

Structuring Real Estate Joint Ventures: Looking Back and Looking Forward



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INTRODUCTION

As the real estate industry negotiates the treacherous current economic environment it is clear that most real estate professionals are in one of two modes. They are either looking back to try and determine how to fix their existing problem deals or looking forward and formulating strategies to take advantage of the opportunities that will be created by other parties' problem deals. In either case, given the current and foreseeable issues in the debt markets and the resulting increased importance of equity, the structuring or restructuring of joint ventures will play an essential role in moving the industry forward.

This outline is intended to provide a general discussion of issues to be considered when structuring or restructuring a joint venture between a developer and an equity investor for a real estate transaction. It is not intended to be a comprehensive discussion of partnership or limited liability law. Ideally, this outline will provide a starting point and checklist for a party or counsel who are about to prepare, negotiate and/or restructure a governing joint venture agreement.

This outline is divided into six areas. The first lists and defines a number of commonly used terms associated with joint ventures. The second addresses the issues to be considered when deciding on the type of entity to utilize in a transaction. The third focuses on preliminary information that should be considered in order to decide on the appropriate entity prior to proceeding with the formation of that entity and the drafting of the governing documents. The fourth section of the outline discusses certain key sections typically negotiated in a real estate joint venture document and the issues that should be considered when negotiating or drafting those sections. The fifth section addresses the restructuring issues being confronted by joint ventures as they struggle with the harsh reality of the current real estate economic environment. This sixth area deals with particular problems arising when a party, or the venture itself, is in bankruptcy. It should be noted that this outline is intended to be generic in nature and local laws should be consulted in connection with the preparation of documents for a particular jurisdiction.

I. GLOSSARY OF COMMONLY USED TERMS.

The following is a list of some of the terms commonly utilized when discussing, negotiating, and drafting joint venture agreements.

Additional Capital. The additional capital contributed by one or more of the partners to fund the ongoing business endeavors of a joint venture if the venture's initial capital and financing does not adequately fund the capital requirements of the joint venture.

Allocations. The basis on which the profits and losses generated by the joint venture from a tax perspective are allocated among the members of the joint venture. Allocations should be distinguished from "Distributions" of cash made by the joint venture to its partners.

Buy/Sell. The buy/sell provisions of a joint venture agreement are the provisions that allow one or more partners to initiate a predetermined mechanism whereby the initiating partner ends up either buying the interest of the other partner(s) or selling its interest to the other partner(s). Buy/Sell provisions are typically included in joint venture agreements to enable the partners to initiate a process to effect a non-adversarial dissolution of a joint venture. If joint ventures can be considered equivalent to "marrying for money," and if joint venture agreements can arguably be considered equivalent to "pre-nuptial" agreements, then buy/sell provisions should perhaps be considered equivalent to "no-fault" divorce.

Capital Proceeds. Capital proceeds are the proceeds generated by a sale, refinancing, casualty or condemnation involving the assets of a joint venture. Capital Proceeds are generally distinguished from, and distributed by the joint venture in a different manner than, "Cash Flow."

Cash Flow. Cash Flow is the net revenue generated from the day-to-day operations of the joint venture, as distinguished from "Capital Proceeds." Cash flow is generally distributed by the joint venture in a different manner than Capital Proceeds.

Dilution. A circumstance where a partner's original percentage ownership interest in a joint venture is reduced. Typically this occurs in connection with the admission of additional partners into a joint venture to provide required Additional Capital. This may also occur when Additional Capital is contributed by partners in different percentages than their contributions of Initial Capital.

Distributions. Distributions are the means by which the Cash Flow and Capital Proceeds generated by a joint venture are delivered to the partners of the joint venture. Such Distributions are to be distinguished from Allocations in that they involve actual payments of cash versus an allocation of profits and losses.

Initial Capital. The capital contributed by one or more of the partners of a joint venture at formation or very early in the life cycle of the venture to fund the capital requirements of the joint venture that are not funded by financing.

Internal Rate of Return or IRR. IRR is the compounded return on investment sought by partners providing capital to a joint venture. IRR can be used simply as a means of evaluating projections generated by the "Promoter" of a joint venture or used as a benchmark for Distributions generated by the joint venture.

Major Decisions. These are the decisions made in connection with the management of the joint venture that require the approval of multiple partners or of partners owning a specified percentage of the ownership interest in a joint venture. Such decisions are typically distinguished in joint venture documentation from day-to-day or minor decisions, which are typically permitted to be made by the general partner, manager or managing member without the approval of other partners or members. Major decisions might include the sale or refinancing of the property, approval of proposed financing, admission of new partners or members, calls for additional capital contributions, and approval of annual budgets.

Mezzanine Financing. Mezzanine Financing is financing obtained in lieu of or in addition to the equity required to carry out the purpose of the joint venture. Typically Mezzanine Financing is secured by ownership interests in the joint venture rather than by the physical assets of the joint venture.

Preferred Return. Preferred Return is a return on the capital contributed by a partner, calculated like interest, that is distributed to the partner or partners providing capital to a joint venture prior to any Distributions to a partner or partners who have not contributed any capital, or whose capital has a different priority for purposes of returns on capital.

Promote. A Promote (or "promoted interest") is an ownership interest in the joint venture or a right to receive certain Distributions of the joint venture that is granted to a partner in recognition of such partner being the "Promoter" or organizer of the joint venture (versus the ownership interests allocated to partners based upon their capital contributions).

Promoter. The Promoter of a joint venture is typically the partner who located the opportunity with respect to which the joint venture is being formed, assembled the other partners, and organized the joint venture. Typically a Promoter is granted a "Promote" in recognition of his or her efforts in locating that opportunity and organizing the joint venture.

Waterfall. This term is typically used in the context of the Distributions made by the joint venture to the partners. Specifically, as an incentive to the Promoter, the percentage interest representing the Promoter's Promote is increased as Distributions to the partners who provided equity to the joint venture generate returns to those partners which exceed an agreed upon IRR or Preferred Return.

II. CHOICE OF ENTITY

This section addresses those issues typically considered when deciding what type of entity to utilize in a particular transaction. The four alternatives discussed below are limited partnerships, limited liability companies ("LLC's"), general partnerships and corporations. When deciding among these entities, four primary issues are typically considered: liability issues; control issues; tax consequences; and securities law considerations.

A. Liability. Corporations, limited partnerships, and LLC's provide limited liability to investors. In a corporation, limited liability is available to each shareholder. In a limited partnership, limited liability is available to the limited partners, while the general partners are fully liable for the obligations of the partnership. In an LLC limited liability is available to all members of the LLC. In a general partnership, however, each of the partners has full liability for the obligations of the partnership. Accordingly, when deciding on which entity to utilize, consideration should be given to the risks inherent in the investment, the likelihood of liability, the insurability of such liability and the willingness of one or more of the participants to be exposed to that liability. The greater the concern about potential liability, the greater the reason to use an LLC or a corporation. As between the LLC and the corporation, given the tax considerations discussed below, in almost all circumstances the preferable choice will be the LLC. It should be noted, however, that the decision to use an entity that generally provides limited liability to the owners of the entity does not necessarily mean that limited liability will be achieved for all purposes. For example, one or more of the owners of the entity may be asked by third-party lenders to personally guaranty certain financing and/or to be personally liable for so-called "bad-boy" carve-outs (e.g., losses incurred due to gross negligence, willful misconduct, and/or environmental liability).

B. Control. Participants in corporations, general partnerships, LLC's, and limited partnerships are allocated control of those entities in a variety of ways. In the corporate entity, control can be allocated either through stock ownership, election to the board of directors and/or as officers of the company, the issuance of different classes of stock (except in S corporations) or via the use of shareholder agreements and/or voting trusts. In general and limited partnerships, as well as for LLC's, control can be allocated contractually through the partnership or operating agreements. The management provisions in partnership and operating agreements can specifically define the power, authority and duties of the partners or members. Such provisions can also specifically limit or enlarge the rights of the limited partners or members. In drafting such provisions, care must be taken to ensure that the governing state statute allows the variation the parties are looking for. It should also be noted that, in some jurisdictions, in order to preserve limited partners' limited liability, limited partners are only permitted minimal control over the day-to-day operations of the entity. This is in contrast to the LLC and the corporation, in which a member or shareholder can participate fully in the management of the LLC or corporation as a manager (in the case of an LLC), or, in the case of a corporation, as an officer and as a member of the board of directors, and still maintain limited liability.

C. Tax Consequences. There are a number of tax driven reasons that favor the use of an LLC or a limited partnership over a general partnership or a corporation in real estate transactions. Those reasons include avoiding double taxation and (subject to the "at risk" rules) the

ability to utilize debt to increase the amount of losses which may be passed through by the partnership or LLC to a partner or member who is either not subject to passive loss limitations or can use the losses notwithstanding those limitations.

General partnerships typically do not offer tax advantages over individual ownership of real estate. This is because, for tax purposes, each general partner is merely "passed-through" its proportionate share of the general partnership's profits and losses. Accordingly, if a general partnership is utilized in a real estate transaction, it is generally for reasons other than tax considerations (e.g., control or securities considerations [as discussed in D below]).

Double taxation is the primary reason the corporate entity is historically disfavored for use in real estate transactions. A corporation is treated as a separate taxable entity for federal income tax purposes. Its profits are therefore taxed both at the corporate level, as corporate profits, and again at the individual shareholder's level to the extent that the corporation distributes its profits as dividends. Furthermore, corporate losses are not passed through at all to individual shareholders. This double tax and inability to use losses severely reduces the economic returns available to participants using a corporation for real estate investment purposes.

The foregoing effects can be mitigated, however, by electing to be taxed as an S corporation. A corporation which makes an "S" election may pass through profits and losses to its shareholders without double taxation. Unfortunately, however, there are a number of disadvantages to using an S corporation: (i) an S corporation may not have more than 75 shareholders; (ii) an S corporation may not have more than one class of stock; (iii) the only permitted shareholders of an S corporation are individuals, estates, certain trusts, employee benefit plans (ESOPs) and 501(c)(3) organizations (i.e. the stock of an S corporation may not be owned by a corporation, partnership, or a non-resident alien or (with certain exceptions) a trust or estate; (iv) a shareholder may only utilize losses up to the amount of his capital contribution to the S corporation plus his basis in any debt owing from the corporation to the shareholder (unlike limited partnerships and LLC's in which the partners may utilize certain non-recourse debt to increase their basis in the entity and, subject to the "at risk" limitations, increase their ability to take losses generated by that entity).

Overall, given the foregoing limitations on S corporations, LLC's and limited partnerships have a number of tax advantages over a corporate entity.

D. Securities Considerations. Limited partnership interests, membership interests in LLC's, and shares of corporate stock are securities under both state and federal law and must either be registered with state and federal authorities or fall within specific exemptions to such registration. Furthermore, the issuance of such securities is subject

to the anti-fraud provisions of the federal securities laws. Accordingly, in order to avoid incurring liability under the securities laws, the organizers of a corporation, LLC, or a limited partnership must comply with the applicable state and federal securities laws. As a result, the formation of either a limited partnership, an LLC, or a corporation often involves legal costs associated with soliciting securities advice as well as the potential costs of providing the disclosure to investors required by the federal and state securities laws. These requirements might be avoided by utilizing a general partnership. Because of the control generally afforded to partners in a general partnership, interests in a general partnership are not typically considered securities and are, therefore, not subject to state and federal securities laws. As a result, where liability and control issues are not major concerns to participants, many real estate transactions are structured and operated as general partnerships.

E. Conclusion. Parties deciding upon the appropriate entity to utilize in a transaction should consider each of the foregoing issues and should consult with their legal and tax advisors to select the entity that provides the most advantageous combination of desired attributes under the circumstances in question. On occasion, when liability is not a major issue and the investors want to avoid the legal and time costs of addressing securities law issues, a general partnership might be used. Typically, in real estate transactions in which the parties consist of an organizer or developer and passive equity investors providing equity, the decision as to choice of entity is between a limited partnership, an LLC or an S corporation. Clearly, LLC's have become the predominant vehicle for real estate investment because (i) as a pass-through entity, they offer the same tax advantages as a limited partnership and have certain tax advantages over S corporations, (ii) they offer limited liability to all members (i.e. there is not a general partner with personal liability), (iii) there is tremendous flexibility in structuring the operation of an LLC through its operating agreement, and (iv) it is easy to delegate authority to a manager or to a managing member (and thereby minimize the participation and voting rights of the non-managing members) who may own a minority of the percentage interest of the entity.

III. PRELIMINARY INFORMATION

In order to determine the appropriate type of entity to use and to begin the preparation of the necessary documents, certain preliminary information should be solicited from the parties involved. This information will facilitate the choice of entity and the preparation of entity documentation that accurately reflects the business deal. This section sets forth in outline form certain basic questions that should be answered at the outset of a transaction. These questions are designed to provide certain necessary information as well as to encourage parties to focus on and address issues they may not have previously considered.

A. Purpose.

1. What is the purpose of the entity?
2. Will the entity be a "single purpose entity" created for one specific transaction or will it be utilized for more than one transaction?
3. What activities will the entity conduct?

B. Principals.

1. Who are the parties involved?
2. Individual?
3. Other entities?
4. United States citizen or non-resident aliens?

C. Principal Place of Business.

1. Where will the entity's principal place of business be located?
2. Where are most of its assets located?

D. Capital.

1. What are the initial capital needs of the entity?
2. How will those needs be funded?
 - (a) Loans?
 - (i) Third party institutional sources?
 - (ii) Investor loans?
 - (b) Equity?
 - (i) Specific source – individuals, institutions, "accredited" or "non-accredited" investors?
 - (ii) Unknown sources?
 - (iii) Private Offering?
 - (iv) Public Offering?
 - (v) Special needs of certain equity investors—Tax

exempt entities may not be able to tolerate unrelated business taxable income; entities which include Pension funds may have unique structuring needs to comply with ERISA; and Real Estate Investment Trust may not be able to tolerate certain types of income.

3. What provisions are being made for future capital infusions?
 - (a) Will the additional capital be provided by the initial participants in the entity? If so, will additional capital be provided by all, or only some, of the initial participants?
 - (b) Will there be penalties (e.g., a dilution of ownership interest; and/or a change in distribution priorities) if a participant fails to contribute additional capital?
 - (c) Will additional capital be provided by new equity sources? If so, what is the basis for determining the terms on which such capital is procured?
 - (d) Will the entity seek to borrow additional capital and under what circumstances and on what terms?
 - (e) Who can initiate calls for additional capital and who must approve such calls?
 - (f) Will capital needs for non-discretionary expenditures such as real estate taxes and insurance premium increases be treated differently than discretionary expenses?
 - (g) Will any party guaranty additional capital required as a result of cost overruns and, if so, how will such additional capital be treated?

E. Management.

1. Who will manage the entity?
2. What limits will be placed on that manager's authority?
3. Will that manager have certain duties and tasks it will be required to perform?
4. What rights will the passive investors have in management?
5. Are there affiliates of the principals providing services and, if so, under what circumstances may they be engaged and

how will they be controlled?

6. What compensation will be paid to the principals and their affiliates?
7. What restrictions will be placed on the management's right to withdraw or retire from the entity?
8. Will passive investors have the ability to remove the manager? If so under what circumstances?

F. Profits and Losses/Cash Flow.

1. How will profits and losses be allocated for tax and accounting purposes?
2. Will the entity generate cash flow from operations and how often and on what basis will that cash flow be distributed?
3. Will "cash flow" and "capital proceeds" be distributed on different basis?
4. Are there any special allocations, preferred returns, "promotes" or special requirements, such as reserves, which need to be considered?
5. Do any of the principals have special tax needs, which must be addressed? For example, if the capital includes funds from tax-exempt entities, allocations of profits and losses must be carefully devised to comply with the rules applicable to such investors.
6. Will there be provisions for loans to cover investors' taxes derived from "Phantom Income"?

G. Transfers of Interests/Admissions of Partners.

1. What restrictions, if any, are to be imposed on the transferability of interests in the entity?
 - (a) Transfers by the managers, promoters, organizers, or principals?
 - (b) Transfers by the equity sources, passive investors?
 - (c) Transfers to affiliates or relatives, or estate transfers?
2. Are there any rights of first refusal?

3. Will there be any buy/sell rights between the participants?
4. Under what circumstances may new participants be admitted into the entity:
 - (a) Who will have approval rights?
 - (b) Under what circumstances can such new participants dilute the rights and interests of the existing participants?

H. Liquidation/Dissolution.

1. Are there any special circumstances in which the entity is to be dissolved or liquidated?

I. Defaults. How will disputes or defaults be handled?

1. Is there a buy/sell right?
2. Are there specific penalties for a default by a participant?
3. Are participants required to submit certain, or all, disputes to arbitration? Where will the arbitration occur?

J. Impasse Resolution. How will disputes be resolved?

1. Simple majority controls?
2. Super majority controls?
3. Arbitration?
4. Buy-Sell?

K. Buy-Sell.

1. If a Buy-Sell is utilized how will value be determined?
 - (a) "Dueling appraisals"?
 - (b) Shot-gun?
2. Is there a disparity among the parties regarding access to capital? If so how will such disparity be addressed?
 - (a) Timing?
 - (b) Penalties for non-performance?

For purposes of the balance of this article, it has been assumed that an entity is being formed for the purpose of setting forth the terms on which a developer and an equity source are entering into a joint venture to develop a specific real estate project. Furthermore, it has been assumed that, from liability, management and securities standpoints, the parties agree that the appropriate entity to utilize is a limited liability company.

The balance of this article will focus on those provisions in an operating agreement that, from a business and legal standpoint, are fundamental in structuring and negotiating a joint venture between an investor and a developer for a real estate development project. The last section of the article dealing with the bankruptcy of a party or of the venture will focus on what constraints bankruptcy law imposes on restructuring and how it can upset the expectations built into the negotiated deal. This article will not provide an exhaustive discussion of all of the provisions of an operating agreement, nor will it necessarily address all of the possible considerations in the negotiation and drafting of the discussed provisions; rather, it is intended to alert the reader to certain issues and the perspective of the developer and investor with respect to those issues.

IV. OPERATING AGREEMENT PROVISIONS

A. Purpose. This section should set forth the business purpose for which the company was formed. The scope of that purpose, as drafted, should strive to strike a balance between limitations imposed by the members, on the one hand, with the need for some flexibility to deal with unforeseen opportunities or circumstances. It should also be recognized that this clause may also need to incorporate limitations that may be imposed by the company's potential lenders. Typically, those lenders have specific language limiting the scope of the entity's purpose so that entity qualifies as a "single purpose entity" and thereby minimizes the likelihood of a bankruptcy from peripheral activities. The purpose clause can also be important from a tax planning perspective. If the joint venture is intended to generate capital gain income, care must be taken that the purpose clause does not include any activity which under applicable tax law would give rise to ordinary income.

B. Percentage Interests/Capital Contributions. This section, together with the "Profits and Loss", "Cash Flow" and "Liquidation and Dissolution" sections of an operating agreement, constitute the economic heart of the operating agreement of a limited liability company. It also reflects, in part, the complicated interrelationship between the Internal Revenue Code and the operating agreement. The goal is ultimately to try to provide the members with the distributions, allocations, and membership interests they desire while giving those allocations "substantial economic effect" from a tax perspective. If these sections are not drafted correctly, the IRS can disregard the members' agreements and allocate profits and losses in the manner that the IRS believes will give those allocations "substantial economic effect." Although this article will touch on some of the issues that must be considered in order to meet the

current tax regulations, it will not attempt to explain the allocation regulations or provide language to deal with those regulations. This article's purpose is to alert the drafter to the fact that there are tax considerations which must be addressed in all operating agreements and to suggest that the drafter have each agreement reviewed by a tax advisor unless the drafter is comfortable with his or her own familiarity with the then current tax regulations. After the appropriate tax sections are incorporated into the agreement, the drafter should be sure that those sections do not materially alter the business deal. To the extent such alterations do occur, the drafter (or tax advisor) should explain to the client what those alterations are and why they are being made. Once the alterations have been explained, the client will often do its own analysis of the implications of the tax sections and make the final decision on the ultimate faun of tax-generated provisions.

1. Percentage Interests. Generally, the operating agreement will set forth fixed percentage interests for each member. These percentages will typically govern certain distributions and allocations or profits, losses and cash flow. Frequently, as a result of priority distributions, the inclusion of "promotes", and special allocations for tax and other reasons, the actual distributions and allocations do not precisely or exactly mirror the percentage interests set forth in this section of the agreement.
2. Initial Capital Contributions. The nature, amount and timing of the members' initial capital contributions should be specifically set forth.
3. Additional Capital Contributions. The operating agreement must address the company's capital needs in the event the company's initial capital and available third party debt financing is inadequate to support the operation of the business. This section is typically a potential source of the most serious conflict arising between members. The following questions should be considered:
 - (a) Who decides when and if additional capital is required? The ability to initiate an additional capital call must be negotiated so as to insure that the company's capital needs can be met. This need must be balanced against the concern of the weaker financial member (typically the developer) that capital calls might be used by the stronger financial member (typically the investor) to dilute or remove or create leverage against the weaker member. It must also address the investors' needs for certainty and their desire to hold the developer accountable for the cost projections upon which the investor decided to invest.

- (b) Under what circumstances and from whom (e.g., third

parties or the members) is the company required to try to borrow funds to meet its capital requirements before an additional capital call occurs?

Typically, unless the parties agree otherwise, before initiating a call for additional capital, the company will seek to borrow money from third party lenders. The operating agreement should set limits on the terms of such financing or establish parameters pursuant to which the members have the opportunity to approve those terms as the need arises.

(c) Are any members obligated to contribute additional capital?

The resolution of this question is one of the fundamental issues in any operating agreement. A balance must be struck between the members' desire to limit their downside liability and the company's ability to obtain additional capital in order to address unforeseen needs and insure the ultimate success of the project. This balance is often reached by making additional capital contributions non-mandatory, while creating incentives for the members to contribute their pro rata share of the company's additional capital needs. This can be accomplished by use of one or more of the following mechanisms:

(i) Additional capital contributions can be returned to the contributing members, with interest at a favorable rate, on a priority basis out of the company's cash flow and capital proceeds (this effectively dilutes the return of any member who does not make the non-mandatory additional capital contribution); and/or

(ii) contributing Members contributing the additional capital can be given the right to acquire a portion of the noncontributing member's interest at a discounted purchase price based on a formula tied to the amount of additional capital that the non-contributing member failed to contribute to the company.

(d) If one or more of the members of the LLC are required to guarantee a loan to the company, how will payments under their loan guaranties be treated? Should payments be treated as other additional capital? Should liability be allocated among the members? If so, in what proportions? Generally, the investors will resist any obligation to guarantee the company's liabilities and/or will insist on additional compensation to do so. That compensation might come in the form of a higher

preferred return, a higher return priority or a fee for providing the guaranty. If more than one party provides a guaranty, those parties should execute an agreement to share any liability proportionately in the event the lender does not elect to pursue all guarantors (i.e., such an agreement is sometimes referred to as the "re-guaranty" agreement). This circumstance is particularly relevant if one guarantor (i.e. the investor) has a high liquid net worth which the other (i.e. the developer) does not. Arguably, any non-proportional payments made pursuant to a personal loan guaranty should be treated in the same manner as a non-mandatory contribution of additional capital. Such contributions often receive an earlier or higher return priority and a higher rate of return.

- (e) If any member guarantees additional capital required as a result of certain circumstances (e.g. budget overruns), how will that additional capital be treated? Will it be treated on a similar basis as other additional capital (i.e. as a loan or returned on a priority basis) or will the contributing member receive no "extra" credit for that additional capital? In the latter circumstance, the member will be unable to recover that capital on a priority basis.

Generally, the obligations of the members to contribute additional capital must be carefully negotiated between the parties, taking into consideration the potential needs of the project, the financial strength and the ability of each member to contribute additional capital if required, and the willingness of each member to suffer the consequences if it is unable to provide additional capital required by the company.

C. Allocation of Profits and Losses for Tax and Accounting Purposes. The provisions governing the allocation of taxable income and loss essentially constitute a book or paper allocation and must be carefully distinguished from the sections governing the distribution of cash generated by the company, although those distribution sections are, by necessity, interwoven with the allocation sections. The allocation sections must be reviewed by the parties' expert tax advisors to ensure that the allocations will be upheld if challenged by the IRS.

Broadly stated, the goal of the allocation provisions of an operating agreement is to create an allocation of profits and losses that reflects the business deal of the parties and meets IRS regulations. From a business standpoint, a primary concern is that taxable income follows, to the extent feasible, the company's distributions of cash. This is particularly important where a member (generally the investor) receives a preferred return on its equity contribution. If care is not taken to insure that taxable income follows cash, the other member (i.e. the one who does not

receive a preferred return) could end up with a pro rata allocation of taxable income (i.e., so-called "phantom income") without the cash to pay the taxes. It is not atypical for a developer and an investor to negotiate a provision that, subject to certain adjustments and compensation, insures that, to the extent cash is available, then, regardless of the distribution priorities set forth in the operating agreement, the party that receives phantom income will be allocated cash sufficient to pay that party's tax obligations on such phantom income.

Overall, the allocation provisions should be drafted in consultation with a tax consultant familiar with the then current tax regulations.

D. Distributions of Cash. The provisions governing the distribution of cash generated by the company (as opposed to the profits and losses allocated for tax and accounting purposes) often distinguish between the "cash flow" generated from the day-to-day business operations of the company and "capital proceeds" generated from a sale, refinancing, casualty, condemnation or other disposition of the assets of the company not in the ordinary course of the company's business. The provisions establishing the priority in which cash flow and capital proceeds are distributed to the members constitute the financial architecture of the business relationship of the partners. Such provisions are, from a business standpoint, undoubtedly the most important sections of an operating agreement.

While the actual distribution priorities will vary in transactions depending upon the nature of the transaction and the relative leverage and business acumen of the parties and their representatives, joint ventures between equity investors and developers do typically follow certain basic parameters. Those parameters include the following:

1. Equity investors generally require that the first distribution of cash flow or capital proceeds be utilized to pay that investor a "preferred return" on (as distinguished from a return of) the capital it invests in the transaction (if the developer also invests equity, the developer may also be entitled to a preferred return on a pari passu basis with the equity investor). The actual amount of the preferred return will depend upon the economic environment, the risk in the transaction, and the leverage of the parties. The preferred return is often cumulative (i.e. if the return is not paid in particular fiscal year, the unpaid return accumulates and is payable prior to the preferred return in any subsequent year) and may be a compound return. The distribution of accrued but unpaid preferred return is typically a first priority distribution made by the company when it has either cash flow or capital proceeds available for distribution to the members (although the members may provide for the repayment of additional capital, together with interest on such additional capital, ahead of the preferred return on and preferred return of initial capital).

2. After the distribution of certain agreed levels of preferred return on and/or preferred return of additional and initial capital, operating cash flow is typically distributed to the members based on their percentage interests in the company. This distribution essentially (a) recognizes that the investor's goal is for cash flow to, at a minimum, pay its preferred return and (b) rewards the developer by providing the developer with a percentage of the cash flow, if any, available after payment of that preferred return. In many transactions, the investor's share of cash flow in excess of its preferred return is applied as a reduction of that investor's capital contribution. This reduction again recognizes that the investor's goal is to receive current cash flow in an amount sufficient to pay its preferred return. The application of cash flow to reduce the investor's outstanding capital creates an incentive for the developer to maximize cash flow as quickly as possible because, by reducing the investor's outstanding capital by the application of excess cash flow, the cash flow also reduces subsequent distributions to the investor of preferred return.

3. As stated above, when a company generates capital proceeds (i.e. net proceeds of a sale, refinancing, casualty or condemnation), the first priority distribution is generally to pay accrued but unpaid preferred return and then current preferred returns (assuming that there are no outstanding additional capital contributions to be returned). After payment of accrued preferred return typically any outstanding capital contributed by the members is reimbursed on a pro rata basis. After repayment of all preferred returns and outstanding capital, the balance of the funds are generally distributed to the members based on their percentage interests but, in many cases, on a formula intended to provide a developer with a "promote" or reward for exceeding expectations. Typically, this "promote" is tied to the overall internal rate of return ("MR") paid to the investor in the transaction. By way of example, an operating agreement may specify that the members each initially own a fifty percent (50%) percentage interest in the company and that, following an event generating capital proceeds, those capital proceeds will be distributed (after payment of preferred return) 50/50 until the investor has received a twenty percent (20%) IRR and then twenty-five percent (25%) to the investor and seventy-five percent (75%) to the developer. The additional twenty-five percent (25%) constitutes the developer's "promote". There are endless potential permutations for distributions depending upon the nature of the project, the expectation of the parties and their respective leverages. It should be noted that Congress has considered, and may adopt in the near future, provisions which would deny capital gain treatment to a "promote" paid in investment partnerships, including real estate partnerships.

4. In addition to issues governing the priority and amounts of distributions, the parties should also focus on when and how often distributions are to be made. Typically, to the extent cash flow is available, distributions are made at least quarterly, with distributions of capital proceeds being made promptly following the event that generates those capital proceeds.

5. Sometimes an investor will insist on a "clawback" measured at the time of disposition of the asset, or perhaps more frequently, to make sure that amounts allocated between the developer and the investor over the life of the project were not distorted by excess distributions to the developer (for example, out of operating costs or proceeds of a refinancing). If a "clawback" is utilized, the question of who guarantees the obligation to restore funds often becomes the central issue.

E. Management of Company. There is tremendous flexibility available to control how a company will be managed. This is no limitation on the authority that may be granted to a member since a member retains its limited liability while participating in the management of a limited liability company. On the other hand, since most limited liability company acts do not contain a requirement that a member be given any "minimum rights" or votes with respect to the management of the company, a drafter may totally exclude any member from any and all management decisions.

Typically, in a joint venture between a developer and an equity investor, the developer will assume the role of manager and the responsibility for the day-to-day operations of the company. The developer's authority will almost certainly be circumscribed by a number of "major decisions" that will require the consent of the investor member. The scope of those major decisions will be negotiated between the parties and will typically turn on the nature of the transaction, the experience and reputation of the developer, as well as the relationship between the developer and the investor member. The "major decisions" will almost always include limitations on the manager's right to cause the company to borrow funds, enter into major leases and sell the primary asset of the company.

In addition to dealing with the general authority of the manager to operate the business of the company, the management sections may also deal with the obligation of the manager to prepare and abide by the terms of an annual budget approved by the investor, the right of the manager to conduct business with affiliates, the compensation payable to the manager or its affiliates in connection with a company's project (e.g. the right of the manager or its affiliates to be paid development or other fees in connection with the company's activities), and the right of the manager (and potentially other members) to engage in businesses other than that of the company even if those businesses compete with the business of the company.

The management agreement may also address performance standards imposed upon the developer/manager and the consequences if the developer/manager fails to satisfy those performance standards. In particular, those consequences may include the right of the investor member to cause the removal and replacement of the developer as manager of the company.

F. Transfer of Partnership Interests. Another highly negotiated section of an operating agreement of a real estate joint venture is the section that governs the rights of members to transfer their membership interests. Typically, due to their different roles in the operation of the company, the operating agreement will contain separate transfer restrictions on the rights of the manager/developer and that of the investor member.

Given the importance of the role of the developer/manager/promoter in developing and operating the project, together with the financial commitment made by the investor, most investor members will insist that the developer manager cannot transfer its membership interest without obtaining the consent of the investor member, and/or that the developer manager is prohibited from making any transfer prior to the occurrence of certain key events or milestones in the company's business plan. For example, in a ground up development project where the developer manager conceives and will play a pivotal role in the development, a transfer prior to a milestone such as achieving a certificate of occupancy or substantial completion could adversely affect the ability of the entity to achieve its business purpose. The only transfer right the member/manager generally retains is the right to transfer all or some portion of its interest to an affiliate controlled by the manager's principals or to relatives of the manager for estate planning purposes. In those cases, the investor member will insist that the principals with whom the investor has invested its equity (and whom it is relying upon to make the project a success) will remain in control of and responsible for the operation of the company.

Consistent with the foregoing, the operating agreement will also contractually restrict the right of the manager to resign as manager of the company or withdraw from the company. The operating agreement might contain provisions relaxing the foregoing limitations after the company's project has "stabilized" as evidenced by meeting certain agreed upon objectives. While these provisions can and should be carefully and seriously debated and crafted, a third party lender may well impose comparable restrictions on the developer manager to those that the investor member is seeking to impose.

While the investing member is not responsible for the day-to-day operation of the company, the developer member certainly will want an absolute consent right to any transfer of the investor member's membership interest until such time as the investor member has contributed all of its required capital to the company. Even following that

time, the developer member will certainly seek the ability to approve any transferee based upon the ability of that transferee to meet any future obligations, as well as based upon the reputation of that transferee.

Generally, neither the developer member nor the investor member will want to be forced to accept an unknown or undesirable partner. In crafting these provisions it is often helpful to distinguish the transfer of economic interests from the transfer, assignment or delegation of other rights, obligations and interests, particularly in the areas of management, control, voting and approval rights.

G. Right of First Refusal. One mechanism often included in operating agreements to address and control transfers of membership interests is a right of first refusal, which, in the event a member desires to transfer its interest, allows the other member to acquire that interest and thereby avoid an unwanted or undesirable partner. Generally, only permitted transfers to affiliates or family members for estate planning purposes are excluded from the scope of a right of first refusal. Furthermore, the right of first refusal is generally included in addition to, rather than in lieu of, the rights of the members to consent to a transfer.

H. Buy-Sell Provisions. Another provision often included in an operating agreement is a buy-sell provision, which allows each member to effect a peaceful dissolution of the company by requiring the other member(s) either to sell its interest or buy the interest of the member who initiates the buy-sell mechanism. A buy-sell provision should take into consideration the relative economic strengths of the parties involved, as well as any restrictions on the use of the buy-sell provision. For example, in a company which is developing a property, neither party should be able to trigger the buy-sell mechanism during the development process. The parties should agree upon a time frame to insure that the company's project has had adequate time to be completed and to stabilize. The goal is to avoid allowing either member to take advantage of the instability of a project when exercising its buy-sell rights. Since the investor member in a development joint venture typically has better financial resources and liquidity than the developer member, the developer member needs to be sure that the buy-sell mechanism provides adequate time for the developer member to respond to a buy-sell initiated by the investor member and in which to locate financial resources to make such response. Disparities in financial condition between members can also be addressed, at least in part, by allowing such a developer member the right to make a smaller down-payment and to use "seller financing" for an agreed upon, limited period of time.

In addition to timing, the central issue in crafting a fair Buy-Sell provision is the method to determine fair market value. Many object to the typical method of calling for up to three separate appraisals, as slow, expensive and subject to manipulation. An alternative is a "shot-gun" procedure in which the party who initiates the procedure must name a price for the property at which he would be willing to be either the buyer

or the seller of his own interest. The other party then gets to choose whether to buy or sell. In either case, the seller gets an amount equal to the proceeds he would have gotten had the property been sold as a whole at the designated price and the company liquidated. Another issue is who gets a savings from the absence of a brokerage fee (and transfer taxes in jurisdictions) that may be derived because the property is not sold to a third party. If there is debt on the property the requirements of the lender may interfere with the implementation of any Buy-Sell, and yield maintenance provisions may make simply replacing the debt prohibitively expensive, unless care is taken to obtain the preapproval by the lender of the Buy-Sell provisions and any change in ownership and management that may result.

Generally, the inclusion of a Buy-Sell clause provides an excellent mechanism of resolving a bad marriage between the members and functions like a no-fault divorce, provided that the mechanism recognizes the relative strengths and weaknesses of the parties involved.

I. Indemnification. Typically the developer/property manager is indemnified by the company for claims or losses arising when acting on the company's behalf, except in the case of gross negligence and willful misconduct. Frequently investors have been strengthening these standards and requiring the developer/manager to indemnify the company to acts constituting simple negligence and for specific failures.

J. Conclusion. The foregoing discussion is intended to highlight certain provisions of joint venture documentation between a developer and investor member, which are fundamental to the transaction and are often highly negotiated by the parties. It is not intended to be an exhaustive discussion of all provisions to be included in an operating agreement, but rather is to be used as a tool to allow an attorney to be comfortable that he is familiar with those issues typically addressed. Obviously, all deals are different and there are additional provisions and considerations which must, by necessity, be handled in response to unique circumstances but, hopefully, this outline will provide a good starting point.

V. RESTRUCTURING ISSUES

Virtually all of the joint ventures formed over the past decade were formed based on optimistic assumptions that land values and rental rates would continue to rise, demand for commercial and residential development would remain strong, financing would be easy to obtain, and cap rates would be stable or improve, all of which would facilitate quick sales and large profits for the investors. Many, if not most, of those joint ventures are now faced with a harsh new reality in which land values and rental rates have declined, development has slowed (or disappeared in some areas), lending standards

have tightened considerably and cap rates are rising. As a result, these joint ventures are facing liquidity problems, loan maturities without the availability of new financing, and declining value due to the foregoing as well as to rising cap rates. While the original documents for these joint ventures generally contemplated the "good" and the "bad," the magnitude of the current "bad" crisis is forcing partners to look outside their existing agreements in order to restructure their joint ventures in a manner which will allow those joint ventures to survive the storm. Clearly, the "right way" to restructure a troubled joint venture will vary considerably depending upon the specific facts and circumstances of each case.

A. Assessing the Situation. Before addressing what restructuring options may be available, the partners in the joint venture must assess the specific situation. Like the Preliminary Information contemplated in Section III above, there are certain questions that must be asked before deciding how to proceed.

1. Status of the Joint Venture's Project.

- (a) Does the project remain viable?
- (b) Is there positive cash flow before or after debt service?
- (c) Does the estimated value of the project currently exceed the mortgage and/or is there a scenario under which the value will exceed the mortgage in the foreseeable future?
- (d) Is the project's mortgage currently or about to be in default?
- (e) On what terms will the project's lender cooperate with the joint venture?
- (f) Is there a reasonable scenario where the partners can recover some or all of their invested equity?
- (g) If no, can they at least put off the recognition of any income from losing the property for long enough to make a restructuring worthwhile?

2. Status of the Joint Venture Partners.

- (a) Does the manager or general partner of the joint venture have an incentive to work to preserve the viability of the transaction?
 - (i) Personal guarantees?
 - (ii) Concern with reputation and ability to do deals in the future?

	<p>(iii) Viability of its promoted interest?</p> <p>(b) Does the manager or general partner have the ability to contribute capital to the joint venture?</p> <p>(c) Does one or more of the existing equity partners in the joint venture have an incentive to provide additional capital to the project?</p> <p>(i) Long term viability of the project?</p> <p>(ii) Ability to recover equity investment?</p> <p>(d) Does one or more of the existing equity partners have the ability to contribute additional capital?</p> <p>(i) Does an equity fund have existing or access to new funds?</p> <p>(ii) Is a high net worth individual still in a position to contribute capital?</p> <p>3. <u>Options Available to the Joint Venture to Attract Required Capital.</u></p> <p>(a) Does the existing joint venture agreement provide an adequate mechanism to attract a capital infusion by existing partners?</p> <p>(i) Loan terms</p> <p>(ii) Return on and priority of additional capital contributions</p> <p>(b) What terms might the partners consider or require if the joint venture is restructured to attract additional capital?</p> <p>(i) Higher return on and priority of additional capital from existing partners?</p> <p>(ii) Creation of new class of membership interest.</p> <p>(iii) Dilution and subordination of existing interests to new capital.</p> <p>(iv) Modification of management provisions to provide greater management rights to new equity.</p>
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B. Restructuring the Joint Venture. After the above questions have been considered, the partners should have enough information to either (i) recognize and accept the project may not be salvageable; (ii) elect to work within the parameters of the existing joint venture agreement; or (iii) seek to restructure the existing joint venture in a manner that will attract the capital necessary to maintain the viability of the project. Assuming the partners elect to restructure the joint venture, the following are likely scenarios that may develop, although the ultimate terms will depend upon the very unique circumstances of each individual transaction.

1. Additional Capital from Existing Partners. Assuming the existing joint venture agreement does not adequately incentivize the existing partners to contribute additional capital, the partners will need to consider increasing the return payable on such additional capital to a level that creates the required motivation and/or revising distribution provisions to give greater priority to the return of that capital and potentially of the contributing partners' original capital contributions. While this would effectively dilute any non-contributing partners' interests, the partners might also consider a reallocation of percentage interests including of any promoted interest previously allocable to any partner. The contributing partner may demand greater control over the day-to-day operation of the joint venture as consideration for its additional capital. The specific terms of any such reallocation will depend on the circumstances as determined by the questions in Section V.A above.
2. Additional Capital from New Investors. If no existing partner is willing or able to contribute the required funds, the next logical alternative is to recruit a third party to inject new capital. Any new capital will likely make the same, if not more, aggressive demands, that were discussed in the foregoing section with respect to existing partners. Unless that new capital is funded as a loan, any new partner will almost certainly require a specific reallocation of the percentage interests of the existing partners (or the creation of a new class of membership interests), the subordination of distributions to the existing partners including any promoted interests, and a role in the management of the joint venture. A new partner may also want to revisit the amount and priority of any fees being paid to existing partners. Generally, the primary difference between a restructuring with an existing versus new partner is that the new partner will be empowered to review and restructure any and all terms of the joint venture, while an existing partner may feel constrained to revisit terms that had previously been negotiated between the parties.
3. Lender Issues. If the joint venture is unable to stay current on its loan payments while it attempts to restructure, it will be forced to simultaneously deal with its lender. Even if the joint venture is

able to service its debt in a timely manner, if the value of the lender's collateral has declined significantly, the joint venture may be in default of other loan covenants (such as debt to equity ratios). As a result, the lender will often play a significant role, directly or indirectly, in the restructuring of the joint venture. The partners will need to use their efforts at restructuring the joint venture and attracting new capital to deter their lender from declaring a default or exercising its rights with respect to a declared default. Similarly, the lender's willingness to defer its remedies and possibly restructure its loan will impact the joint venture's ability to attract new capital.

4. Deadlock, Dissolution or Liquidation. If the partners are unable to agree upon the terms of a necessary restructuring for the joint venture, the deadlock might be broken by one or more of the partners buying out the deadlocked partner's interest, either pursuant to the buy-sell terms of the joint venture agreement or a negotiated buy-out. A party that is not willing to inject more capital into a troubled joint venture may be more willing to use its capital to obtain control of the joint venture, especially if the terms of the buy-out require the seller to finance a portion of the purchase price. If the partners are truly deadlocked and cannot agree upon the direction of the joint venture or a buy-out of one of their interests, then, if circumstances allow, the only other alternative may be a judicial dissolution of the entity, which would be accompanied by the liquidation of the joint venture's assets.

5. Conclusion. Not unlike the process of initially structuring and negotiating the terms of a joint venture, the restructuring of a joint venture is a fact driven process that requires an understanding of the particular circumstances that have lead to the restructuring and the leverage possessed by the parties to that restructuring. Ultimately, those facts and circumstances will dictate how the options discussed in this section are utilized by the partners in a particular joint venture.

VI. BANKRUPTCY

Increasingly, the restructuring options available to investors outside of bankruptcy are just not enough. This section discusses some of the principal issues arising when an investing partnership or one of the partners is in bankruptcy.

A. Single Asset Deals. In prior real estate downturns bankruptcy was often used as a delaying or negotiating tactic by owners of single asset real estate entities. This option has been substantially eliminated by amendments to Section 362(d) of the Bankruptcy Code in 1994 and again in 2005. Today, unless the debtor has a good chance of reorganizing, a court must generally allow a secured

creditor to proceed with a foreclosure action in spite of the automatic stay. There are still instances when bankruptcy may be a viable option for owners of a single asset entity, but only discussion with experienced bankruptcy counsel will be able to bring such options forward.

B. Bankruptcy of a Partner or Member.

1. General. Much ink has been spilled over whether the bankruptcy of a partner dissolves a partnership or limited liability company. While this concern reflects early partnership law, more modern statutes provide that filing a bankruptcy petition "dissociates" the partner or the member in a manager managed limited liability company and does not in and of itself dissolve the entity. Nevertheless, many state statutes have not been updated to reflect changes to the Uniform Acts. For instance, a leading treatise states, "The LLC statutes commonly provide that bankruptcy of a member dissolves the LLC unless the non-bankrupt members agree to continue the LLC." Ribstein & Keating, Limited Liability Companies § 14.4. The vast amount of confusion existing on this issue arises from the overlay of different state statutes on the matter with conflicting court decisions. Some courts have held dissolution statutes unenforceable based on the Bankruptcy Code prohibition on so-called *ipso facto* clauses. Others have allowed upheld the statutes because they did not want to force other partners to accept performance from a party with which they did not contract, i.e., a bankruptcy trustee.

2. Specific Partnership Agreement Provisions – Enforceable in Bankruptcy or Not?

(a) Management Rights. Most of the law in this area that deals with management rights is split between those courts which hold that the Bankruptcy Code does override an agreement to allow a transfer of rights where applicable non-bankruptcy law would not allow that transfer and those which refuse to enforce what they see as the *ipso facto* rule of traditional partnership law. While it would take a lengthy law review article to establish a hard rule, most cases would not force non-bankrupt partners to accept the bankruptcy trustee, representing creditors, as a partner. Whatever rationale a court uses, it will generally protect unrelated third parties. Some courts have approached this question by starting from the position that a partnership or LLC agreement creates a fiduciary relationship between the parties, akin to a personal services contract. If, absent a bankruptcy, the non-bankrupt parties would be entitled to reject performance from an assignee of the bankrupt partner, these courts allow those parties to reject

performance from the debtor. Thus, the debtor is seen as a different person because he or she owes fiduciary duties to the creditors in the bankruptcy case. Courts allowing non-bankrupt partners to reject performance from a bankrupt general partner essentially adopt the view that the bankruptcy results in a transfer to that different person, and, if the other partners could have rejected another sort of transfer, they can reject this one. See, for instance, In re O'Connor, 258 F.3d 392 (5th Cir. 2001). Other courts adopt a "facts and circumstances" test, essentially asking whether allowing the debtor to continue with managements rights would deprive non-debtors of the benefit of their bargain. E.g., Summit Investment & Development Corp. v. Levoux, 69 F.3d 608 (1st Cir. 1995).

- (b) Transfer Restrictions. If a partner or member goes bankrupt, can the remaining partners or members enforce reasonable, pre-agreed transfer restrictions? There does not appear to be any case dealing directly with this question. Most likely, a court would not compel the admission of a buyer as a partner or member, however, it is also unlikely that the nonbankrupt partners or members would be allowed to completely block a debtor's ability to extract value from his interest. It also would be likely that courts would respect reasonable rights of first refusal and similar rights that are otherwise enforceable under non-bankruptcy law.
- (c) Capital Contribution Obligations. Whether a bankrupt partner's or member's obligation to make additional capital contributions is enforceable or not is likewise not the subject of any published case. It likely depends, at least in the first instance, on whether the contract is treated as executory, and, if it is, whether it is affirmed or rejected by the debtor. If the debtor affirms the contract, it is agreeing anew to the contract's terms. A more difficult question is whether failure to make a required contribution by a bankrupt partner or member could lead to a "squeeze down" of the debtor's interest. Most likely, a squeeze down would not be allowed since the squeeze down would be viewed as interference with the property of the estate, and is normally seen as being in the nature of a penalty.
- (d) Calculations of Buyout Price. Some agreements set a predetermined or formula price to purchase a withdrawing partner's interest. There is no clear precedent on this issue. Many courts refuse to enforce buy-out provisions triggered by the bankruptcy itself. Others have simply disregarded the formula price. The most effective approach to addressing this question is to look at the case law in the relevant jurisdiction.

C. Bankruptcy of Partnership or LLC Itself. There are only a few points relative to the bankruptcy of the entity relevant here.

1. "Jungle Rule". The so-called "jungle rule" arises when a general partner is in bankruptcy and the partnership itself is either in bankruptcy or is severely financially distressed. The rule essentially provides that in the event of a bankruptcy of a partnership, a general partner's separate creditors have to be paid in full before his assets can go to pay his secondary liability for partnership debts. If there are multiple general partners, this rule often has the effect of placing more of the burden of partnership debt on non-bankrupt general partners, since a bankrupt general partner's estate will pay out to his separate creditors first.

2. Tax Issues. There are a number of cases in which courts took tax consequences to partners into account in interesting ways. One court approved a plan in a liquidating Chapter 11 case in spite of the fact that payments were stretched out over many years, because to approve the competing plan would have divested the partners of the property and caused immediate negative tax consequences to the partners. In re View Shopping Center, 260 B.R. 10 (Bankr. D. Kan. 2001).

Another court found that a Chapter 11 filing made essentially to forestall unfavorable tax consequences from foreclosure was not made in bad faith. In re Fay Associates Limited Partnership, 225 B.B. 1, (Bankr. D. D.C. 1998). This holding may be questionable to the extent it validates using a bankruptcy filing for other ends than reorganization.

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