

NON-COMPETE PROVISIONS IN REAL ESTATE JOINT VENTURE AGREEMENTS



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A thorny question in any joint venture relationship is to what extent the partners are permitted to freely engage in business outside of the venture that may compete with the venture. On the one hand, certain partners are likely to engage in numerous projects of a similar nature and their freedom to do so is integral to their success; on the other hand, both partners have an interest in ensuring their venture is successful without conflicts of interest or poaching from a partner's competing projects. This article provides a brief overview of how non-compete provisions in a joint venture agreement may be negotiated and structured to address these issues. For simplicity, this article will assume there is a real estate venture (JV) between an investor (Investor Member) and an operator/developer (Operator Member) that owns certain real estate (Property), and is governed by a joint venture agreement (JV Agreement). The Investor Member and the Operator Member are

sometimes referred to in this article individually as a "Member" and, collectively, as the "Members."

WHAT IS A NON-COMPETE PROVISION AND WHAT DOES IT TYPICALLY RESTRICT?

A non-compete provision restricts one Member or both Members from engaging in certain activities that are viewed as competitive with the JV. The typical provision would impose restrictions on acquiring an interest in, or developing, encumbering, selling, leasing, or managing, any property viewed as competitive with the Property (Competing Property) located within a specified area (Non-Compete Area), except for the benefit of the JV. Certain other activities may also be restricted in the JV Agreement, such as: (i) self-dealing directly relating to the Property (e.g., acquiring an additional interest in the Property that is not contemplated by the JV Agreement, such

as an interest in the financing that is secured by the Property, or providing services to, or investing in, a lender or purchaser of the Property); and (ii) competition relating to existing projects in which a Member already has an interest (e.g., diversion of tenants, suppliers, or personnel from the Property to such projects). In this article, we will focus solely on restrictions on activities involving new Competing Properties within a prescribed Non-Compete Area.

WHO IS SUBJECT TO THE NON-COMPETE RESTRICTIONS?

In the authors' experience, the non-compete typically applies to the Operator Member and certain of its affiliates. The Operator Member may resist being subject to a non-compete (or try to narrow the application of the non-compete), especially if the JV is investing in an area where the Operator Member is based and does the bulk of its business. Many, if not most, investor members will seek some protection nonetheless. To the extent the Operator Member agrees to be subject to a non-compete, it will try to limit those affiliates who are subject to the restrictions. From the Investor Member perspective, obvious candidates to be restricted are the parties in control of the Operator Member and those entities which are controlled by one or more of such parties. The Operator Member may also want the Investor Member to be similarly restricted. However, many Investor Members will resist any such reciprocity arguing, among other things, that the Investor Member's involvement is immaterial because if another developer will be acquiring, developing, and operating a competing project, it will do so with or without the Investor Member and its affiliates. For simplicity, this article will assume that only the Operator Member (and certain of its affiliates) will be bound by the non-compete.

WHAT IS A COMPETING PROPERTY?

It is important that the Members carefully consider the definition of a Competing Property. From the standpoint of the Member benefiting from the non-compete, the definition should be broad enough to capture all properties that will actually compete,

or have the potential to actually compete, with the Property. For example, if the Property is a multifamily housing project, the definition of Competing Property could include not only "any multifamily property project," but also "any mixed-use project that has a multifamily component and any property that can reasonably be expected to be developed or redeveloped into a multifamily property or a mixed-use property with a multifamily component."

From the standpoint of the Member bound by the non-compete, the definition should be narrow enough to exclude categories of projects that do not actually compete, especially those the Operator Member plans to pursue. For example, if the Property is a first-class luxury apartment building, the Operator Member may not want to be precluded from doing low-income housing apartment deals nearby. This can be difficult to draft, given the varied types of projects that are possible. For example, an apartment building might have a percentage of low-income units but otherwise have market-rate units. In such instances, the Members may be required to determine whether any number of market-rate units is sufficient to trigger the non-compete, or whether some minimum percentage of the units must be market rate for such project to be prohibited by the non-compete.

NON-COMPETE AREA

The Non-Compete Area is typically a geographic area, often in the form of a radius restriction (e.g., "within a two-mile radius of the Property") or as depicted on a map. While the radius approach is common, it is not always clear what it means if no drawing of the area is included in the JV Agreement. Do the Members intend to cover a Competing Property if the distance from *any point* on the Competing Property to *any point* on the Property that is less than or equal to the prescribed radius? What if only a part of a Competing Property is within one or more circles that have a center at any boundary point of the Property and the prescribed radius? What if that portion of the Competing Property is open space that will not be improved? Is the land or only the building comprising the Competing

Property covered by the radius? To avoid confusion and misunderstandings, it is recommended that the Members attach an exhibit to the JV Agreement that clearly depicts the Non-Compete Area.

FOR HOW LONG DOES THE NON-COMPETE RESTRICTION APPLY?

The Investor Member may want the non-compete to apply for so long as the JV owns the Property. By contrast, the Operator Member may argue for a shorter term. For example, in a multi-family development deal, the Operator Member may argue that it should be able to start working on a new multi-development prior to completing its development of the Property, so long as the initial lease-up of the Property is expected to be complete before the Competing Property is ready to hit the market. In response, the Investor Member may push for more protections, such as a minimum number of years (regardless of the status of the Property) following formation of the JV, or a requirement that the Property must reach a point of rent stabilization (e.g., at least 90 percent leased and occupied) before the Operator Member may pursue a Competing Property.

FIRST LOOK RIGHT

The Operator Member may offer instead to give the Investor Member a “first look” at the Competing Property, meaning that the Operator Member must first give the Investor Member the opportunity to invest in the Competing Property with the Operator Member before the Operator Member may pursue the Competing Property alone or with another investor. This is a common request of Operator Members who are asked to provide a non-compete because it gives them a path to pursue a Competing Property within the restricted area if they desire to do so. If the Investor Member rejects the deal following its “first look,” then the Operator Member would have the right to proceed with the rejected deal, but as discussed below, this right may be subject to certain conditions.¹

Relationship between new and existing deals

The Members will need to determine whether an accepted new deal will be done by the JV (e.g., with crossing of promote), or as part of a new parallel venture. Doing the deal through the existing JV is simpler from a documentation standpoint because the original JV Agreement may be drafted to contemplate the acquisition of additional assets so that no new JV Agreement must be entered into at the time a Competing Property is acquired. Even if the Members agree not to cross-promote between the original Property and new Competing Properties, separate distribution waterfalls may be built into the original JV Agreement for future projects. If the Members agree to acquire any Competing Property in a separate parallel venture, life may be more complicated. At the very least, a new JV Agreement must be drafted, negotiated, and executed, which takes time and legal fees.

In that event, the Investor Member may want the Members to agree that the parallel venture will be entered into on the same terms as the original JV, modified solely to reflect the facts, so that the Investor Member’s ability to do the new deal is more reliable. However, the Operator Member may want to reserve its right to shop for better equity capital terms and merely allow the Investor Member to match those terms. If the Operator Member is successful in this request, the Investor Member may face a difficult choice in the future—whether to: (i) enter into a new venture on terms that it would not otherwise accept in order to protect its investment in the Property; or (ii) allow the Operator Member to compete with the Property.

CONDITIONS TO PURSUIT OF REJECTED DEAL WITHOUT INVESTOR

Even if the Investor Member rejects the deal offered for the Competing Property, it may attempt to place certain conditions on the Operator Member’s ability to proceed with the rejected deal, such as those described below.

Second look

The Investor Member may require the Operator Member to close the rejected deal within a certain time period after the Investor Member rejects the deal, on not materially better terms. The market may change after the Investor Member's rejection of the deal, so the Investor Member may want another look at the terms for the Competing Property if enough time passes or if the deal becomes available on materially better terms than those originally offered to the Investor Member. The Members must establish the relevant time period within which the closing must occur and may want to specifically define the applicable materiality standard.

No diversion of resources

The Investor Member may require that the new deal not interfere with Operator Member's performance under the JV Agreement (e.g., the Operator Member may not divert its on-site personnel or other key employees or resources to the new deal). A seasoned Operator Member may resist this requirement, arguing that it employs only experienced personnel and should not be required to do more than meet the standard of care in the JV Agreement. However, the Investor Member may be concerned that staffing changes could be disruptive to the operation of the Property, even if replacements are made with equally experienced personnel. For example, if a good on-site project manager has been working on a JV development that is only 80 percent complete, the Investor Member may not want someone with no familiarity with the specific project to take his or her place.

No direct competition with the property

The Investor Member may require that any deal pursued separately by the Operator Member not be located within a narrower "blackout" area. In other words, the Operator Member would be completely restricted from involvement with a Competing Property within the smaller blackout area, unless the Members do the deal together. For example, the Investor Member may be willing to accept a first look right for Competing Properties within a 10-mile radius, but only if there is a strict prohibition on Competing Properties within a one-mile radius. In addition, the Investor Member may want to impose some restrictions on direct leasing conflicts outside of the "blackout" radius, especially in the case of office or retail projects.

Reimbursement of dead deal costs

The Investor Member may require that the Operator Member reimburse the costs expended by the Investor Member and the JV in reviewing the rejected deal. If the Operator Member is willing to agree to a reimbursement condition, it may argue for limitations as to timing, for example that the reimbursement will occur only if and when the closing on the Competing Property occurs. It may also want to limit the amount of the reimbursement, for example, with a cap or limited solely to costs jointly approved by the Members.

CONCLUSION

A well-drafted non-compete provision will help the Members strike an appropriate balance between being sufficiently invested in the success of the Property and being able to run their respective businesses, which may inherently conflict with the business of the JV in some respects. 🍀

Notes

- 1 Note that if the Investor Member agrees to include reciprocal non-compete protections for the Operator Member's benefit (unlike our assumed fact pattern), the "free look" may not be a viable alternative to a non-compete because the Investor Member is typically being offered the deal by

another operator/developer who has already tied up the property, and, consequently, the Investor Member may have no role in the deal to offer the Operator Member (other than to share in the investment, which may not be appealing to the Operator Member).