REAL ESTATE JOINT VENTURES: SHARING PURSUIT COSTS



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In any joint venture formed to acquire real estate, one point that should be addressed early in the process is whether, the extent to which, and how the parties intend to share costs incurred by each party individually in furtherance of the venture prior to the closing of the acquisition. Without a clear understanding of this allocation of responsibility, the parties may be reluctant to incur such costs or, perhaps worse, there may be subsequent disputes or animosity, or both, that could easily have been avoided.

For purposes of this article, unless otherwise indicated, we assume the following facts:

 There is a proposed joint venture (Venture) between two parties (Parties) - an institutional investor (Investor) and a local operator/developer (Sponsor);

- The Venture is being formed to acquire, either directly or through a wholly-owned subsidiary, real estate (Property);
- The Parties have agreed to contribution percentages to the Venture (JV Percentages) of 90 percent for Investor and 10 percent for Sponsor;
- Sponsor has previously entered into a purchase and sale agreement (Purchase Agreement) with a third-party seller to acquire the Property.

WHAT ARE PURSUIT COSTS?

This article will focus on the costs incurred by the Parties in furtherance of the Venture prior to the closing of the acquisition of the Property by the Venture (Closing). These costs (Pursuit Costs) can cover a broad range of expenses associated with the

acquisition of the Property and the formation of the Venture, including:

- The costs of inspection and other due diligence (e.g., the cost of environmental or other consultants to prepare environmental, property condition, and other reports; the cost of a survey; the legal costs associated with reviewing title to the Property, possible land use, environmental issues, development rights, and other legal matters related to the Property);
- The legal costs of negotiating the Purchase Agreement and other documentation (e.g., confidentiality and access agreements) associated with the acquisition of the Property;
- If there will be acquisition or construction financing (the Loan) obtained by the Venture or a subsidiary, whether by obtaining a new loan or assuming an existing loan, the legal costs of negotiating a loan (or assumption) application, term sheet, commitment, and other documentation (e.g., confidentiality agreements);
- · Earnest money and other deposits (PSA Deposits) required to be delivered under the Purchase Agreement, and loan application, upfront commitment fees, and similar costs (Loan Deposits) for the Loan;
- The cost to form the Venture entity and any subsidiary formed to acquire the Property; and
- The legal costs (JV Negotiation Cost) of negotiating the Venture agreement and related documents (e.g., a management or other service agreement between the Venture and an affiliate of Sponsor) as well as other documents between the Parties (e.g., a letter of intent or a cost sharing agreement).

WHAT PURSUIT COSTS ARE **ELIGIBLE FOR SHARING?**

The Parties rarely agree to share all potential Pursuit Costs that may be incurred by either Party. To appreciate the limitations often imposed, it is helpful to sort Pursuit Costs into two general categories: (i) historical Pursuit Costs; and (ii) future Pursuit Costs.

Historical Pursuit Costs are known amounts that have already been incurred and can therefore be documented, explained, and evaluated. For example, the costs associated with an environmental report or a survey that has already been produced constitute historical Pursuit Costs. One Party may feel that certain historical costs incurred by the other Party are too expensive or should not have been incurred at all. In such event, because the amounts are already known, the Parties can simply agree on what is eligible for sharing, which may include full sharing, partial sharing, or no sharing for certain costs.

Future Pursuit Costs, unlike historical Pursuit Costs, are less certain. Neither Party—particularly Investor, given its role and JV Percentage—may be willing to share in the payment of all future Pursuit Costs and may therefore insist on some controls over which future Pursuit Costs are eligible for sharing. One solution is for Investor and Sponsor to approve jointly any future Pursuit Cost, and there might even be different standards of approval (e.g., reasonableness or unfettered discretion) depending on the specific cost. It may prove cumbersome in practice, however, to obtain the approval of each Party for each individual cost before it is incurred. To allow for flexibility, the Parties instead may require that each cost be incurred in accordance with a budget that both Parties approve. Adopting and complying with an approved budget also has its challenges. For example, what happens if both Parties are incurring costs within the same line item (e.g., each Party may have counsel incurring costs for legal diligence and ensuring compliance with the Purchase Agreement)? This overlap issue sometimes can be addressed with separate columns in the budget for Investor and Sponsor or by specifying the vendor or service provider who will be paid each budgeted amount.

JV Negotiation Cost

The JV Negotiation Cost in particular can be controversial. Investor may not want to share in Sponsor's legal costs associated with the negotiations between Investor and Sponsor. Even if Investor persuades Sponsor to share in Investor's legal costs, Investor will not want to pay a large portion of the aggregate JV Negotiation, which (as discussed below) would occur if these costs were capitalized and then shared in accordance with JV Percentages. Investor may argue that it should not be required to pay 90 percent of Sponsor's cost to negotiate against Investor. Some investors may be willing to capitalize these costs along with the other costs of the transaction, though this has been a rare scenario.

Acquisition Fee

Another consideration that may be relevant to Investor is whether Sponsor will be receiving an acquisition fee from the Venture for signing the Purchase Agreement and bringing the potential acquisition to Investor. Investor may view an acquisition fee as a success fee that should compensate Sponsor for incurring costs to make the deal and taking the risk that Sponsor may not be reimbursed if Sponsor is unsuccessful in closing the deal.

HOW IS THE SHARING OF PURSUIT COSTS DOCUMENTED?

The sharing of Pursuit Costs is typically memorialized in one of three documents: (i) a letter of intent for the formation of the Venture (LOI); (ii) a separate cost sharing agreement (CSA); or (iii) a joint venture agreement (JV Agreement). Absent an agreement regarding the sharing of Pursuit Costs, Investor may expect to incur much less than 90 percent of the Pursuit Costs prior to the Closing. Consequently, Investor may prefer to address the Pursuit Costs in the JV Agreement as part of the contributions required to be made at the time of Closing. By contrast, Sponsor often expects to incur much more than 10 percent of the Pursuit Costs and may want some assurance that it will be reimbursed for a portion of those costs, especially if the Closing does not occur. Accordingly, Sponsor would generally prefer to address the sharing of Pursuit Costs at an earlier stage (e.g., pursuant to an LOI or CSA).

WHAT IS THE RATIO FOR SHARING ELIGIBLE PURSUIT COSTS?

Capitalization Upon Closing

If the Closing occurs, then eligible Pursuit Costs are typically capitalized into the Venture and shared between the Parties in accordance with the JV Percentages.

Dead-Deal Costs

However, if the Venture is not formed or the Property is not acquired by the Venture, then the eligible Pursuit Costs become "dead-deal costs." In that event, there are different possible sharing ratios that the Parties may establish. The Parties typically select one of the following sharing ratios: (i) 90/10, in accordance with the JV Percentages; or (ii) a ratio in which Sponsor bears more than 10 percent but usually not more than 50 percent (and most often, 50). There are, however, other potential sharing arrangements for dead-deal costs:

- Each Party may agree to bear its own costs, regardless of percentage or amounts incurred;
- Different cost categories may be shared in different ratios. For example, Investor might be willing to bear 90 percent of the PSA Deposits and Loan Deposits, even if dead-deal costs are otherwise shared evenly, in exchange for affirmative control over decisions relating to the Purchase Agreement and the Loan;
- Sponsor might agree to bear more than 50 percent of dead-deal costs; or
- An Investor (particularly a preferred equity investor who is operating with more of a lender mentality) may require that Sponsor bear 100 percent of all Pursuit Costs incurred prior to the Closing and may also require Sponsor to fund an upfront deposit to cover Investor's Pursuit Costs.

The relative shares of dead-deal costs might also vary depending on the reason for a termination of the joint venture transaction (Termination) or whether there is an acquisition of the Property by either Investor or Sponsor after the Termination. For example, if

one Party elects to terminate the Purchase Agreement over the objection of the other Party (and, as a result, there will be no acquisition by the Venture), then the Parties might agree that the terminating Party bears a greater share of dead-deal costs than it would otherwise bear (but, typically, not when Investor has bargained for this right by agreeing to bear 90 percent of the PSA Deposits). However, if one Party elects to proceed with the acquisition over the objection of the other Party (and, as a result, no Venture is formed but the Property is acquired by one of the Parties), then the Parties might agree that the proceeding Party will reimburse the non-proceeding Party for its eligible Pursuit Costs. Such reimbursement typically occurs when the Property is actually acquired by the proceeding Party or one of its affiliates, and then only if the acquisition occurs within a certain period of time after the Termination.

WHEN DOES THE SHARING OCCUR?

Eligible Pursuit Cost sharing is most likely to occur at one of two transaction points: (i) the Closing, in which event the JV Percentages apply; or (ii) the Termination, either because the negotiations to form the Venture break down or the Purchase Agreement terminates, in which event, the agreed-upon dead-deal cost sharing ratio or ratios would apply. Sharing may also occur upon formation of the Venture, prior to Closing, and there may be different ratios upon formation and then upon Closing, although these alternatives are rare.

True-Up

To the extent the Parties have previously incurred unreimbursed eligible Pursuit Costs in a different ratio, there would be a reconciliation, or true-up, to achieve the desired sharing ratio or ratios. A reconciliation at the Closing is normally effectuated with a credit against the Parties' contribution obligations to the Venture, which includes an obligation of each Party to contribute its JV Percentage of the total eligible Pursuit Costs¹.

Interim Sharing

Prior to Termination or Closing, the Parties may not know whether or not the eligible Pursuit Costs will

become dead-deal costs, and each Party might agree to bear its own costs. Alternatively, the Parties may agree to share eligible Pursuit Costs before the Closing or Termination in fixed percentages. Typically in such event, each cost is not divided in the prescribed ratio but instead there may be one or more reconciliations (and reimbursements) before Termination or Closing. Customarily, the two most common possibilities for the timing of a reconciliation, if prior to the Closing or Termination, are: (i) the time of formation of the Venture; or (ii) the time PSA Deposits become non-refundable (which typically occurs when the due diligence termination right is waived by the buyer under the Purchase Agreement), even, in some transactions, if the Venture has not yet been formed. For example, if Investor has agreed to fund a certain percentage of the PSA Deposits in exchange for control of the Purchase Agreement, or the Loan, or both, then this funding will often occur at the end of the due diligence period when the initial PSA Deposit becomes nonrefundable and any additional PSA Deposit may be required.

CONCLUSION

For investors and sponsors alike, there is value in reaching agreement in the early stages of the business relationship on how to allocate Pursuit Costs for the acquisition of real estate and formation of a joint venture. Documenting the agreement on Pursuit Costs can alleviate potential conflicts as each Party incurs costs in furtherance of a relationship that will hopefully produce long-term benefits for both Parties.

Notes

1 For example, assume that the total eligible Pursuit Costs are \$100X (so that Sponsor is obligated to contribute \$10X of the eligible Pursuit Costs) and further assume that Sponsor has paid either \$5X or \$15X of the eligible Pursuit Costs. In that event, the cost-sharing true-up would work as follows: if Sponsor has paid \$5X of the eligible Pursuit Costs, then Sponsor would receive a \$5X credit, would be deemed to have contributed that amount, and would actually contribute the remaining \$5X; and if Sponsor has paid \$15X of eligible Pursuit Costs, then Sponsor would receive a credit of \$15X, would be deemed to have contributed that amount, and would receive a distribution in the amount of \$5X (i.e., the amount by which its credit exceeds its contribution obligation).