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Reconciling Competing Developer and Institutional Investor Perspectives in Joint-Venture Real Estate Deals—Proven Models

Separated by a Common Language

George Bernard Shaw once remarked that the Americans and the British were two peoples separated by a common language. Much the same is true of the typical real estate development and operating company (the "Developer") and the typical institutional real estate investor (the "Institution"), especially when they decide to participate together in joint ventures. What is said by one party to the joint venture and what is actually heard by the other party are often two very different things because of the ingrained, divergent perspectives each party brings to the relationship. Reconciling the divergent perspectives of the Developer and the Institution, understanding their respective hot-button issues, and forging a fully functional joint venture in which both parties are treated fairly are goals that depend heavily upon both parties' abilities to listen, learn, and adapt.

The Developer

The typical Developer creates value by employing risk capital to control and obtain entitlements for sites in markets selected by the Developer based upon an array of considerations, ranging from market demographics and product type to the limitations of the Developer's expertise. The successful modern Developer is better capitalized than its predecessors and has super-regional or national development and operating expertise. However, although the Developer may be better capitalized, its resources are not unlimited. The Developer therefore turns to the Institution for project-based capital.

The Institution

The typical Institution creates value by employing investor capital to obtain risk-adjusted returns within parameters and based upon policies and investment time horizons that vary with the type of Institution or within the Institution, depending upon the internal allocations of available investment dollars. Many Institutions need to obtain investment returns that are available only from real estate investment activities that require the special expertise (and from the Institution's perspective, financial co-investment) of the Developer. The Institution therefore turns to the Developer for assistance with development, redevelopment, or "value-added" investments.

The Challenge

Initially, the joinder of Developer and Institution is a marriage of convenience driven by the Developer's need for capital and the Institution's need for enhanced returns. As equity providers for the real estate capital markets, however, the Developer and the Institution are at different ends of the risk-tolerance spectrum. How, then, do these disparate participants in this marriage of convenience grow happily together?

Effective Communication Enables Efficient Negotiation—The Term Sheet of Endearment

Communication is at the heart of any good relationship. At the inception of a deal, the Developer and the Institution will often enter into a nonbinding term sheet. This should contain essential deal terms and forms the

basis for the later drafting and negotiation of a definitive joint-venture agreement. Though the term sheet is a useful tool, it cannot and should not attempt to anticipate every issue and answer every question. Rather, it should cover those issues about which, experience dictates, the Developer and the Institution are likely to hold substantially different viewpoints. Such issues are best identified and resolved early on in the process.

During preparation of the term sheet, the Institution should make the Developer aware of the nature and quality of periodic financial reporting that will be required. Many real estate development companies are capable of generating the kind of financial disclosure and reporting most institutional investors require, but an investor may occasionally require the use of a specific type of financial reporting software and hardware package that the Developer may not have. As this would be a cost item, any special requirement should be discussed early. Other issues raised in discussions surrounding the term sheet may include these:

- Does the Institution have unrelated business taxable income or REIT "bad-income" issues?
- What types of carve outs and flexibility will the Developer need in the noncompete agreement?
- If there is going to be debt on the project, at what levels will it exist, and does the Developer or the Institution have a relationship with or preference for any particular lender?
- Who will take the lead on various aspects of the deal?
- Does the Developer have other business lines that will need to be involved in the project, such as management, construction, or brokerage?
- Who will do the first draft of the joint-venture document?

Role of Counsel

Attorneys for both sides should be involved in the creation of the term sheet and should play a key role in establishing a framework for effective communication throughout the deal, particularly if the deal is the first in which the Developer and the Institution will appear together on the inevitable tombstone. Both sides must be careful to avoid the unproductive "we always do it this way" mindset. Neither side is going to dictate every term in a successful joint venture, and when the Developer's "we always do it this way" confronts the Investor's opposing "must have" in an environment of poor communication or incomplete understanding, friction and inefficiency result. Optimally, the Developer and the Institution each has counsel that has substantial experience representing both developer/operators and institutional investors. Such counsel can play a useful role by providing the perspective of the other side for his or her client, as well as insight into the types of compromises that others have used to resolve deadlocks. Understanding *why* the other side is asking for something is every bit as important as understanding the request itself.

The simple value of one attorney's making an introductory phone call to the opposing counsel cannot be overstated. Such communication commences building the trust and rapport that are critical to the establishment of a working relationship that will enable timely and efficient resolution of the deal's more difficult issues. Many preliminary issues can be spotted in such a phone call, and many unnecessary and time-wasting conflicts can thereby be avoided, minimized, or at least dealt with up front as part of the basic business discussion. A deal negotiation is successful if there are no surprises for either side with respect to must-have and hot-button issues by the time the first draft of the joint-venture document is written. If the attorneys are unable to break a log jam, the deal broker (if there is one) can often give valuable insight to help the parties come to terms with any disappointing but immutable realities.

Always Say What You Mean; Then Explain It

Example: A 'Development Deal' Without 'Entitlement Risk'

As an example of the importance of adopting the foregoing approach to communication, consider the following. Let's suppose the Developer and the Institution agree upon a term sheet that says they are going to do a "development deal." Such a deal necessarily involves the Developer's obtaining many permits, approvals, and other public or quasi-public entitlements, not all of which, quite frequently, will have been issued by the time the Developer has acquired title to the property to be developed or otherwise put significant amounts of its own capital at risk. Because the parties have agreed to do a development deal and because from the Developer's perspective some entitlement risk inheres in the nature of most development deals, the Developer

might conclude that the Institution's willingness to do a development deal in the first place means it is prepared to co-invest and is willing to take the *same risks* the Developer is taking at the *same time*. The Developer would likely be wrong. Most Institutions will not take so-called entitlement risks, even in a development deal and even though they expect development returns.

What exactly does the Institution mean when it says it is willing to do a development deal but not take entitlement risk? The crux of what is most commonly meant by "entitlement risk" from the Institution's perspective is the risk that any issuing authority may exercise discretion to deny or modify any pending permit application. Even though the Developer may believe with good reason that there is no practical risk that a certain as-yet-unissued discretionary permit might not be issued, the Developer must not fail to understand that the absence of the permit is usually a nonwaiveable impediment to closing from the Institution's perspective. The Institution's fiduciary client has given it parameters that must be observed, and those parameters often do not allow the investment of funds before the project is fully entitled.

Obviously, not every conceivable permit for a project of significant scope will have been issued by the time the Institution's funds must be committed in a development deal. Thus, if any pending entitlements exist, the Developer should be prepared to demonstrate to the satisfaction of the Institution and its counsel that any such pending entitlements are truly ministerial. Much the same showing will in any case need to be made to the construction lender (if there is one), and it may be helpful for the Developer to think of the Institution in this way in relation to entitlement issues. The Institution should be careful to make sure the Developer understands it is not suggesting it has any real concern whether a particular permit would ultimately be issued, but rather that the issuance of such a permit is simply a "must-have" condition precedent to funding. In the rare case where the deal cannot be done without the Institution's taking entitlement risk, the Developer should make its expectations clear as part of the term sheet, if not earlier. Then, if the Institution agrees to take some entitlement risk, it will want to make clear exactly how much and identify any specific entitlements that might be required before funding.

What Diligence Is 'Due'?

Packaged Solutions

Much time and money can be saved if the Developer anticipates the Institution's due-diligence requirements and prepackages organized diligence books together with solutions to likely issues. For example, the Developer may request a commitment for title insurance containing extended coverage and other typical endorsements that a lender would be likely to require, such as survey, comprehensive, zoning, subdivision, tax lot, access, and creditors' rights endorsements. The Institution may also wish to have a non-imputation endorsement added to the policy, whereby the title insurer agrees not to deny coverage benefiting the Institution based on matters known to the Developer but not known to the Institution. The survey should be a current American Land Title Association survey and should be certified both to the property-owning entity and directly to the Institution. If environmental diligence suggests the real estate has any unfavorable history, the Developer may also consider placing environmental cleanup cost cap and/or third-party pollution legal liability insurance policies. Many Developers now maintain such policies on a portfolio-wide basis and have come to value them as a way to give additional comfort to Institutions and lenders. Having substantially complete diligence information and acknowledging what still needs to be provided allows the Developer to build trust and a level of comfort not only between the Developer and the Institution but also between their respective attorneys. The deal's flow from term sheet to definitive documents and through the Institution's due-diligence process is more orderly if diligence is primarily a matter of confirming the expected rather than discovering the unexpected and then having to deal with it in an environment where no prior communication occurred.

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Where There's a Lender

Many of the diligence requirements of a lender and the Institution are likely to be the same or substantially similar. The Developer should work to have one checklist apply to both the lender and the Institution and should anticipate that it will have to provide the same reports, opinions, title policies, surveys, and the like to both the lender and the Institution in a format that permits direct

reliance. Where the Institution's and the lender's due-diligence requirements diverge, however, the Developer should bear in mind that the Institution's money is going in first and coming out last. The lender, therefore, has a substantial equity cushion and may also have a long-term relationship with the Developer not enjoyed by the Institution. For these reasons, it is not productive for the Developer to remind the Institution that it is taking equity risk. Once again, the same term may mean two different things. To the Developer, "equity risk" means that it will not see its back end until after the lender is repaid and the Institution has received its return but that its initial capital is already at risk. A small dollar risk relative to overall transaction size from the perspective of a lender is a much larger risk (as a portion of its equity) from the perspective of the Institution. Thus, to the Institution, equity risk requires the Institution to conduct a thorough and critical review of all diligence because loss will fall first not on the lender but on the Developer and the Institution.

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Lender requirements that involve items to be produced by the Institution should be identified by the Developer and communicated to the Institution as early as possible, most particularly if any action of a governing body of the Institution will be required. The Institution's counsel should be proactive and make inquiry with respect to any lender requirements affecting the Institution, as such counsel is in the best position to assess what is likely to be available (versus what may be on the lender's wish list) and the turnaround time and process necessary to satisfy any request. The Developer will likely have a relationship with the lender and a conformed set of loan documents from prior dealings. The Institution should be sensitive to this relationship and confine its review of the loan documentation to key issues affecting its deal with the Developer. On the other hand, the Institution may likewise have a relationship with the lender and a conformed set of loan documents. In that case, both the Developer and the Institution have a unique opportunity to borrow provisions from the best of two different sets of documents. This enhanced set of documents may be a template for the next deal involving the same parties and may benefit the Developer or the Institution in a subsequent deal that does not involve both parties.

The Joint-Venture Agreement

Type of Entity

The definitive joint-venture agreement itself is, of course, the single most important document in the deal and should reveal the differing perspectives held by Developer and Institution on several recurring issues. Initially, there may be a question as to the form of business entity to be used as the property-owning vehicle. Most often, the Developer creates a shell limited-liability company in anticipation of later admitting the Institution as a member. Sometimes, however, for reasons that the Developer cannot easily anticipate, the Institution requires that the property-owning entity be a limited partnership. This can result from special tax requirements (often involving foreign investors) or accounting issues.

Control of Draft

Although the Developer usually forms the joint-venture entity, in a nod to the golden rule, the Institution usually generates the draft definitive agreement. If the Institution has both transactional counsel and house counsel, the transactional counsel should contact the house counsel with respect to any form of entity or standard joint-venture document requirements prior to creating the first draft joint-venture agreement.

Hot Buttons

Major Decisions: The Institution's participation in decision making by the joint venture is generally limited to so-called major decisions, and the Developer is responsible for the day-to-day management. The foregoing having been said, the most interesting issues arise when the negotiation focuses on defining what constitutes a major decision and those circumstances under which the Institution may unilaterally decree that a major decision be implemented. Invariably, a "major" decision to an Institution is often a "day-to-day" decision to the Developer. Most Institutions have the following on their list of major decisions:

- adopting or changing annual or project budgets (with some percentage, dollar amount, and/or beyond-control exceptions);
- creating or amending material contracts or giving any consents, approvals, or waivers thereunder (with contracts involving the Developer's affiliates subject to a more stringent set of rules that are often in the sole control of

the Institution);

- changing insurance coverages or third-party insurance requirements;
- changing plans and specifications in any material way;
- undertaking material capital improvements;

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- taking any action with respect to material environmental matters;
- establishing borrowing parameters;
- selling or pledging joint-venture property;
- entering into any material lease or any lease that is not consistent with an agreed-upon pro forma and standard form;
- settling or confessing judgment in any criminal proceeding;
- disposing of any material civil claim;
- using insurance proceeds or eminent-domain awards in any material amount;
- acquiring or leasing any new property;
- admitting new joint venturers; and
- filing or acquiescing to the filing of any bankruptcy or insolvency proceeding.

The challenge for the most part is in defining materiality. The last thing the Institution should do is hamstring the Developer by failing to give it at least the degree of flexibility necessary to get the project built, to operate it, and to respond to emergencies.

Bad Acts: Institutions may expect to have recourse to a financially responsible, Developer-affiliated party for so-called bad acts. Because recourse is involved, raising the issue at the term sheet stage is advisable, although setting forth full details on all bad acts should not be necessary. The same should apply to standard lender nonrecourse carve outs.

Noncompete: The scope and duration of noncompetition covenants binding on the Developer is frequently heavily negotiated. The negotiation may be further complicated if the parties cannot agree on the definition of what constitutes a competing project. For example, does a low-rise, garden-style apartment complex actually compete with a high-rise, luxury apartment project? How long should the covenant last? For as long as the Institution is in the deal or only through some negotiated milestone, such as the issuance of a certificate of occupancy or some level of leasing? The answers will depend on a matrix comprising the way in which the Institution has underwritten deal risks and the definitions of competing project and market area. The Developer must be careful to maintain flexibility by defining competing projects as narrowly as is fair and consistent with the level of protection to which the Investor is reasonably entitled. The Institution must be careful to understand the subtleties embedded in any definitions of competing project or market area. Although the Developer's greater market and product knowledge gives it the upper hand, the Institution is not likely to be making the investment in the first place if it did not have a fairly good understanding of the local market and the projects that compete with the joint-venture project in that market. Institutions cannot reasonably expect Developers to put themselves out of business or at least entirely at risk of further investment by the Institution within an entire market area. On the other hand, if the Institution's relationship with the Developer is a mature one, and especially if the Institution has funded any pre-development-risk capital requirements, the Developer may agree to give the Institution first look at any upcoming projects.

Keeping an Eye on the Exit

Institutions that survived the last down real estate cycle learned some hard lessons. Among them was avoiding the trap of having no way to force a sale at a time when the Developer has no further effective economic interest in the joint venture. A Developer hanging on to fees and desperately trying to avoid tax recapture paired with an Institution craving liquidity make for a very unhappy marriage. As a consequence, modern joint-venture documents are much less Developer-friendly than those of the 1980s. Dilution of the Developer's position will often result in a control shift. In addition, most Institutions have an explicit investment time horizon and insist on having the right to require the joint venture to sell or refinance the joint-venture property after a certain time, after a

buy/sell, or by some other method to ensure liquidity on expiration of the investment period.

Developers and Institutions that listen, learn, and adapt create joint ventures that function effectively and can be reproduced as a template for other deals.

Conclusion

Use of the proven models of communication, structuring, and issue resolution suggested in this article should result in lower overall transaction costs, better relationships, and enhanced opportunities for future cooperation. Organisms that succeed replicate. Developers and Institutions that listen, learn, and adapt create joint ventures that function effectively and can be reproduced as a template for other deals. ■

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