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Taking the plunge: Key considerations for joint ventures with developers

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Joint ventures between institutional investors and developers often present great opportunities for higher returns than stabilized properties. Like all relationships, however, there are pitfalls and challenges of which to be wary, and it is best to build the relationship on a stable foundation of communication and trust, as well as an equitable spread of risk and reward.

The following are some of the matters investors should carefully consider before entering into a joint venture with a developer.

Choose the structure

Unless there are particular tax concerns, the majority of joint ventures are structured as limited liability companies or limited partnerships. Limited liability companies are the simplest to form and provide the benefits of limited liability to their members while also offering flexible management and operation rights. Besides determining the best investment vehicle for a venture, an additional threshold matter to be decided is whether it will be a platform venture focusing on the acquisition and development of specified property types located in certain target markets, or a venture for the development of an identified project or portfolio of related properties.

Determine timing of initial investments and contributions of properties

It is not uncommon for a developer to acquire raw land or enter into a purchase agreement to acquire the land, and then attempt to bring in an investor to provide the capital necessary to complete the acquisition process and/or development of the property. As part of the discussion regarding the structure, the developer may suggest it contribute a certain property or related group of properties as the initial investment(s) of the venture, which will affect the allocation of costs, risks and liabilities among the members upon the origination of the venture. The developer, for example, may request reimbursement and/or upfront payments from the investor to cover its due diligence expenses, initial lender fees and other predevelopment expenses. If the developer member has already entered into a purchase agreement, the investor must evaluate the risks of relying on the due diligence conducted by the developer during a time in which it was not subject to any standard of care set forth in the venture agreement.

If the developer already owns the property and desires to contribute the property and/or its membership interest in the existing entity that owns the property, the investor should obtain certain assurances in the form of indemnities and representations and warranties to mitigate the risks associated with occurrences at the property and with actions taken by the developer and the owning entity prior to the closing of the contribution. An investment into an existing entity adds another layer of complexity to the transactions because the investor will want entity-level as well as property-level representations and warranties, addressing matters such as pending litigation, financial status, tax payments and other liabilities of the entity, to protect the investor from inheriting these pre-closing liabilities without any ability to allocate the responsibility to another party. Preferably, the entity-level representations and warranties and indemnities will have a sufficient survival period to mirror the long-term liability of acquiring an ownership interest and all assets and obligations associated with the entity. The parties also should discuss how the property will be valued for purposes of determining the initial actual or deemed capital contributions of the members, as well as any tax consequences associated with the contribution of property to the venture.

Address cost overruns

One of the most negotiated provisions in a venture agreement pertains to allocating responsibilities for costs that exceed the approved budget. On the one hand, the developer does not want to be responsible for cost overruns outside of its control, and on the other hand, the investor does not want to be obligated to fund more capital than what it allocated to the project (and may not be able to do so without receiving investment committee approval for an increase).

The investor will want any cost overrun that is incurred by the venture because of the developer’s failure to comply with the applicable standard of care, to be paid 100 percent by the

developer. Developers often push back on this, advocating for the venture to pay any cost overruns that are not due to the developer's own gross negligence, willful misconduct or other bad acts. This puts the venture at risk for cost overruns caused by mismanagement (i.e., simple negligence by the developer), however, and could result in the investor funding much more than originally planned to have the project completed.

Another good position for the investor is when the developer takes responsibility for 100 percent of the cost overruns up to a fixed dollar amount, so the initial cost overruns to be funded in excess of the budget are borne by the developer. This approach incentivizes the developer to not exceed the budget because it alone must fund such initial cost overruns. Cost overruns due to force majeure usually are excluded, with the venture responsible for those incurred due to unforeseen weather delays, labor strikes, etc. — although what is considered force majeure is also heavily negotiated.

Because it is such a hotly contested issue and a sensitive one for developers, which often have more limited access to additional funds, the cost overrun issue should be addressed at the term sheet stage.

Establish investor approval requirements

Another issue to address early on is the approval rights, or major decisions, over which the investor can exercise discretion or control. Major decisions inevitably become more detailed with development projects. There will be a push-pull between a developer who is concerned about satisfying a completion guaranty to a lender and, therefore, wants the flexibility to take action with limited oversight, and an investor with 90 percent or more of the equity in the project who wants to be involved in decisions regarding how the project is built. The developer also will desire as much latitude as possible to incur costs, adjust the budget and schedule, and otherwise deal with contractors to complete the project in a timely manner.

Consider default remedies

In development ventures, investors and developers spend considerable time discussing and negotiating the ability of the investor to remove the developer as manager of the venture if the manager is in material default under the venture agreement or fails to meet certain performance standards, to protect the institution's investment. Investors should consider that removal of a developer midstream might not be beneficial, however. The investor will have to provide substitute guarantees to a construction lender, and may not have the capability or the capacity to deal with contractors, lenders, etc., to complete the project. Investors should consider penalties for default other than removal, such as the right to offset losses against distributions and dilution of the developer's interest in the venture, or otherwise establish relationships with developers who might be willing to take over a project for a fee.

Limit sale rights

Most developers earn a promote, or carried interest, as compensation for a successful development after all investor capital and a return thereon have been paid to the investor. Therefore, most developers will look to liquidate a development project as soon as possible after stabilization to earn that promote. For investors with a long-term hold strategy, selling the project after stabilization may not be desirable. Therefore, the investor should consider whether to allow the developer to put its interest to the investor, force a sale to a third party subject to an

investor right of first offer, or stay in the deal with the promote being crystalized and paid by the investor to the developer in cash (and the developer otherwise leaves its capital in the project until sale).

Monitor affiliated transactions

Developers often have affiliated companies that perform specific services such as construction management, development management and property management, and the joint venture agreement should accurately reflect the expectation of the parties with respect to the developer's ability to enter into contracts with its affiliates to perform these services. Because developers often receive acquisition fees, asset-management fees, construction- or development-management fees, and disposition fees through the venture — in addition to any fees payable to the developer affiliates — it is critical to clearly describe the fees in the venture agreement. At a minimum, the investor should have approval rights with respect to the form of the services agreement, or a preapproved form should be negotiated in conjunction with the venture agreement. In addition, if not set forth in any approved form of services agreement, the venture agreement should mandate the compensation be consistent with market rates for such services, or otherwise expressly approved by the investor. The investor will want the service agreement to provide it may be terminated without cause at any time the developer partner ceases to be the managing member of the venture. The investor also may want to require each affiliate to be subject to the same standard of care as the developer under the venture agreement.

Conclusion

The above is a sample of issues that could arise when entering into a joint venture with a developer. It would be difficult to summarize all potential pitfalls, but these are some of the most prevalent complications, as well as the strategies an investor may employ when confronted with them. The fate of the relationship of a developer and investor does not need to be written in the stars but, rather, the parties should take the time at the beginning of their relationship to carefully draft an agreement that anticipates the possible complexities, and clearly delineates the parties' respective rights and obligations with respect to the venture.

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