Real Estate Joint Ventures: Considerations for Passive Investors

~ E. John Wagner II

Traditionally, both income-producing real estate and development real estate opportunities prominently feature a role for the passive investor. This person may make a loan that a financial institution is unwilling or unable to make—or even invest equity in the joint venture holding the real estate. Even real estate investors with substantial experience may be unfamiliar with the considerations for the joint venture structure through which the real estate is owned. This article addresses issues to consider before you become a passive investor in real estate joint ventures.

The Economics, Stupid

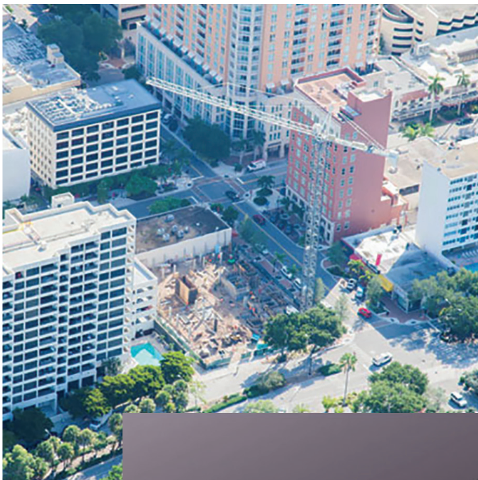
Just as James Carville famously coined the phrase, "The economy, stupid," to help Bill Clinton's 1992 presidential campaign focus on its core message, if you're considering becoming a passive investor in real estate, focus your evaluation on the investment's economics. If the economics are undesirable, even the most favorable legal documents will not make it desirable.

You should also understand the long-term plan for the real estate project before you consider the joint venture terms. Some joint venture terms may be more appropriate for a project of relatively short duration, sold after completion, than for a project held for lease or other operational purposes for the long term after development is complete.

If you are not experienced in real estate operations or development, engage an independent consultant to evaluate the anticipated risks and rewards of the real estate investing activity. As a passive investor, also consider a mechanism for monitoring the real estate project after the initial investment. This may extend beyond regular meetings with the management team to independently verify the project's physical progress, financial performance, or other matters. You may do it directly or through independent consultants.

Form of Investment

Once you understand the expected potential returns from the real estate investment—and you are satisfied that the economics are sound—you must decide on the form of investment. It could be a loan. It could also be equity. Or it could be a mix of both. A mix of loan and equity is advantageous to you as a passive investor because you can enjoy the greater upside of equity-type returns if the investment performs well, along with the security a lender enjoys if the investment performs poorly.




The Jewel
Thomas James Mannausa, Developer
Courtesy of Hoyt Architects
Sarasota, Florida

It's important to understand that the operational partners who will actively manage the project or investment will almost always prefer that your investment comprise equity. This is because a lender may seize the property if payments are not made, whereas an equity investor is more likely to have limited remedies if an expected payment or cash flow stream does not materialize. By limiting the passive investor's investment to equity, the operational partners keep a tighter grip on control of the investment, even if it performs poorly.

If the operational partners want to obtain institutional loans, they may find those lenders might object to an equity stakeholder making a loan to the enterprise, even if that loan is subordinated to the institutional financing. Institutional lenders rarely want to risk dealing with other lenders, even fully subordinated lenders, if a default occurs.

If you are a passive investor who may plan to push strongly to make at least a portion of your investment as a loan, know that it may not be possible on all transactions. With institutional lenders imposing tighter lending standards than those that prevailed in the past, loans from equity stakeholders—even passive equity stakeholders—have become less common, while more complex, debt-like, hybrid equity investments have become more common.

Cash Flow Distribution Waterfall

As a passive investor, whether the form of your investment will be a loan, equity, or both, you must understand the cash flow distribution waterfall through which you receive money back out of the venture. It is typical for passive investors to receive their investments back in priority over distributions to the operational partners. This priority return may also include a "preferred return" at some preset time value of money factor after the return of capital, so passive investors realize significant returns before the operational partners receive any equity distributions.

Operational partners, however, may receive management fees even before you receive a return of capital or preferred return. These management fees typically comprise a relatively small portion of the total cash flow expected from the transaction.

If you plan to be a passive investor, understand there is a wide variation in how profits are shared between operational and investing partners after passive investors receive a return of capital and distributions based on the time value of money factor. Institutional private equity firms may expect to receive the vast majority of residual percentage profits. Non-institutional passive investors are generally more flexible in that they may accept a smaller residual percentage profit in exchange for the opportunity for higher overall returns than are available where they invest. While an institutional private equity firm may expect to receive 80 percent or more of the residual profits, a non-institutional passive investor may accept 50 or 60 percent of residual profits, sometimes even less if the project's expected overall returns are sufficiently desirable.

For the operational partners, keeping a larger percentage of residual profits creates an incentive to deal with one or more non-institutional passive investors who may require more attention and coordination and who may not add operational support in the same way possible with an institutional investor. As a passive investor, you should understand and appreciate the operational partners' point of view when negotiating sharing residual profits between non-institutional passive investors and operational partners.

Additional Investments After the Initial Investment

Many real estate joint ventures contemplate that the initial capital investment or borrowing will not be the only source of capital. The project economics may require you to make capital contributions in stages over a significant period before any investment returns are received. This may be a more efficient method for you than contributing your entire investment at the outset, because you will have the use of the incremental amounts of money not immediately required until the additional contributions are needed. Another benefit to you of this method is that it gives you the opportunity to ensure the operational partners implement the business plan as expected, possibly even enabling you to refuse to contribute more capital unless the operational partners fulfill their commitments. Real estate joint ventures vary widely regarding the conditions upon which passive investors may refuse requests for future contributions. The level of control you may have over the timing and number of requests for additional capital will vary based on your negotiation power and your expertise regarding the real estate project inside the venture.

The consequences of your refusal to contribute additional capital when required by a joint venture agreement also vary widely. Sometimes, the consequence may merely be dilution of your interest. Often, however, your refusal may trigger a punitive forfeiture or buy-back provision. In other cases, another party who covers the contribution you refuse to make may be deemed to have made a loan to the venture or to the investor at a high interest rate, causing you to have a future liability from the venture rather than a cash-flow stream. If you are a passive investor unsure of your long-term commitment to a venture, it's highly desirable to restrict the joint venture's remedies to non-punitive dilution. At the same time, operational partners will often negotiate for more punitive remedies. This is because they count on a passive investor's future capital contributions to satisfy their own commitments to lenders and to execute the project as planned.

Control

The operational partners will exert a significant influence over the day-to-day operation of the venture. As a passive investor, you may exert significant influence through veto rights or other rights regarding the budgeting process, expenditures, or significant actions that impact the real estate project. Even if those powers are initially limited, springing powers may be negotiated to come into effect if the operational partners fail to reach certain operational or financial milestones. If you are a passive investor with the wherewithal and expertise to take over a project, you may even negotiate for the right to do so if certain hurdles or goals are not met.

Operational partners may tolerate such constraints upon their management discretion from non-institutional passive investors because institutional investors almost uniformly demand even more control and oversight. A non-institutional passive investor who realizes the breadth of the management rights imposed by institutional investors may be bolstered in negotiating for more limited rights for themselves.

Exit

Although all parties may expect to exit their investment when the underlying property is sold, this is not the only possible scenario.

If you are considering becoming a passive investor, you may have difficulty negotiating a right to force the sale of your interest (i.e., a put right), especially in the early stages of a project, because real estate investing is illiquid. Your investment will be of little use to the operational partners or the project if the operational partners must keep significant reserves to cash out your investment on a whim.

You may have more success negotiating a right to force the sale of an underlying project to create liquidity or to force the operational partners to choose either to buy your interests or sell the operational partners' interests to you under certain circumstances. If the operational partners will be forced to buy, they will usually need significant time to find a new investor to finance the buyout of your investment. If you, as a passive investor, will be forced to buy, you may also want a significant period of time to find a suitable replacement operational partner. In either case, the buy-sell mechanism is often structured so that the initiating party names a price or terms at which that party is willing to either buy or sell. The non-initiating party can then choose whether to be the buyer or the seller in the transaction.

Many think that this structure gives the initiating party a significant incentive to be fair regarding the proposed price and terms, because the initiating party does not know whether the other party will be the buyer or the seller. Because real estate investing is a long-term endeavor, it is unusual for such buy-sell agreements to be initiated at anyone's whim. More commonly, the right to initiate the buy-sell mechanism arises only if there is a deadlock concerning budgeting or other major decisions related to the project, or if the project fails to meet certain goals within established time frames.

Real estate joint ventures may also include tag-along and drag-along rights regarding sales to third parties. If you become a passive investor, tag-along rights give you the ability to participate in a sales transaction initiated by the operational partners. This prevents the operational partners from cashing out and leaving you behind to deal with a new operational partner you did not choose. It also gives you the opportunity to enjoy the same liquidity enjoyed by the operational partners. Conversely, the operational partners may have a right to force you to sell (or be "dragged along") if the operational partners wish to initiate a sale. Such a drag-along may only be permitted after the project has reached a certain stage at which the sales price may reasonably be expected to be maximized. While you may prefer to control the timing of a transaction, giving the operational partner a drag-along right may be the price you have to pay for the corresponding tag-along right to participate in a sale initiated by the operational partners.

Tag-along and drag-along rights may also work in the opposite direction. If you, as the passive investor, may initiate a sale, then the operational partners may be benefitted by their own tag-along rights and burdened by drag-along rights that favor you as the initiating passive investor.

Covenants and Fiduciary Duties

If you plan to become a passive non-institutional investor in a joint venture, there are pitfalls you want to avoid. Passive investors often underappreciate the significance of restrictive covenants and fiduciary duties. These deserve more attention than they usually receive. Typically, operational partners disclaim any fiduciary duty of loyalty or care to the venture or to the passive investors. This means they have no obligation to bring similar transactions to the venture and may have little or no obligation to the venture or to the passive investor, even if these operational partners commit serious mistakes. Some venture agreements will permit self-dealing transactions that allow the operational partners to force the venture to pay additional fees or enter into transactions with the operational partners on terms the passive investor may consider uneconomic or unfair. Naturally, it is better to consider the negative effects of these terms and conditions before making the investment. Even if the operational partners do not have fiduciary duties, self-dealing transactions may still be limited. Even if the operational partners are not required to bring every new project or every project of a certain type to the venture, they may be required to present to the venture projects within some radius of a similar type that may be appropriate for continued investment before other parties are given consideration. Even if an operational partner has no duty to avoid simple negligence in carrying out his or her duties to the venture, imposing liability for gross negligence, or at least recklessness, is typically appropriate.

The parties also may consider other covenants, such as confidentiality agreements, to protect proprietary information related to the venture. And the parties may be required not only to keep information confidential, but to not use confidential information about the venture to benefit another venture. This could be useful in preventing an investor or operational partner with interests in two competing projects from using information from one project to the detriment of their partners in that project.

Dispute Resolution and Remedies

There are other issues you would be wise to consider before becoming a passive investor. One is the form of dispute resolution that will be utilized if a disagreement occurs regarding the venture. Some parties may prefer private arbitration as a dispute resolution mechanism because of its privacy; however, many private dispute mechanisms take even longer than do legal processes in a court of law, making any remedy hard to achieve.

Whether judicial process or private legal process is utilized, consider the form of remedies. The operational partners may prefer to prevent you or another passive investor from obtaining a lien upon the project under any circumstances because of the deleterious effect that would have on their loan financing or ability to execute the project as planned. The operational partners may negotiate to limit remedies, particularly pre-judgment remedies, to non-real estate assets of the company. You may find this undesirable because it forces you to wait until the real estate is liquidated or until a final judgment is secured to collect monetary damages. On the other hand, it may be unreasonable for you to jeopardize an entire project by threatening to place a pre-judgment lien on the project property merely because you are in a dispute with the operational partners.

Wrapping It Up

Since every real estate transaction is different, every joint venture will have slightly different considerations. Advanced planning surrounding these issues will help the passive investor increase the chances of success in both highly profitable ventures and those that do not go as planned.

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