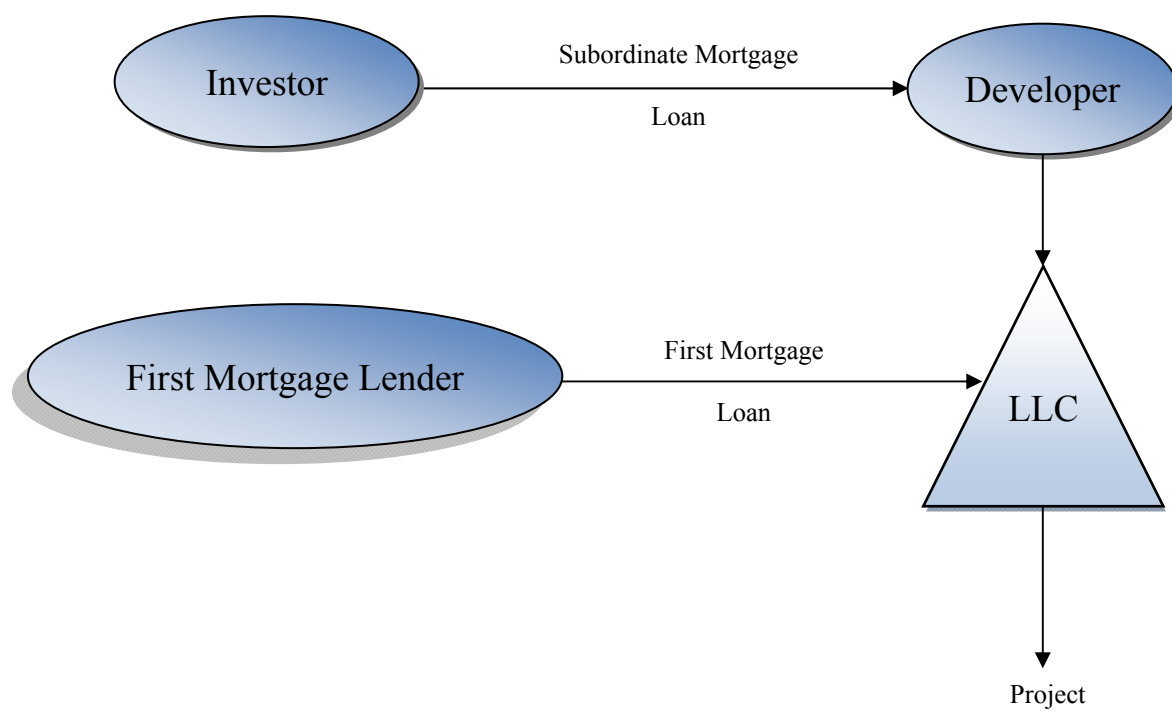
Structure #3: Debt - Mezzanine Loan



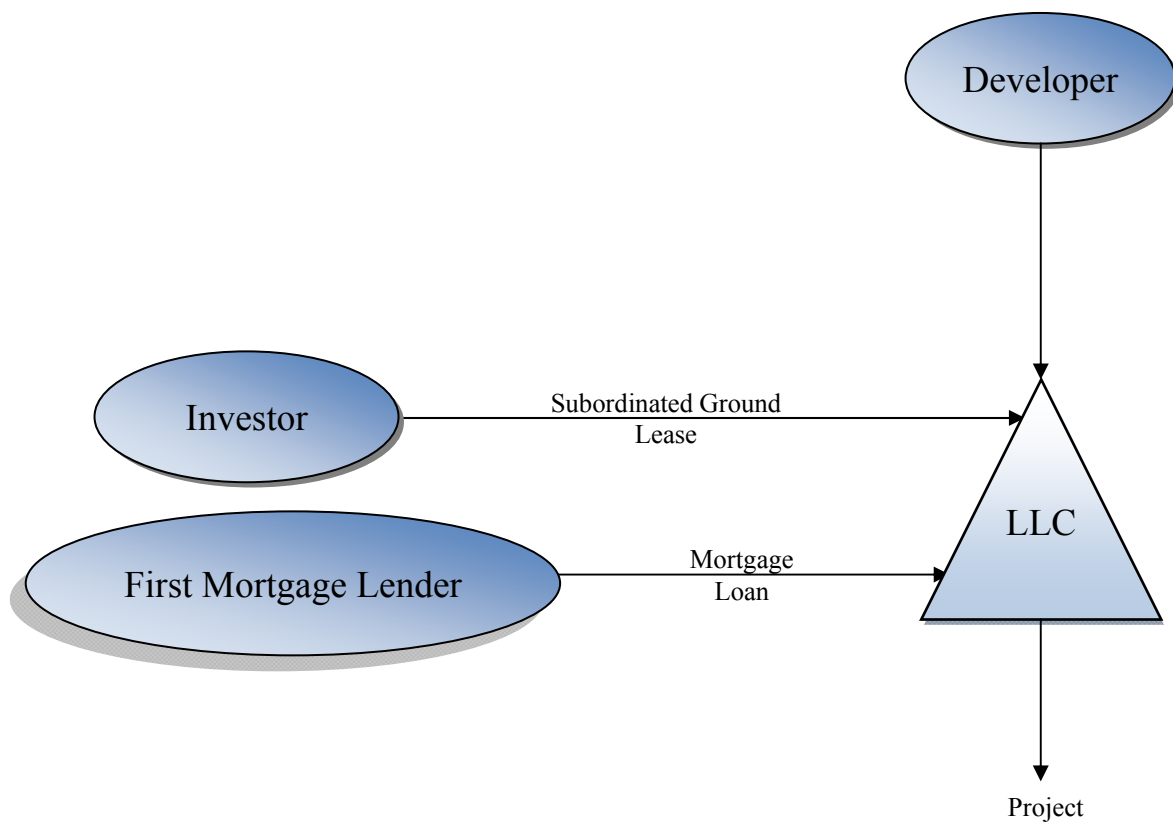
Structure #4: Debt - Hybrid Mezzanine Loan



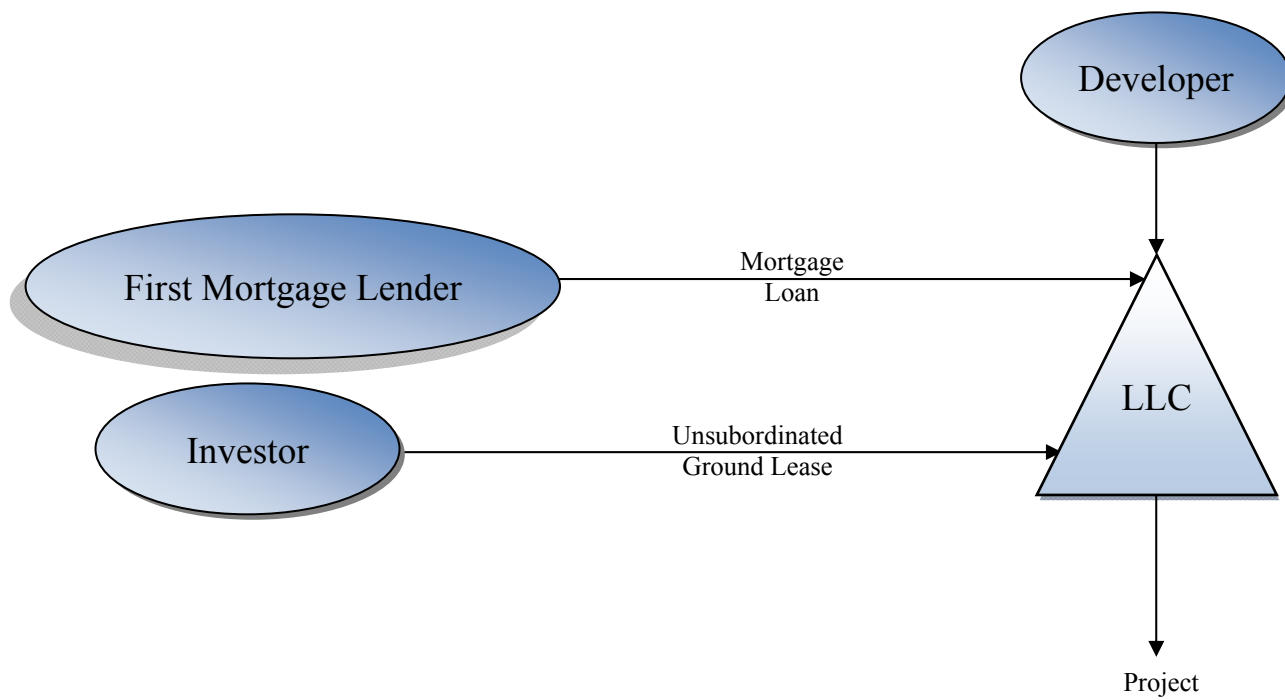
Structure #5: Debt - Subordinate Mortgage Loan



Structure #6: Property Interest - Subordinated Ground Lease



Structure #7: Property Interest - Unsubordinated Ground Lease



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Biographies of Panelists

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Michael D. Goodwin, Chair of the Real Estate Practice at Arnold & Porter LLP, focuses on commercial real estate development, hospitality, public/private partnership and debt and equity financing. He is listed in Chambers USA, Best Lawyers and Who's Who Legal, and named a "DC Super Lawyer". Mr. Goodwin is a fellow in the American College of Real Estate Lawyers.

Andrea MacIntosh Whiteway

Andrea Macintosh Whiteway is a partner in the law firm of McDermott Will & Emery LLP and is based in the Firm's Washington, D.C., office. She is the head of the Firm's Pass-Throughs practice. She has substantial experience in sophisticated tax planning involving the use of partnerships, including in the dispositions and acquisitions of real estate and operating businesses, complex partnership transactions, real estate investment trust (REIT) tax status and tax structured dispositions of real estate involving REITs, corporate acquisitions and mergers, corporations and structuring private REITs. Andrea advises on forward and reverse like-kind exchanges and exchanges of tenancy in common interests in real estate. Andrea has been listed in the 2008 to 2011 editions of The Best Lawyers in America in the area of tax law and has also been selected as a fellow of the American College of Tax Counsel. She is ranked by The Legal 500 United States as a leader in her field. Andrea has the honor of being the first woman to serve as chair of the Real Estate Committee of the American Bar Association Section of Taxation. She is also a former member of the steering committee of the District of Columbia Bar Section of Taxation and a past Chair of its Pass-throughs and Real Estate Committee. Andrea is an active member of Urban Land Institute and serves on its Small Scale Development Council. She also serves on the Tax Policy Advisory Committee of the Real Estate Roundtable and is a member of the National Association of Real Estate Investment Trusts. Andrea is the author of approximately 100 professional articles and a frequent lecturer on tax topics at conferences across the United States. Andrea is admitted to practice in the District of Columbia and Maryland. She is a graduate of Cornell University (BA), the University of Maryland School of Law (JD) and holds an LLM in Taxation from the Georgetown University Law Center.

Keith Willner

Keith Willner is one of the six international firm-wide Practice Leaders of Mayer Brown's Real Estate practice. He regularly counsels major REITS, institutional developers, banks, private equity and opportunity funds, insurance companies, pension funds and pension fund advisors, asset managers and other capital providers in connection with the acquisition, venturing, financing, leasing and disposition of real estate. His transactions often focus on complex structuring issues, and tax, ERISA, bankruptcy and corporate considerations, involving foreign and domestic investors.

Keith's practice incorporates all of the major real estate classes, including office, multifamily, retail, hospitality, industrial and assisted living. He is a co-head of Mayer Brown's Global Hospitality and Leisure Group and heads up the firm's senior housing practice.

Keith has been elected to membership in the American College of Real Estate Lawyers. In addition, he has been listed in Chambers USA as a leading real estate lawyer every year since its first publication in 2002. Clients have praised him in Chambers USA 2009 for being "great at sizing up a situation and reading the other side, and helping us to understand what is important and what is not." He is also listed in Legal 500 USA as a leading real estate lawyer and described as a "fantastic lawyer" who "brings motivation and technical capabilities to the table."

Keith has been admitted in California and the District of Columbia. He currently serves on the advisory board of the National Multi Housing Council and National Real Estate Investor.

Charles A. Malloy

Charles A. Malloy is counsel in Arnold & Porter LLP's Washington, D.C. office and practices with the firm's Bankruptcy and Corporate Restructuring group. He has represented secured and unsecured creditors, lessors, asset purchasers, strategic investors, debtors and other parties in bankruptcy cases and insolvency proceedings throughout the country. He is admitted to the bars of the District of Columbia and Maryland, and has practiced in bankruptcy courts across the United States. He is a member of the American Bankruptcy Institute and has authored or co-authored on the intersection of real estate and bankruptcy issues, including The Intersection of Chapter 11 and Real Estate with Richard M. Lucas (American Bankruptcy Institute Journal, November 2006) and Master Leases and Cross-Default Clauses in Bankruptcy, with Michael L. Bernstein (Real Estate Finance Journal, Spring 2003). He graduated summa cum laude from The George Washington University and holds a law degree from Vanderbilt University Law School.