The Practical

Real Estate Lawyer

March 2022

CAPITAL CALLS IN A REAL ESTATE JOINT VENTURE

By Michael E. Scheinberg and Richard H. MacCracken

CAPITAL CALLS IN A REAL ESTATE JOINT VENTURE

RICHARD H. MACCRACKEN is an of counsel member in the real estate department of Pircher, Nichols & Meeks LLP. He was formerly an associate (1983-1987) and partner (1988-1992) of the firm. Mr. MacCracken's practice focuses on commercial real estate joint ventures as well as acquisitions and dispositions. His experience also includes financings, workouts, and commercial leasing. Mr. MacCracken has represented investors in numerous international joint ventures, including hotel, residential, and industrial development joint ventures in Mexico, Argentina, India, and Russia.

MICHAEL E. SCHEINBERG is a partner in the real estate department of Pircher, Nichols & Meeks LLP. His practice focuses on commercial real estate transactions, including private equity fund formation and joint ventures (including preferred equity investments), restructurings, construction and development, real estate finance (including construction and permanent loan origination and workouts and mezzanine financing), portfolio and single-asset acquisitions and dispositions and leasing.

Much has been written about capital calls in a real estate venture, especially the remedies available when a partner[1] defaults in its obligation to respond to a capital call.[2] This article will focus on other issues related to the rights and obligations of the partners to call for and fund capital and the consequences of funding non-mandatory capital. For the sake of simplicity, the assumed context is a two-party real estate joint venture (Venture) between an institutional investor (Investor) and a local operator or developer (Operator) who expect to fund 90 percent and 10 percent, respectively, of the capital required for the Venture. It is also assumed that the Venture is being formed to purchase real estate from a third party (a common occurrence in the authors' experience). Specifically, this article will address: (i) the right versus the obligation to make capital calls; (ii) limits on the obligation to respond to capital calls; (iii) mandatory versus discretionary capital; and (iv) the consequences of disproportionate funding of discretionary capital.

RIGHT VERSUS OBLIGATION TO MAKE CAPITAL CALLS

Almost every real estate joint venture agreement contains provisions relating to calls for additional capital after the initial capital is funded. The specific terms of such provisions tend to vary based on the facts of the deal, reflecting: (i) the type of project (e.g., stabilized assets, opportunistic/repositioning investments, or ground-up development); (ii) the relative percentage interests of the partners; and (iii) the relative bargaining power of the partners. Even where the Operator is expected to have a relatively small percentage interest (e.g., 10 percent or

---

[1] The term "partner" in this article is intended to include "partners" in a partnership or "members" in a limited liability company.

[2] See, e.g., Stevens A. Carey, et al., Contribution Default Remedies in a Real Estate Joint Venture, Business Entities (November/December 2013); available at https://www.pircher.com/media/publication/53_Contribution%20Default%20Remedies%20in%20a%20Real%20Estate%20Venture.pdf; Stevens A. Carey, Partner Loans to Fund Capital Call Shortfalls in Real Estate Partnerships: Loan to Non-Contributing Partner vs. Loan to Partnership, 5 Real Estate L. & Indus. Report. 26, 917 (Dec. 25, 2012) available at https://www.pircher.com/media/publication/10_PrtLnsSAC.pdf.

less), the Operator may still have strong bargaining power because of its expertise and management depth or simply by virtue of having tied up a very attractive asset.

Additional capital calls may be necessary for various scenarios including:

- To fund required equity for the acquisition closing;
- To fund "budgeted" costs of development, of material renovation, or of other capital improvement projects contemplated in an approved business plan;
- To pay operating cash flow shortfalls if income is not sufficient to cover expenses;
- To pay down debt (e.g., a scheduled principal payment) or to fund a shortfall at loan maturity if the refinancing proceeds are not sufficient; or
- To acquire additional assets contemplated in an approved business plan.

It is typical for the Operator to have an obligation to make capital calls as and when the Venture requires additional capital (sometimes on a periodic basis). The Investor may also want the right, but not the obligation, to make capital calls. However, the Operator may not want the Investor involved in making capital calls to avoid duplication and confusion. Sometimes, the Investor's right to make capital calls may be changed to: (i) a right to require the Operator to make the capital call; (ii) a right to allow the Investor to make capital calls but only in urgent situations; or (iii) both. In practice, in the authors' experience, most investors don't exercise their right to call capital. The bigger issue is how the partners must respond to a capital call.

LIMITS ON OBLIGATION TO RESPOND TO CAPITAL CALLS

The Investor may want a limit on its obligation to fund additional capital for several reasons, including:

- Not wanting to write a "blank check";
- To establish practical leverage to require changes to the Venture's development or operating strategies if the project is soaking up more capital than originally anticipated (e.g., requiring redesign of an over-budget construction project or implementation of operating efficiency measures);
- Provisions in the Investor's internal documents (e.g., fund documents) limiting the allocations to individual investments or the funding beyond a prescribed investment or holding period; or
- Avoiding the need for multiple investment committee approvals.

Limits can be effected in many ways, including a right to approve any capital contributions beyond the initial contributions, a right to approve any unbudgeted capital contribution, or more specific funding conditions (e.g., approval over capital contributions to the extent they cause a pre-determined aggregate dollar cap to be exceeded). Such limits on the Investor's funding obligations may be troublesome to the Operator who is often, if not usually, looking to the Investor to fund the bulk of the equity capital required by the Venture. This issue will be less of a concern to both partners if it is anticipated that most, if not all, of the equity capital requirements will be satisfied by the initial capital contributions. However, in a development deal involving substantial ongoing equity requirements, the Operator may seek narrower limits, especially if the Operator is providing a construction lender with a completion guaranty.

The Operator may have similar concerns regarding its obligation to fund its share of the equity capital. The Operator often has even more limited resources than the Investor and may have multiple projects making demands on those resources. Consequently, the Operator may also request protections (e.g., "budget" or "dollar cap" limits), especially where the Investor has the right to propose and cast the deciding vote on capital contributions.

MANDATORY VERSUS DISCRETIONARY CAPITAL

The limitations agreed to by the partners will create lines of demarcation as to which capital contributions are mandatory. These lines are not necessarily the same for each partner and how they are drawn may vary depending on the facts of the particular deal, including the type of investment and the relative bargaining power of the partners. If *mandatory* capital is not contributed, default remedies, such as dilutions or discounted buyouts, will apply. But what about capital that is not mandatory? Do the partners have a right to contribute it? Not always. But when they do, it may be called *discretionary* capital.

If the Investor has funding conditions that allow it to veto a capital call, then it may not want to give the Operator the right to fund capital when the conditions are not met and the Investor doesn't think the money should be invested. However, in some cases, the capital may be needed by the Venture (e.g., if the capital is budgeted and required to meet the Venture's obligations but a cap on the Investor's funding obligations has been reached). To address this concern, the partners may try to establish a common understanding of necessary capital that will constitute discretionary capital when it is not mandatory. Necessary capital may include, for example, capital required to pay operating expenses, taxes, insurance, and monthly debt service. A partner with an affiliate signing guarantees might also want necessary capital to include capital to fund an indemnification by the Venture for "no-fault" recourse claims (e.g., environmental claims).

CONSEQUENCES OF DISPROPORTIONATELY FUNDING DISCRETIONARY CAPITAL

What are the consequences if a partner elects not to fund its share of discretionary capital? Presumably, there should be no punitive consequences, but there should also be equitable compensation to the partner funding some or all of such capital. Often, the funding partner will have the right to fund the non-funding partner's share, and that may often be the outcome when only one partner elects to fund. How does the Venture account for such capital funded entirely by one partner? The consequences may vary.

Dilution

A common consequence is simple, proportionate dilution (with no penalty factor), although this approach may prove tricky if there is also a punitive dilution formula. Even in the absence of such a formula, this approach may nonetheless feel punitive if there has been appreciation in the value of the Venture assets, because the non-funding partner's share of such appreciation will also be diluted. And if there has been a loss (where the partners' equity is less than their unrecouped capital contributions), dilution could actually hurt the funding partner by increasing its share of the loss.

Loan to non-funding member

A loan to the non-funding partner of the non-funding partner's share at a modest interest rate[3] is also common although it is sometimes difficult to agree on the rate. For example, if the Investor is the funding partner, it may not want to receive less than its lowest distribution waterfall hurdle rate; on the other hand, the Operator may not want to pay so much when it is the non-funding member.

Loan or contribution to venture

Another common approach is a loan or preferred contribution to the Venture, which is repaid with a return before any distributions. This approach is similar to the previous approach, but it may have unintended consequences if there is a promote structure, as is often the case. Such a loan or preferred equity could be dilutive or accretive to the Operator's promote, depending on whether the rate is higher or lower than the preferred hurdle rate (and the Operator may resist a higher rate for discretionary capital to avoid dilutive consequences). Such a loan or preferred equity contribution to the Venture may be more desirable than a loan to the non-funding partner (an alternative described earlier) from the perspective of the funding partner because of the risk associated with a potential bankruptcy or insolvency of the non-funding partner as a borrower.

CONCLUSION

The right or obligation to make capital calls, limits on the funding obligations of both the Investor and the Operator, and the treatment of disproportionate discretionary funding are issues with resolutions that can vary widely from deal to deal, depending on factors such as the type of investment and the relative bargaining power of the Investor and the Operator. Importantly, these issues are best addressed early when the partners outline Venture terms (e.g., at the "term sheet" or "letter of intent" stage).

[3] Sometimes the funding partner has the option to choose this approach or the dilution approach.