What About the Equity?
A Qualitative Analysis of Governance Provisions and Return Structures for Equity Investments in Joint Venture Real Estate Projects

by

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ABSTRACT

This paper looks at the equity component of real estate finance – the equity portion of the capital stack, if you will. It begins by characterizing the process through which real estate equity is secured by developers, and conversely, how it is placed by investors. It moves on to a discussion of the typical components of joint venture real estate LLC operating agreements – the primary document used to formalize joint equity investments in real estate projects. Through the author's observation of a collection of operating agreements (primarily at the institutional level) governing both operating real estate projects and ground-up development projects, the paper discusses the six primary governance issues that are common across most joint venture real estate projects - financing and capital structure, cash management, leasing, investment horizon, dispute resolution and defaults, and certain administrative issues. It further outlines how contractor control, control of the construction process and cash management issues emerge as the three additional critical governance issues in ground-up development projects. The paper continues with a discussion of the two primary return structure models prevalent in the market today – preferred equity and participating equity. While the models are often tailored to meet the specific needs of parties to different transactions, the primary negotiated variables – hurdle return rates, profit percentages (promotes), and carried interest amounts – generally remain consistent. The author observes that the level of contractual control demanded by investors does not necessarily increase with projects of greater risk. Instead, the quantity of controllable issues increases. Further, there appears to be a positive correlation between the level of control demanded by an investor and the investor's level of investment in the project as a percentage of total equity. Additionally, as the priority of an investor's ownership claim rises (i.e. straight preferred equity over participating equity), the level of direct contractual control demanded by the investor tends to decrease.

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CHAPTER 1: INTRODUCTION

Info-mercials, Chickens and the "Equity Gap"

I am a real estate developer. I want to find a piece of real estate, gain control of it, improve it, and benefit from my efforts. On the surface, it seems like a pretty simple concept. Three easy steps – 1) find it, 2) control it, and 3) improve it.....and then it's payday! Nothing to it…..right?!!

Well, here's the good news. If you stop reading this now and flip to channel 68, you will find several entertaining info-mercials that will reinforce this simplicity…..and for as little as $19.95, you can buy a video tape (now available in DVD as well) that may in fact convince you that buying and selling real estate is your most efficient and luxurious route to fame and fortune and perhaps that mansion on the gulf coast of Florida from whence they shot the TV spot.

Here's the bad news. Countless hundreds have tried that route and have proven that by strictly following the easy steps in your video manual, the chances you will ever make as much money in real estate as they actor they hired to shoot the info-mercial made from his 30-minute cameo are comparable to that of chicken trying to parallel park an 18-wheeler (the later part of this comparison has been tested less rigorously).

What's the point, you ask? Well, the point is, it's just not that easy. And what does a chicken's parallel parking savvy have to do with equity investments in real estate? Well, nothing. But ponder this for a moment. Let's look at the three simple steps described above. Take the first step - finding a piece of real estate. Much time and resources are dedicated to understanding the physical characteristics of real estate. On a practical level, our interaction with the physical aspects of real estate is quite prevalent. In fact we all use a variety of real estate products everyday – we live and sleep in residential real estate, we work in commercial real estate, we shop in retail real estate, etc. The resulting body of common and academic knowledge about how to find a piece of real estate is extensive and fairly comprehendible for your average developer. Take the third step – improving the real estate. This "improvement" process is pretty well understood as well. There are volumes of academic writings that explain step by step how to fix a roof or pave a parking lot or even build a building. By golly there's even a whole bunch of construction experts and contractors out there that will do it for us at a pretty darn good price.

But what about that second step – gaining control of the real estate? There is inherently a little more to this. Frankly, there's a lot more. How do we gain control of it? Well, we can buy it, we can lease it, we can option it, we can ask our friend to buy it with the understanding that we will buy it from him or her later….the list goes on and on. But let's keep it simple for now. Let's assume we buy it. And, in order to buy it, we probably need some money. And, since we have not struck it as rich as the guy on the info-mercial, let's assume we don't have enough. What do we do now? Well, by George let's do what everybody does…..let's borrow it (ah yes, debt…..another topic well-understood by developers and lay-people alike). But here's the catch! What if, after we've borrowed as much as we can, we still don't have enough? Well, my friend, this is the question developers have been asking themselves for years and years - how do we fill this “equity gap”.

In today’s day and age, there are a host of reasons that a developer may have an equity gap. And it may not be that he or she just doesn’t have enough money. In fact, it is quite commonly by design. There are so many ways to finance real estate projects these days, and so many different sources of capital, that every real estate project must be analyzed carefully to determine the most favorable financial structure.

This paper attempts to address the equity component of real estate finance. Specifically, it will undertake a comprehensive description of the typical components of joint venture real estate operating agreements, it will outline of the key contractual control provisions that govern the decision making rights within these agreements, and it will analyze the common equity return structures that accompany them. Further, it will attempt to outline the key differences between the governance provisions associated with investments in ground-up development projects versus those of existing operating properties (the distinguishing feature between the two being the existence of a *construction phase* in a development project). In preparation for these issues, this paper will characterize the process by which real estate equity is secured by developers and placed by investors and it will categorize the primary participants in the process. If there’s time, it will also address chickens and their history with parallel parking.

Inspiration and Methodology

This paper was inspired by the author's opinion that there seems to be a lack of academic focus on real estate equity. In graduate programs across the country, there is a plethora of information available regarding debt within the real estate industry (from regular mortgage loans to CMBS), and there is a wealth of information related to private equity as it applies to corporate finance. But there appears to be a relatively limited body of literature on modern real estate equity, and specifically, the sponsor-investor joint venture relationship, which is a widely used model in today's real estate world. This paper is not intended to be a comprehensive analysis of real estate equity, but rather and introduction to the major participants in the industry, the process of securing real estate equity, and the nature of the sponsor-investor relationship as it relates to governance and return structure. It is the author's hope that this paper may stimulate a bit more research on this very important and largely uncharted (from an academic perspective) territory.

The information presented in this paper is based on a three-pronged research approach. First, a literature review was completed through which the author explored a variety of existing publications related directly or indirectly to the subject matter. Primary topics of research included financial contracting theory, incomplete contracting theory, capital structure as it relates to corporate finance as well as real estate finance, the theory of the firm, organizational architecture and private equity practices. This background provided a solid foundation upon which to base real estate equity-specific findings. Second, the author collected and analyzed a variety of modern operating agreements that are currently in use by an array of institutional and private equity providers (the collection includes documents from REITS, Pension funds, opportunity funds, investment banks and high net worth individuals). This collection includes contracts governing multi-family projects, retail projects, hotel projects, office projects, and industrial projects. Further, the author specifically looked at projects with varying risk-profiles (from stabile operating properties to ground-up development projects). Most of the documentation that was studied was institutional in nature. That is, it was created to be used for the placement of equity funds by institutional investors (as opposed to private investors), the likes of which will be outlined in more detail below. Accordingly, this paper will focus largely on joint venture relationships where the equity provider is an institutional investor. While equity investments by private individuals often share many of the same characteristics, and certainly present a host of interesting issues, the market space associated with such investments tends to be less transparent and documentation governing such investments tends to be less standardized and less accessible. Third and finally, the author conducted interviews, either in person or by way of the telephone, with fifteen industry professionals. This group of professionals includes both local and national developers, a variety of equity providers (both institutional and private in nature) including REITS, investment banks, pension funds, opportunity funds, and high net worth individuals, as well as real estate attorneys. For the purposes of this study, the identities of interviewees (as well as the actual operating agreements) must remain confidential.

Much of the research regarding governance provisions in this paper looks at the allocation of decision-making control. This decision-making control affords the entity in possession of such control freedom to act and make decisions as they see fit in order to adjust to the ever-changing economy and real estate environment. Accordingly, in many ways, the allocation of decision-making control is loosely analogous with risk allocation (albeit with a negative correlation). That is, possessing contractual decision-making control affords the ability to make risk-aversion decisions, and therefore is, in itself, a tool for regulating risk. As such, the allocation of control and the allocation of risk, at least for the purposes of this paper, are considered to be directly related to each other.

Findings

This study, which is largely descriptive in nature, presents seven primary findings. They are as follows:

- There are six primary governance issues that are a part of most joint venture operating agreements including financing and capital structure, cash management, leasing, investment horizon, dispute resolution and defaults, and certain administrative issues.
- With respect to ground-up development projects, there are three additional key governance issues including contractor control, construction process control and development related cash management and capital calls.
- The *level of control* required by an investor does not necessarily change across properties of different risk, instead, the *quantity of issues* that must be controlled increases.
- There is a direct relationship between the level of control demanded by an investor and that investor's level of investment in a project (as a percentage of total equity).

- *Preferred equity investments* and *participating equity investments* are the two primary types of equity return structures in wide use today.
- Investors with preferred equity positions in real estate projects will generally require less direct decision-making control then their participating counterparts.
- The primary negotiated variables with respect to real estate equity returns are the hurdle return rates, profit percentages (promotes), and carried interest amounts, all of which are highly variable.

CHAPTER 2: THE PLAYERS AND THE PROCESS

A Few Generalizations

In the "real world", things are complicated. The roles played by the major real estate industry participants are often skewed and fuzzy. Equity providers sometimes act as developers, developers sometimes provide equity, investment advisors and investment banks sometimes do both, or neither, and on and on. Sometimes, through a syndication, there are 20 different equity providers in a real estate project, and sometimes there is only one. It is as a result of these blurry lines and gray areas that I fear any attempt on my part to present my findings in a manner that is "consistent with the world's inconsistencies," would leave us all more confused than when we started. Therefore, like many brave and bold pioneers before me, I will attempt to stylize things a bit. But, in doing so, it is as important that the reader be aware of this stylization as it is that the writer stylize it. So consider yourself warned!

Now that I've adequately disclaimed myself, let me next completely contradict myself. When I said the real world is complicated, I was exaggerating. I needed to make a point! It's actually not that bad (this is the confidence-building section of this paper). In fact, if you'll allow me to overuse the word "most" for a moment, I think I can sum it up in a few sentences. Here goes. *Most* of the time, *most* of the major industry participants will focus *mostly* on their *most* central business activities. Further, *most* joint venture real estate projects adhere to *most* of the common governance guidelines (although *most* of these are tailored a bit to be *most* effective for the specific deal) and assume *most* of the common structural components. For the *most* part!

While we're on the topic of generalizations, let's clarify one other central point. For the purposes of this paper we will use the term "joint venture" to refer loosely to a real estate project where there are two or more "equity partners" (one typically being the sponsor) who hold an equity interest in the project. The intention here however is to differentiate the joint venture structure from the "syndicated" structure, which also implies a situation where two or more parties hold an equity interest in the project. The primary difference between the two is that a syndicated structure implies a scenario where the equity ownership rights have been reduced to securities and sold to a group of investors. Traditionally it would also imply a larger group of investors than in a simple joint venture project where you can usually count them on one hand, and quite often on just two or three fingers. In fact, it is overwhelmingly common for there to be just two equity partners, one being the developer (sponsor) and one being the primary equity provider (investor). For the most part, it is this simple bilateral sponsor-investor relationship that we will examine throughout this paper. Before we get there though, let's look at some of the participants we alluded to earlier.

The Sponsor

For the purposes of this paper, we will define the sponsor as follows: Those who seek profit by identifying and developing or operating real estate investment opportunities. Traditionally, this role is played by the entity that we commonly know as the "local developer". However, this term implies two things which may or may not be true. First, the term "developer" implies a focus on ground-up development, which really only covers a portion of the population of joint venture projects (and, frankly, of real estate projects in general). There is a larger subset of projects that are "operating" in nature. That is, they involve the acquisition of existing operating properties. Accordingly, there is a population of entities whose primary business is pursuing these operating projects. As you might expect, consistent with our "fuzzy roles" scenario described above, many entities will do both. In any case, we will use the term sponsor to describe all of these entities. Further, the term "local" implies a local focus which also may be erroneous as many modern developers have a much broader geographical scope (see the next paragraph). While real estate, at least at the "project level," is very much a local business, the fundamentals, and associated skill sets, are quite mobile.

Sponsors can be categorized several ways. Generally, these categorizations fall into three subsets – scope of business, product type, and risk profile. Scope of business refers to a sponsor's geographic orientation, and generally is either local, regional, national, or international in nature. Product type refers to the types of real estate products a sponsor may specialize in. The primary product types are residential, office, industrial, retail, and hotel (which is really a type of residential, but its business model is different enough that, in many settings, it warrants its own category). Some sponsors will specialize in just one product type while others will be involved in all of them. Risk profile refers to the risk inherent in a particular project. In general, the risk of a real estate project is a direct function of the stability of its cash flows. For example, a class A office building with a long-term lease to a Fortune 100 company will offer a much more stabile set of cash flows than a speculative ground-up development project that won't be completed for two years and has no pre-leasing commitments. The risk profiles of these projects, therefore, are dramatically different. Generally, there are five major risk categories from an institutional investment perspective. They are as follows:

- Core – This is the least risky subset. It generally involves high quality real estate with very stabile cash flows.
- Core-plus – This is slightly more risky than core. It usually involves high quality real estate with some curable flaw.
- Value-Added – This is midway down the "risk-list" and typically involves real estate with a more serious value impediment.
- Opportunistic – This is the most risky of all "operating" real estate. It may involve complete redevelopment projects, acquisitions of vacant properties, etc.
- Development – Often falls under the "opportunistic" title, but is really a separate subset. It may be further broken down into speculative development versus pre-

leased or build-to-suit development, which, in themselves, have different risk profiles.

Some sponsors will focus on properties with a particular risk profile while others will have a more broad orientation.

The Investor

For the purpose of this paper, we will define the investor as follows: Those who seek profit by securing equity positions in real estate projects on behalf of themselves or others. The investor is the equity provider. Typically, in a bilateral (investor-sponsor) joint venture, the equity provider will furnish most, if not all, of the equity capital. In the "typical" scenario, they rely on the sponsor to source and operate the project, although the role of the investor can take many forms and is often more comprehensive. There is a great variety of entities that provide equity for real estate projects. In fact, the list is long enough that the author has decided to let the reader perform its own detailed due diligence on each, as a comprehensive description of these investors would likely out-read the subject research. They are as follows:

- Pension Funds
- Endowment Funds
- Trust Funds
- Specialized Real Estate Funds
    - Core Funds
    - Core-Plus Funds

    - Value-Added Funds
    - Opportunity Funds
    - Funds of Funds
- REITS (Real Estate Investment Trusts)
- REOC (Real Estate Operating Companies)
- Corporations
- Insurance Companies
- High Net Worth Individuals (HNWI's)
- 1031 Exchange Buyers
- Tenant-In-Common Buyers
- Foreign Investors (may be institutional or HNWI's)
- Investment Banks
- Investment Advisors

While this list is not comprehensive and involves some overlap, it outlines the major equity providers that are active in the industry today. As a function of the need for portfolio diversification and real estate's growing role as a major asset class, pension funds have been a growing (and are now the largest) source of equity funds for the real estate industry. Many of their equity investments are placed through opportunity funds or investment advisors and still others are placed directly. The term investor, as it is used throughout this paper, will generally refer to one of the equity providers on this list. As mentioned above, most of our research involved institutional equity providers so our discussion is slanted in that direction.

The Process

Somehow the sponsors and investors must come together. Like any other "market" where there are "buyers" and "sellers", sometimes the parties come together directly, through private networks or previous relationships, and sometimes they come together through an intermediary, like an investment bank or a broker. In either case, there are two things that hold constant. First, there will always be an underlying property or properties that serve as the basis for investment. Second, there will always be some form of agreement between the sponsor and equity provider that governs how the property investment will be operated and how the profits and losses will be shared. These governing agreements are as varied as the underlying properties. In small and unsophisticated transactions, these agreements may be as basic as a verbal arrangement between the parties or a simple "handshake" understanding. On the other hand, at the largest institutional level, these agreements may consist of hundreds of pages of legal documents. But in either case, the parties must find each other. Let's look at some of the issues that each party must contend with in approaching these transactions.

How does a sponsor source equity?

Sometimes sponsors will secure equity first and then find a property or properties later. Other times, sponsors will find a property or properties first, and then secure the equity. This is a business decision on behalf of the sponsor, driven by individual firm goals and objectives. In either case, we will assume that the sponsor has a reasonable level of experience in the field, efficient access to the property market, and efficient access to debt financing. We will also assume that the sponsor has a limited amount of internal funds and wishes to use such funds as sparingly as possible so as to maximize the number of projects it can pursue. In a typical real estate project, the sponsor may be able to secure somewhere between 50% to 85% of the acquisition costs (depending on the nature of the project – i.e. ground-up development vs. existing asset, pre-leased vs. speculative, etc.) from debt financing sources. The rest will have to come from equity. The sponsor can raise equity in one of two ways. First, the sponsor could identify one or more investors who would be willing to contribute equity directly at the project level (or project entity level, as will be discussed later) in return for a share of the ownership of the project. This is what we have identified as the joint venture method and it is, of course, the primary focus of this paper. Second, the developer could pursue the process of securitizing equity shares of the ownership and, in turn, selling the securities to prospective investors. As noted above, this is commonly known as the syndication process. While there are obvious inherent similarities between the two methods, there are also significant differences. First, depending on the number of securities to be sold and the nature of the sale, certain procedures outlined by the SEC may need to be employed in a syndication. The purpose of this is to protect prospective purchasers of a security from any fraudulent activities or misrepresentations. SEC regulations are generally not a concern under the joint venture method. Further, as the holder of a security under a real estate syndication generally posses a more diluted interest in the project, their control rights are often equally diluted - sometimes to the point where the sponsor ultimately has 100% of the decision making authority. In a joint venture this is generally not the case. Joint venture equity holders will all usually have some degree of control over the outcome of the project. This direct control is typically stronger than that of syndicated security holders. Many sponsors who elect to pursue the syndication route have a well-established network of investors to which they regularly offer their real estate securities. Others may find themselves sourcing new investors on a deal by deal basis. More prolific sponsors may have in-house securities brokerage personnel while others may use outside brokerage professionals.

Like the syndication-oriented sponsors discussed in the preceding paragraph, many sponsors who typically use the joint venture approach to sourcing equity also have well-established networks of investors. In sourcing this equity, they will generally select from the menu of equity providers outlined above, depending on which classes of investors are available to them as dictated by their track record and the nature of the investment opportunity. Less established sponsors may again find themselves scouting for joint venture partners on a deal-by-deal basis. Many sponsors have relationships with mortgage brokers who are taking a more central role in matching sponsors with equity providers.

Regardless of funding method, other things being equal, sponsors are generally motivated to find the equity provider who will offer the best "cost of capital." That is, the least expensive equity source. The cost of equity can be measured by the required returns to be paid on such capital as well as the profit sharing splits (the "promote," discussed below) after certain return hurdles have been met. Sponsors are also motivated to maximize their level of direct project decision-making control in an effort to minimize their risk.

How does an investor place equity?

Much like sponsors must "pick their poison" with respect to the types of projects they will focus on, investors must determine what types of projects they will pursue before actually placing the equity. Generally, investors will establish their return requirements and project criteria before approaching the sponsor community so that they can better pursue opportunities in a focused an expeditious way. Similar to the way sponsors search for equity funding, investors will employ a variety of methods in sourcing equity placement opportunities. Many investors have well-established networks of sponsors that they work with, while others tend to find sponsors project by project. Investors will make use of brokers, investment bankers, attorneys, advisors, mortgage brokers, and other intermediaries in search of appropriate investment opportunities. In any case, investors generally cite three issues as the most important determinants of project selection – the quality of the opportunity (that is, the real estate opportunity itself), the track-record of the sponsor, and integrity of the sponsor.

Generally, investors (particularly institutional investors) are motivated to place equity. Often, the more equity an investor (again, particularly institutional investors) can place, and the faster it can place it, the greater their opportunities for profit. In some cases, investors, who are investing on behalf of others, take investment management fees based on the aggregate value of invested capital. Prudent investors acting in this capacity must therefore balance their desire to place equity and their obligation to secure quality investments.

CHAPTER 3: OPERATING AGREEMENTS – THE FUNDAMENTALS

The Entity and the Agreement

The first step in formalizing the joint venture relationship is to establish an entity. This entity, whose *equity interests* (shares of ownership) will be owned by the joint venture partners, will likely hold title to the subject real estate (or it will control the entity that will hold title). Today, the overwhelming majority of these entities are created in the form of an LLC (except in Texas where LP's are typically used, as LLC's are subject to a unique entity-level tax). An LLC is formed by the filing of articles of organization with the Secretary of State in the state of establishment (although it will need to be legally recognized in all regions within which it wishes to do business). It is a non-corporate entity that affords its owners, called *members*, the limited liability of a corporate shareholder as well as the flow-through tax treatment of a partnership. An LLC is generally managed by a *manager*, who may or may not be a member (*managing member*). Typically, in joint venture real estate transactions, one of the members (usually the sponsor) serves in the capacity of managing member.

Once the LLC is formed, rules for its operations must be created. This is done in the form of an *operating agreement*. If the LLC were a country, the operating agreement would be its' constitution. The LLC operating agreement will not only define the nature of the entity and the guidelines for its operations, but it will also govern how all cash flows and distributions will be handled (as the money flows from the operations and activities of the real estate asset).

This section aims to outline the key components of typical LLC operating agreements formed for the purpose of governing joint venture real estate transactions. It should be noted here that even implying that there is a degree of typicality in these agreements would likely come under fire by many industry experts. Like with any contract, the structure and content of an operating agreement may vary widely depending on the nature of the situation, the intentions of the parties and the preferences of those who ultimately draft and edit the document itself. However, due to the nature of our regulatory system and the common purpose of these documents, there is, at a bare minimum, a set of issues that must regularly be addressed and that will commonly be encountered in an operating agreement of this type. This section does not intend to be a comprehensive inventory of all issues related to these documents, nor does the order of topics below reflect an organizational structure that is at all industry standard. Instead, this is intended to be a cohesive introduction to some of the more common issues and clauses found in these agreements.

Definitions

Operating agreements, like many other contracts, will often lay out a glossary of key terms that will be encountered within the document. This section is intended to be a point of reference for the interpreter. Sometimes it is included at the beginning of the document and other times it is at the end.

General Provisions

Real estate operating agreements, although specific in purpose, must also address regular legal issues surrounding the company's formation. This is commonly done in the *general provisions* section of the document. This section, which does not always carry this title, is typically at the beginning of the agreement and will address such issues as how and where the subject entity was formed, the name of the entity, the place of business of the entity and the purpose and authorized activities to be undertaken by the entity. It also may identify any agents of the company and the intended term of the company's affairs. It may list or reference the names and addresses of its members, and it may describe how title to company property shall be held and how filings of certificates, statements and other instruments related to the furtherance and continuation of the entity shall be handled.

Capital Contributions, Members Loans and Capital Accounts

This is a critical section. Its general purpose is to identify the initial capital contributions of each party, any subsequent additional capital contributions of each party, what happens in the event of a shortfall, and how capital accounts will be handled for the members. The complexity of this section and the related procedures may vary depending on the nature of the project.

As might be expected, identifying the initial capital contributions is pretty straight forward. This item is typically pre-negotiated in prior discussions or a letter of intent, and the operating agreement simply formalizes the business deal. Initial capital contributions often come in the form of cash, but it is not uncommon for a contribution to be in the form of real property, to which a value is tied. As will be discussed further in the "Distributions" section of this chapter, initial capital contributions will accrue interest (although it is generally not regarded as entity-level debt-like interest, but equity return to be repaid in the event the company profits as expected) at a pre-determined rate of return. Sometimes these rates of return are defined in this section, but they are also commonly defined under distributions.

Additional capital contributions (also known as "capital calls") are a bit stickier. Generally, in the event the entity requires additional capital to fund its' operations, the members will be either *asked* or *required* to contribute such additional capital. Parties to these contracts will sometimes limit their exposure by including a cap on their total investment (including all contributions), while other times their exposure to continued capital contributions is only limited by their ability to sell the project or their interest in the ownership entity. Such additional capital contributions are commonly contributed on a pro-rata basis according to some pre-agreed upon percentage – often either the member's percentage interest in the entity or in accordance with their initial capital contributions. This seems simple enough, right? Not really. What about the timing of the additional contributions? What about the returns to be earned on additional contributions versus the initial contributions? What happens if a member fails to make a contribution? And perhaps most importantly, who makes these decisions? These are all very critical questions - questions (among several others) that lie at the heart of the risk allocation process.

Let’s look first at the timing question. Generally, in the case of a ground-up development or a sizable renovation project, the investor will require that an acquisition/development budget and schedule be prepared and approved by all parties prior to entering into an agreement. This schedule (typically attached to the agreement itself) will serve as the basis for planned capital contributions. So long as the timing and costs stay at or near those in the budget, the process moves along on track. In acquisitions of operating properties, where large initial construction costs and regular capital calls are not budgeted, additional capital contributions, which will be less development-oriented and therefore of smaller magnitude (hopefully), may still be tied to an operating budget.

It is the unbudgeted capital calls, however, that cause the most concern. Again, there will often be differences here related to the development or non-development nature of the project. Development projects will often be more comprehensive in describing the nature of additional capital contributions. For example, a development project may go so far as to classify the reasons for additional capital contributions, tying different rates of return and different contribution proportions to each. Additional contributions resulting from cost overruns might be classified as either “unanticipated or unforeseen”, “discretionary or elective”, or “erroneous”. Unanticipated cost overruns, which occur at no fault to the sponsor or the investor, may be split pro-rata at a base percentage. Discretionary overruns, which result from the members’ joint determination to expand the scope of the project, may be split at a second percentage, and erroneous cost overruns, resulting from sponsor error, omission or fraudulent activity (collectively known as “bad boy acts”) may be born entirely by the sponsor. Quite often these additional capital contributions will accrue interest at different (typically higher) rates of return than the initial capital contributions (described further under “Distributions”, below), except that additional contributions of the sponsor resulting from bad-boy acts will commonly not be repaid at all. In acquisitions of operating properties (where there may be current cash flow from operations) additional capital contributions (which may result from an operational cash flow shortage, among other things) are more likely to be optional in nature, but may still accrue at a different rate of return.

Nonetheless, whether the additional contributions are mandatory or optional, the money must come from somewhere, and the source of this capital can have a dramatic impact on the return scenarios for the members of the entity. Further, the provision of such capital may be of critical importance for the long-term health of the project. So, what happens if a member does not contribute its share of this capital? Well, if it is a mandatory contribution, the non-contributing member will likely find themselves in default and will be subject to all remedies available to the contributing member(s) under a default, which may involve the removal of the non-contributing member, among other things. Generally, the other members will have the right to contribute the non-contributing member’s portion and will then have the option to deal with the non-contributing member as needed. If it is an optional contribution, generally, the other parties will have the right to contribute such non-contributed amount, and such amount will either be treated as a loan to the company or a loan to the non-contributing member. This is sometimes referred to as a “member loan.” While a member loan may take many names, shapes or sizes, they are typically reimbursable prior to further distributions, sometimes directly by the non-contributing member and sometimes by the company. They are generally subject to a very high rate of interest as well. In some cases, the non-contributing member will not be allowed to receive any profits from the entity until such member loan is repaid. Depending on the nature of the loan agreement, the non-contributing member's percentage interest in the entity may be reduced and the contributing member(s)' percentage interest may be increased. Such loans may be secured by the non-contributing member's remaining interest in the entity.

Now for the big question - who decides when an additional capital contribution is necessary and how much capital is required? Unfortunately, the answer to this, like the answer to many contractual questions, is not black or white. It is subject to negotiation, and hence, not easy to characterize. But, since this paper is rooted in making characterizations about that which many industry experts have labeled "uncharactirizable," why not stick my neck out a bit further? It appears that "generally" (have you heard this word before in this paper?), I would even go so far as to say "very generally", the decision making related to capital contributions is roughly proportionate to the members equity contributions in the project. That is to say, when a member is responsible for "most" of the equity in a project (as is commonly the case for equity providers in these joint venture transactions), that member is likely to have "most" of the decision making power as it relates capital contributions. How does one achieve "most" of the decision making power? Another good question. One whose answer might be different for different contractual terms that require varying decision making processes.

In this case, “most” of the decision making power might be defined as the ability to propose the timing and amount of the additional capital contribution, subject to “reasonable” member consent. It might also, on the other hand, be defined by a scenario where another member (let’s say the sponsor, in a case where the sponsor is the managing member and the investor has contributed “most” of the capital) proposes the timing and amount of such additional capital contribution, but the investor has the right, in its “sole discretion,” to approve or deny such proposal. In summary, “most” of the decision making power, for the purposes of this paper and this point anyway, is a situation where one party holds the overwhelming ability to control the nature of the outcome, yet they are at least in some small way dependent on the input of the other(s). Again, generally, in the typical two-party joint venture, where the sponsor is the source of the transaction and the investor is the source of most of the equity, the investor would likely hold most of the control over this decision. In many cases, however, as much as the investor has the ability to approve or deny such additional capital contribution, they are quite dependent on the sponsor to manage the financial day to day activities of the entity, and therefore will rely heavily on their recommendation as to these capital requirements. Ultimately, the nature of this interdependence, while formalized contractually in various ways, boils down to how comfortable the investor is with the sponsor (as do many other control-related issues).

Different contracts will contain different levels of detail related to contingencies surrounding capital contributions. Development projects will often contain more rigid guidelines here as well. Capital contributions from the investor may be contingent on a host of items, including but not limited securing the construction loan, an acceptable business plan, guarantees on construction completion and sponsor contribution from sponsor or principals of sponsor, securing all permits and licenses, satisfactory title insurance, and more. Often times, investor capital contributions (and perhaps the deal in general) will be contingent on the investor's approval of the sponsor's source of funds. The investor wants to be sure that the sponsor's principals, who may well be handling the day to day activities of the entity, are financially committed to the project. Accordingly, there is often a minimum percentage of sponsor funds that must come directly from personal funds of the sponsor's principals.

Another important issue related to capital contributions is that of capital accounts. Generally, the agreement will describe procedures for maintaining a capital account for each member of the entity. These guidelines will be in accordance with treasury regulations and will spell out the events which result in crediting or debiting of accounts. Generally, no withdrawals can be made and no interest is due on these accounts except as expressly provided in the contract. Credits include the value of any cash or property contributions as well as any net income generated by the company and allocated to that member. Any cash or property distributions as well as any net loss allocated to that member are generally charged against the account.

Distributions

The distributions section spells out the manner in which income to the entity will be distributed. It governs the infamous cash flow "waterfall." Income is generally broken down into two types – *net operating proceeds* and *net capital proceeds*. Net operating proceeds are cash flows that result from the operations of the entity. While they may be defined in various ways, generally, they consist of all operating receipts in excess of operating expenses, debt service, capital improvement expenditures and cash reserves. Net capital proceeds can be loosely defined as any proceeds from a sale, refinancing, insurance recovery, eminent domain award or similar capital event in excess of any debt that is due, any transaction costs or any necessary reserves. Operating proceeds and capital proceeds may be distributed according to the same distribution plan, or they may be distributed differently. In either case, this section will lay out the frequency of cash distributions, the method for compounding (interest is normally accrued to provide for cumulative returns) and the order in which capital will be repaid. Further, it will define the returns applicable to all invested capital. There are a variety of methods by which to distribute cash flow. A detailed analysis of this methodology is contained in the chapter of this paper on returns. The distribution section will also describe any necessary distribution withholdings as well as any legal restrictions on distributions.

Tax Issues and Allocations of Profit and Loss

Real estate LLC operating agreements will contain language addressing tax issues and allocations of profit and loss. Common issues of concern include compliance with Treasury Regulations, regulatory and other allocations, minimum gain chargebacks, loss limitations, qualified income offsets, non-recourse deductions, and other adjustments and allocations, all of which are outside the scope of this paper. Often, the agreement will identify a member to deal with tax matters, generally the managing member, who will be responsible for preparing tax returns for the company (or causing such returns to be prepared), determining the appropriate treatment of income and loss, collecting tax information from other members as necessary to deal with Internal Revenue Code issues, and furnishing necessary tax information to other members. The agreement will often spell out basic procedures to be followed by the *tax matters member* in carrying out such tasks.

Accounting, Records, Reporting & Bank Accounts

Operating agreements will generally have language dedicated to the LLC's accounting practices, record keeping practices, reporting practices and bank accounts. The agreement will typically define the accounting method to be followed, the entity's fiscal year, who will maintain the company records (often the managing member) and where such records will be kept. It will define any reports that are to be prepared and delivered to the other members and what the time frames are for delivery. Reports that are commonly prepared and distributed include financial statements (balance sheets, profit and loss statements, cash flow statements and the like), leasing activity statements, budget analysis reports, property management reports, insurance-related reports, business plan revisions, and more. The agreement may further define any audit rights possessed by LLC members as well as any cash management policies (the later being a critical control which is further explained in the next chapter). The agreement may outline how and at what frequency project appraisals are to be completed as well.

Company Management and Membership

This topic is an important one. Under this section, the operating agreement will identify the manager and lay out its rights and obligations. Generally, the manager of the LLC will be the central figure in making company decisions. This doesn't necessarily mean it will have the most decision making authority, but at the very least, it will play a major role in executing decisions once they have been made. As with any LLC, the manager can be a non-member or member, as noted above. In the typical sponsor-investor relationship, where the sponsor is to be active in the project and the investor has contributed most of the capital, the sponsor is often named as the manager (managing member) and strict restrictions are placed on its actions. In this case, the managing member may have some authority to make small day-to-day decisions, but for the most part, they will be restricted to acting in accordance with mutually pre-approved business plans, operating and construction budgets, etc. Further, many operating agreements will go as far as listing specific decisions that may not be made without prior consent of the investor. These decisions, which will be further discussed in the next chapter, include financing decisions, sale decisions, contract decisions (often primarily related to construction, property management, leasing, etc), entitlement decisions, insurance decisions, legal decisions, acquisition decisions, accounting decisions, decisions related to major modifications in the entity itself (transfer of ownership, dissolution, etc.), any decisions that would either fall outside the agreed upon business plan or operating budget or would negatively impact the property in any way, etc. And this list is not nearly comprehensive. This method, while it requires active involvement and regular recommendations by the sponsor, most often places primary decision-making control in the hands of the investor. Similar to the capital decisions referenced earlier, as the sponsor's capital contribution in a given project rises, there will often be a rise in the level of decision-making authority a sponsor will have. Generally, the more "skin" the sponsor has "in the game," and the more comfortable the investor is with the sponsor and its' track record, the more leverage the sponsor will have in negotiating decision-making autonomy.

Another business model that is not uncommon in joint venture real estate projects is one where the investor is named as the manager and the sponsor has some approval rights, depending on its' contribution to the entity. This model is typically used when the investor has in-house development or property management expertise and wishes to be a more active participant in the day-to-day operations of the project. Sometimes the sponsor will step out of the management all-together and other times it will be more of a team effort. Often, under this scenario, where the sponsor has a limited financial commitment to the project and has limited development or property management expertise, the sponsor will effectively yield most all of the decision making control to the investor.

In addition to naming the manager and defining how primary decision making rights will be allocated, this section of the operating agreement will also outline the rights and roles of other members and limitations on liability of the manager and members. Generally, a non-managing member has a limited role in the day-to-day activities of the entity except to provide its decision making authority as outlined by the document. Further, in some cases, non-managing members are prohibited from committing the company to any contracts or financial obligations or from acting as an agent on its behalf.

The operating agreement will also lay out the expectations of the managing member and non-managing members pertaining to their time commitments to the company and their ability to be involved in competing projects (often allowed, but sometimes limited). The agreement will look at compensation and expense reimbursement for both the manager and the non-managing members as well. This can be a very important point. While it is relatively common for most project expenses to be reimbursed by the company to the party making the expenditure, the amount and recipient of the development fee or property management fee are less systematic. These and other fees are important to the transaction because they compensate the developer or property manager, as the case may be, for their time and resources spent on such tasks. As the sponsor or investor may often serve in one or both of these capacities, this is commonly an important point of negotiation, particularly for a sponsor-developer who may rely on this fee for operational funding until they receive profits from the project (if they are so fortunate). Fees that are commonly paid include acquisitions fees, development fees, property management fees and asset management fees. Depending on the nature of the investor, sometimes underwriting fees or investment fees may be paid to them as well.

This section of the agreement (in combination with other sections) will often outline procedures and timeframes to be followed in preparing annual or monthly business plans and budgets. It also will typically lay out company policies regarding the hiring and firing of company employees and contractors. Often, this section will discuss company policies with respect to ERISA (Employment Retirement Income Security Act of 1974) as well as procedures related to UBTI (unrelated business taxable income).

Transfer and Assignment of Interests

Operating agreements will typically address the issue of transferring interests in the LLC and the procedures for doing so. Generally, transfers are not permitted without some level of approval by other members of the entity. Sometimes transfers will be at the sole discretion of other members and other times members will only have "reasonable" approval rights. Many times, certain transfers, known as permitted transfers, are permitted without the approval of other members. Permitted transfers are more commonly available to the investor (particularly institutional investors), as their business models require more flexibility. This section of the agreement will also address substitution of membership rights (which may be separate from interests in the rights to profits, losses, and distributions) and procedures for such substitutions. Often, clauses providing purchase options and right of first refusal options to non-transferring members in the event another member wishes to transfer its interest are included as well. This section will also likely address how admissions of new members will be handled.

Withdrawal, Removal and Resignation

Similar to transfers, noted above, withdrawals and resignations are often not permitted without prior consent of other members. In many cases, a member's request to resign or withdraw from the entity will trigger a buy-sell event or in some cases a default event, depending on the nature of the withdrawal. This section may also outline any events or actions that would justify removal of the managing member and any procedures surrounding such removal. This issue is often addressed in the default section as well, as noted below.

Dissolution and Termination

This section of the agreement will address what events will trigger the dissolution of the company and the actions that will be taken upon dissolution. Generally, the "winding up" of the entity is handled by the managing member and entails the liquidation of all company assets, satisfying the claims of all creditors and a final distribution of any remaining assets according to an agreed upon final distribution plan. It is commonly triggered by the completion or early termination of a project.

Defaults

This section will typically define what events constitute a default on the part of the managing member or non-managing member(s). These are commonly listed separately as they constitute a very different set of events. Defaults by the managing member often include bankruptcy, fraud or gross negligence, a change in the ownership of the managing member resulting in the principal(s) no longer having a majority interest, a default under the loan documents, or simply a material failure to perform its duties. A default on behalf of the investor may be triggered by such major events as bankruptcy, fraud, or withdrawal from the company. As you might expect, default events by the investor, at least under the common scenario where it is the majority owner and non-manager, are not as constricting.

Remedies for default include such items as restrictions on distributions, loss of membership rights, the triggering of a buy-sell event (to be addressed below) and other possible remedies available by law. Further, the investor will often seek additional remedies which allow it to immediately remove the managing member as manager, replace it with another manager, or step in and act as manager itself. It may also seek the right to terminate affiliates of the managing member as agents (brokerage, property management, etc.) as it sees fit.

Third Party Sale

This section will generally outline the procedures to be followed with respect to a third party sale. Perhaps the most central issue here is when to in fact sell the property. In many cases, the investor will have the unilateral ability to initiate a forced sale after what is commonly referred to as the "lockout period." A lockout period is simply a pre-determined period of time within which neither party can force a sale or initiate the buy-sell procedures discussed below. A lockout period is commonly implemented as a mechanism by which to prevent the parties from removing themselves from the project or forcing a sale of the project during the critical early stages of an acquisition or development. The idea behind it is that the parties to the agreement acknowledge that they are dependent on each other for the performance of certain functions in order to get the project to a point where they will collectively be able to realize the value of their initial investment. If either party removes themselves from the project prior to such time, it would be extremely damaging to the remaining members. While lockout periods vary widely and are quite case-specific, a typical development lockout period might be defined as 24 to 36 months after the initial investment, or similarly, 12 months after substantial completion of construction.

Barring a forced sale, this section would define what other events would result in the sale of the project. Often this is tied to the term of the loan or the investment horizon of the investor.

This section also typically describes the method of determining the ask price for the property, the minimum acceptable sale price and other terms of the sale. Often, member consent is required for the determination of such items although, in many cases, the investor has the ability to make the final decision in the event of a disagreement. Other times, a disagreement would trigger a buy-sell event or prompt some form of arbitration. This section will further define the method of responding to offers, timeframes for responding to offers and what level of consent is required for such responses.

Often, the investor will hold very tight control over the sale process, and in the event the property is not sold in a timely fashion, or if the sponsor defaults in any way, the investor can initiate a forced sale over which they often have more or complete control of the process.

This section of the agreement will typically outline the broker selection process, the process for negotiating the terms of the brokerage agreement, and the process for implementing price reductions in the event the property does not sell at the original ask price. The agreement will also typically outline reporting procedures here with respect to the sale, as well as rights and procedures related to tax-free exchanges that members may wish to pursue.

Buy-Sell

Generally, all real estate operating agreements will contain some sort of buy-sell language. The term "buy-sell" is an industry accepted label for what can be a fairly complicated process. However, the concept is really quite simple. It is basically the process by which joint equity holders in an asset engage in and execute a purchase or sale of the other's interest in that asset. This section of an operating agreement will spell out when buy-sell proceedings may be initiated, the procedures that must be followed in order to do so and any other issues surrounding the buy-sell rights.

With respect to timing, there is often a lockout period, similar to that described above, within which buy-sell proceedings may not be initiated (although in some cases an impasse or default my trigger buy-sell provisions prematurely). After such lockout period, buy-sell proceedings can often be initiated by either party – again, sometimes as a result of an impasse or a default, and other times for any reason, simply as a result of one party wishing to withdraw its' interest in the entity.

In its' simplest form, a buy-sell event might evolve as follows: First, the member initiating the buy-sell procedures will deliver an "offer notice" to the other member. The offer notice will normally contain the offering members' determination of fair market value of the company's assets (the buy-out amount) as well as other pre-determined items that may include the proposed date of closing, etc. Once received by the non-offering member, the non-offering member may either elect to sell its' interest in the project at the offer price, or alternatively, it may elect to buy the offering members' interest at the same price. Also, once received, the non-offering member must respond with its intent within some predetermined period of time, or, generally, it will have been deemed to have accepted such offer and will be required to sell its' interest within the allotted timeframe. The provisions will normally outline the closing process, the method for determining fair-market-value (which varies significantly), schedule and location, the treatment and pro-ration of taxes, the treatment of any rents due and any other necessary adjustments. The provisions will also normally lay out any remedies for non-performance. These often include dissolution, loss of deposits, a discounted purchase by the performing member, as well as other remedies including specific performance. Another important concern is whether the purchasing member will be acquiring the selling members' membership interest or direct ownership of the entity's assets themselves. Sometimes this is predetermined and other times the purchasing member may make this election. *Push-put* language, which is quite similar to buy-sell language, often addresses this issue more specifically. Push-put language, which differs from buy-sell language in that it generally *mandates* that one party either buy or sell another party's interest at a given time or within a given period, often implies a purchase or sale of a *membership interest*, whereas buy-sell language often refers to the purchase or sale of the entities *underlying assets*.

Representations and Warrantees

The primary intention of this section is to assure the investor that all information provided by the sponsor, upon which the investor has made the decision to invest its equity, its true and accurate to the best of the sponsor's knowledge. While the investor will sometimes provide a small set of representations (generally related to the fact that it has the full legal capacity to perform its obligations under the operating agreement), the vast majority of this section is dedicated to representations of the sponsor. The sponsor will often make representations that the following issues (among others) have been appropriately dealt with:

- Sponsor's authority and capacity to perform its obligations under the operating agreement
- Utilities and other services to the project
- Licenses, permits and approvals for the project
- Environmental status and hazardous waste as it relates to the project
- Personnel and expertise of sponsor
- Due diligence documentation
- Pending or threatened condemnation or litigation
- Title to the property
- Property financial statements
- Property-related agreements and contracts (brokerage, etc.)

- Property-related insurance information
- Other legal matters

Insurance and Indemnification

The operating agreement will generally outline the insurance to be carried by the company with respect to construction, development, maintenance and operation of the project. Sometimes this "insurance plan" is included within the body of the agreement and other times it is provided under separate cover. Typically, it will describe the nature of the coverage, who is responsible for obtaining and maintaining such policies and which parties shall be named as additional insured. The operating agreement will also describe limitations on liability and indemnifications. This typically protects the members and managing member from liability so long as such parties continue to act in good faith. Further, members are generally not personally liable for debts, liabilities and obligations of the company outside of their committed capital.

Dispute Resolution

Sometimes the operating agreement will spell out specific resolutions to specific disputes or conflicts throughout the document (therefore requiring no specific dispute resolution section). Other times, there will be a section that specifically addresses how certain disputes will be handled. Often, the method of preference is arbitration (sometimes binding and sometimes not). In the event the parties have elected to include arbitration language, this section will spell out the arbitration procedures, how an arbitrator will be selected, and the binding (or non-binding) nature of the arbitration process. This section may further spell out the parties' rights to file applications for relief with a court of appropriate jurisdiction. Dispute resolution is a critical control-related point within a joint venture partnership. When a specific section of an operating agreement does not exist to spell out certain dispute resolution methods, the agreement will generally have dealt with it inherently in other ways. These might involve buy-sell rights, third-party sale triggers, defaults and remedies, etc.

Miscellaneous

Generally, operating agreements have a miscellaneous section which covers many points that don't fit naturally in other places. This section typically addresses short administrative or legal issues which are common to many contracts. These clauses include notices, successors and assigns, amendments, no waiver, litigation, entire agreement, captions and references, counterparts, applicable law, etc.

Common Exhibits

Operating agreements will also commonly have an exhibit section which contains separate documents that are commonly referenced within the agreement itself or other documentation that is too long to fit cohesively within the context of the regular agreement. Exhibit items often include (but are not limited to) the following:

- Names, addresses and contributions of members
- Description of the subject real estate
- Project business plan
- Property budget

- Acquisition and development budget
- Appraisal procedures
- Agreements with third parties (brokerage, development, management, etc.)
- Schedule of reimbursements to the parties
- Guarantee agreements
- Property financial statements
- Operating agreements for affiliated holding companies
- Environmental information
- Cash management policies
- Rent roll and owners reports
- Other policies and procedures

CHAPTER 4 - PRIMARY GOVERNANCE ISSUES

Operating Properties

While joint venture operating agreements can be very extensive and address many subtle details governing the sponsor-investor relationship, six major issues have emerged as the most critical to the joint venture process. These issues govern the primary direction of the project and ultimately have the most influence on its success. It is through the governance of these issues that control of the project is primarily allocated. The issues outlined in this section are generally consistent throughout the spectrum of real estate product types (office, industrial, retail, residential, hotel) and risk profiles (core, core plus, value-added, opportunistic, development). In the next section will look at issues that are more specific to ground-up development deals, but for now we will focus on operating projects. The issues are as follows:

- Financing & Capital Structure
- Cash Management
- Leasing
- Investment Horizon
- Dispute Resolution and Defaults
- Administrative Issues

Let's look at each of these in a little more detail. For clarity of explanation and in order to establish a starting point from which to observe how these issues are controlled, we will again focus on the typical bilateral (sponsor-investor) joint venture situation where the sponsor will handle the day to day operations of the project and the investor will provide the vast majority of the equity.

This, again, sets up the important point that decision-making control has a positive correlation with the amount of equity an investor has placed in a project. For example, in a typical joint venture situation, where the investor holds a 90% initial interest and the sponsor holds a 10% initial interest, we would expect the investor to have the majority (perhaps 90%) of the decision making authority. The sponsor may very well make recommendations and execute the decisions, but it is quite likely that the investor will hold the reins. So, what we will look for below is how the investor will achieve its desired level of control.

First, it is important to understand the key mechanisms by which control is allocated and shared between the parties. There are several common scenarios that dictate control allocation. The first is a scenario where one party has the contractual right to make a unilateral decision. That is, no input from any other party is needed in order to make the decision. The second is one where a party has the contractual right to make a decision, however, that decision must be approved by another party or parties. In this situation, control will be governed by the nature of the approval. If the other party has the right to approve or deny such decision, in its *sole discretion*, than the original party's right to make a decision is really more or less the ability to propose a recommendation upon which the other party will decide. If the other party has the right to approve the decision in its *reasonable judgment* (reasonable approval), than it must practice reasonable discretion with respect to such decision and could only deny such decision if it were justifiably unreasonable. This shifts much of the decision-making authority back to the original decision-maker and results in a more evenly shared control capacity.

These mechanisms depict a few of the technical methods through which contractual control is allocated. It should be noted, however, that there are a variety of other ways to do this. Further, there may be factors outside those which have been addressed in the contract itself which would encourage a party to act a certain way under a certain set of circumstances. Again, decision-making control, regardless of the contractual mechanism that attempts to allocate it, is best described as the overwhelming ability to control the nature of an outcome. It is this "overwhelming ability," regardless of its origin, that one should look for.

Financing and Capital Structure

This issue deals with sourcing and securing capital for a given project. Many joint venture projects will lever the equity interests by securing debt financing. Debt financing comes in many shapes and sizes, from traditional mortgage loans, to construction financing, to mezzanine debt (discussed in more detail below). Equity partners in a joint venture must decide how much debt to obtain, what type of debt to use, who the lender should be, what the terms of the loan(s) will be, and what type of recourse the lenders will have against the equity partners. The debt will have to be paid off over time with some type of debt service payments, which will burden the operating cash flow and ultimately add risk to the investment. Further, the debt will likely be secured by the real estate or the assets of the entity and will take a senior position to the equity interest with respect to distributions.

In addition, the equity partners must decide who will have equity interests in the project and what the priority of their claim will be (see return structures below). In an effort to make sure the best financing decisions are made, it is common that the front end work, at least with respect to debt capital, is done by the party with the most expertise in this area. Many times the investor will be responsible for handling the debt identification process, and still other times, it will be left to the sponsor. If the investor is not responsible for securing the debt itself, at a bare minimum it will have the right to approve, often in its sole discretion, the decisions related to debt sourcing and implementation.

The equity component is often resolved a bit differently. In many cases, the sponsors will have sourced the opportunity and therefore will have more leverage in determining how the equity will be structured. As soon as the sponsor decides to bring in a majority investor, however, that majority investor (particularly if it is an overwhelming majority investor) will likely wield most of the decision-making control with respect to equity allocations moving forward. At the outset, of course, this allocation is a function of the partners' original agreement.

Cash Management

Managing inflows and outflows of cash to and from the project is also of critical importance. With respect to cash flows, the investor is interested in making sure that inflows are credited and deposited appropriately and that cash outflows are only made on necessary items. There are two common mechanisms through which the investor controls cash flows and yet still affords the sponsor ample flexibility to handle the day-to-day financial operations of the project. The first is the project budget. At the outset of the venture, the investor will often require that the sponsor submit a business plan and budget for the property. In the case of an operating property, the budget is an "operating budget" and it would include a line-item pro-forma of all expected costs for a given time period (typically annual). This budget generally requires the approval of all partners and is used as a benchmark throughout the operating period from which the sponsor can make financial commitments. Often, for example, so long as the sponsor only spends money on items included in the operating budget, and so long as such expenses are within a pre-determined range (typically within 5% of the budgeted amount, with a maximum dollar amount cap), the sponsor is free to make financial commitments. In the event of an expense that is either outside the budget or above the pre-determined 5% limit or dollar amount cap, investor approval is often required.

A second common tool is the "cash management policy." Many investors will establish clear guidelines regulating the logistical flow of money. Cash management policies are sometimes written into the operating agreements themselves and sometimes attached as an exhibit to the operating agreement. In either case, they will spell how many project bank accounts will be established, what bank will hold the accounts, how the bank is selected, and who has authority to access and monitor the accounts. For example, an investor may require that a joint venture project have four accounts, one to handle operational inflows, one to handle operational outflows, one to handle construction inflows (funding from equity and debt providers), and one to handle construction outflows. The sponsor may only have access to the operational outflow account for expenses that fall within the pro-forma guidelines. The banking institution may be required to notify the investor in the event of any withdrawal requests in excess of the pre-established limits. Often times the investor will have the unilateral ability to select the banking institution to be used.

Leasing

Leasing is another critical issue. In order to maximize the value of many real estate projects, the most advantageous leasing scenarios must be pursued. Quite often, the investor will require that a "lease-up" pro-forma be provided by the sponsor as part of the business plan. This will outline the anticipated schedule of lease-up activities, the costs of such activities, and the types of tenants, rents and other business terms that will be pursued. Like the operating budget, the lease-up pro-forma will be approved by the equity partners and so long as the sponsor stays within the guidelines (the proverbial "box"), it is generally free to make decisions. Often however, large leases or leases with unique requirements that may somehow affect the value of the project will often require investor approval. Many times, the leasing guidelines will require that the investor actually sign all leases (or leases that meet certain criteria), which obviously affords the investor an inherent approval opportunity.

Investment Horizon

The investment horizon, which refers to the length of time the project is expected to last, or more specifically, the anticipated life of the equity providers' capital investments, is a tremendously important issue.

Often, the investor, which may be an institution (as discussed earlier in the paper) with an obligation to return its investable capital to its own investors after some period of time, will be quite limited in its investment horizon. So much so, that they will often only pursue opportunities with sponsors who have projects that fit their timing needs.

Opportunity funds, for example, are often closed-end funds with a five to seven year window (this varies depending on the fund) within which to pursue investment opportunities. After this “investment period,” the capital must be returned to its investors. Further, investors may require the flexibility to withdraw from the project prior to the completion of the originally scheduled project term. This need for flexibility is a result of many investor concerns, ranging from the need to liquidated and satisfy other financial obligations to simply protecting the fund from over-exposure to a certain market segment. On the other hand, an investor does not want to be compelled to sell at the whim of the sponsor either. The investor has devoted significant resources in placing capital in the project and it wants to keep the money invested long enough to recognize the best possible financial return.

The sponsor, too, is concerned about investment horizon. A sponsor may be in a completely different financial position or business phase than the investor. The sponsor, for example, may wish to hold a certain property as an income property for an extended time (say 10 years), while the investor must withdraw its money after five years, or vise versa. This inherent and common inconsistency has resulted in the creation of mechanisms by which equity partners with different investment horizons may achieve their desired investment life.

In our base situation, where the investor holds a majority ownership interest and the sponsor is managing the day-to-day activities of the project, it is the investor who will often require more stringent language surrounding its investment life. The first way the investor can do this is by causing a third party sale of the underlying real estate and dissolving the project entity. As addressed in the Third Party Sale section above, the investor will often have the unilateral right to cause a third party sale after a possible lockout period. This wouldn't necessarily prevent the sponsor from acquiring the investor's interest, or bringing in another investor to acquire such interests, however, it does provide the investor the ability to withdraw.

A second way that the investor can control its investment horizon is through a buy-sell clause or a "push-put" provision. While buy-sell language (contrary to push-put or *call-put* language) does not mandate the behavior (buy versus sell) of the parties, it often can be written in such a way as to effectively serve that purpose. For example, if the sponsor does not have the financial wherewithal to purchase the investor's interest, and the buy-sell provision mandates a quick transaction process which does not afford the sponsor adequate time to secure external funding, the investor can be fairly confident that by initiating the buy-sell provision, it will have the ability to acquire the sponsor's interest. Once it has done so, it would further have the right to cause a third party sale as it sees fit.

As the implications of the provisions that surround investment horizon are substantial, this is, as you might expect, a very heavily negotiated issue. As indicated earlier, one of the most critical issues in pursuing one of the disposition strategies mentioned here is the time it takes to consummate a sale once the process has been initiated (be it third party sale, push-put, or by-sell). It is not uncommon for the investor to want to sell quickly in order to take advantage of a good market, while the sponsor may want to delay the process in order to secure a new funding source.

Regardless of the outcome of this negotiation, the investment horizon (for the most part, and particularly on behalf of the investor) is selected with the intention of maximizing the return on the equity investment. If the investor believes that it can achieve a better IRR by shortening the holding period and selling a property in a "hot" market, it will likely be inclined to do so. Alternatively, if growth opportunities appear more attractive, it may desire to hold the property for a longer period.

As noted in the Third Party Sale section above, other guidelines may be inserted in the operating agreement that regulate the intended investment horizon by tying a third party sale and entity dissolution to the term of the senior loan or the investor's target investment termination date. While the intended project term is important, it is often the possibility of deviations, and the governing of such deviations (third party sale, buy-sell, push-put), that warrant more focused attention.

Dispute Resolution and Defaults

While operating agreements are designed to provide direction under many potential scenarios, they will nonetheless require that the equity partners to a particular project agree on certain items in order to move forward. But what if the parties just can't agree? Well, from this question grew a set of mechanisms intended to resolve these disagreements. In the case of a dispute, which might loosely be defined as a situation where a decision needs to be made and the equity partners cannot agree on what that decision should be, there are a host of ways that operating agreements will govern the decision-making process. Certain issues, depending on their level of significance, will warrant more or less complex resolution methods. In many cases, if after some pre-determined period of time, a decision cannot be reached, the document will simply pass unilateral authority to one of the equity partners. Other times, the dispute, sometimes referred to as an "impasse," will be sent to arbitration proceedings, where a third party will be called in to help facilitate a decision. Often, as noted earlier, this arbitration process will be spelled out comprehensively in the agreement. Generally, the arbitration language will identify the parties that are qualified to act as the mediator and identify timeframes within which the process must be completed and the ultimate decision must be made. In some cases, arbitration will result in a binding decision. Other times, if the dispute remains unresolved after such proceedings, one party will retain the unilateral ability to make the decision. In many situations, however, if a dispute remains unresolved after arbitration, the prolonged "impasse" will automatically trigger a buy-sell event. In any case, the language surrounding dispute resolution plays a critical role in shaping the nature of control allocation and ultimately the allocation of risk.

Defaults and their associated remedies are also a critical issue for investors and sponsors alike. Both parties are dependant on the other to fulfill certain obligations throughout the life of the project. Accordingly, they need to know that if those obligations are not fulfilled, they will have the ability to fix it. While the reasonable inclusion of defaults and remedies is important to all parties, the investor will perhaps pay more attention to it because, as the saying goes, they often have "more to lose," particularly in the case of a substantial institutional investor (like a pension fund) where their financial wherewithal would make them a likely target in the case of pursuit by a creditor. Accordingly, the ability of an investor to remedy a default by the sponsor, particularly as it may related to the entities' non-performance under a loan agreement, can often serve as the investor's primary means of limiting its financial and legal exposure.

Administrative Issues

While most of the core joint venture issues are directly tied to the performance of the real estate, there are some important issues that are more related to the governance of the project entity itself. These issues include any mergers, reorganizations or dissolutions of the entity, the admission, withdrawal or change of any member or manager, and any changes to the governance of the entities ongoing operations. Quite often, all major decisions related to entity management will require investor approval, which approval may either be granted at the investor's sole or reasonable discretion, depending on the nature of the situation.

Development Projects

From an investment perspective, the primary difference between an operating property and a development project is the addition of the construction phase, prior to stabilization, when the project will likely require a series of cash outflows. Development projects share many of the same core issues described above, but there is an additional set of issues created by the need to control for financial and operational variables throughout the construction phase. While there are a host of new issues that must be addressed in a development project, four issues have emerged as the primary control-related variables. They are as follows:

- Contractor Control
- Construction Process
- Capital Calls/Cash management

With respect to contractor control, majority investors will want control over who the contractors are, how and why they are hired (bidding, etc.) and fired (non-performance, etc.), how they are held accountable for their work (bonding, etc.), as well as the work they will be required to do. With respect to the construction process itself (preliminary through completion), investors will want control over design elements, plan approval, and very importantly, change orders. Change orders can be tremendously costly and often require specific controls like itemized dollar cost limits above which specific investor approval will be required. Entitlements, which are really a pre-construction item, often require a separate set of controls, as well. Some investors will take entitlement risk and some simply will not. Entitlements, if not yet secured, are a key element of development risk and will warrant careful procedural controls.

Capital calls and cash management for development projects require careful attention as well. Separate development accounts are often established for development inflows and outflows, much the same way operating and construction accounts are created for operating properties. Due to the nature and size of the outflows, investors will often retain complete control over distributions related to development and construction.

Wrapping up Risk Allocation

Regardless of whether a project is operational or development in nature, a critical intention of its operating agreement is to allocate risk (by way of allocating governance authority) and set financial incentives for both the sponsor and investor, so that their interests will generally be aligned and they will attempt to act in the collective best interest. Through careful observation of risk allocation in joint venture control provisions across the spectrum of low-risk core investments to high-risk development projects (and several in between), it appears that the *level* of control demanded by an investor does not necessarily change with projects of more or less risk. In stead, the *amount of issues* that need to be controlled for increases. The highest increase in controllable issues is seen in ground-up development projects, where the entire pre-stabilization construction process must be dealt with. Further, as noted previously for a variety of specific governance issues, it appears that the level of control demanded by investors increases as their level of investment in the project (as a percentage of total equity) increases.

CHAPTER 5:   EQUITY RETURN STRUCTURE

Returns and the Capital Stack

The return structure of real estate deals is perhaps the most central issue of the joint venture concept. Investors and sponsors alike base their investment decisions largely on expected project returns. While the concept of returns is a simple one, the structural complexity of returns for any given project is only limited by the creativity of those that craft the joint venture agreement. Accordingly, there are numerous methods used commonly in practice. The fundamentals, however, are relatively consistent and can be broken down systematically.

Before looking at return structure itself, let's break for a moment to review another "structural" issue – the issue of capital structure. Like in the world of corporate finance, capital structure within the real estate world refers to the sources of capital for a particular project. These sources can be organized according to their level of priority to form the traditional "capital stack." Priority, in this context, relates to the level of security of an investment from the investor's perspective (i.e. how likely is it that you will get your money back and/or achieve your desired return). The two primary investment types (which are sources of cash from the sponsors perspective), of course, are debt and equity – debt instruments being more secure than equity instruments as debt has a senior claim to the assets (it gets paid back before the equity does). As the capital markets have grown more sophisticated, so have the availability and nature of debt and equity products. The result has been more complex and often more densely populated capital stacks. For this paper of course, we will focus on the equity component of the capital stack.

The equity component of a real estate project can be divided and classified in a host of ways, much the way stocks of a public company can be divided and classified. Again, for the purposes of this paper, we will look specifically at the joint venture relationship, where a small group of participants (typically two), divide and classify the equity interest between them. Under this relationship, two types of equity interests prevail. That is, two different equity slices that become a part of the capital stack. The first is what we will call straight "preferred equity." The second is what we will call "participating equity." While they share some common characteristics, there are several clear differentiating factors.

Preferred Equity

Let's start with straight preferred equity. This is an equity interest in a project where the bearer contributes capital which is paid back over a predetermined period of time at a fixed rate of return, much like a fixed interest rate on a loan. This return is called a "preferred return," as it is paid ahead of other equity components. It looks and feels so much like a loan, however, that some industry experts actually refer to it as mezzanine debt or "mezz debt." Obviously this can be terribly confusing, especially since true mezzanine debt is perhaps more common in real estate capital stacks (as part of the debt component however) than preferred equity. Don't be mistaken though. It is not debt. It is equity that behaves almost exactly like a loan. Why not just make it debt then? Well, obviously there are some reasons, otherwise we probably would. The real answer to this question from a financial perspective lies in the capital provider's assessment of the risk-return characteristics of the deal. If a capital provider feels that a project is riskier than it would prefer, it may elect to provide mezzanine debt in order to secure a lien on the subject assets and keep itself at a more senior position in the capital stack. This effectively provides a loss-buffer, where the property would have to lose enough value to wipe out all the equity before cutting into the value of the mezzanine debt. On the other hand, if a capital provider feels that a project is sufficiently secure so that the risk-adjusted return that can be achieved through a preferred equity interest (where the rate of return will likely be higher than in a mezzanine loan) in a project is more attractive than that of a mezzanine loan, the capital provider may elect to pursue a preferred equity interest. The tax implications of an equity versus a debt investment are also an important consideration for many investors.

Participating Equity

The second and more common type of equity is participating equity. Unlike straight preferred equity, participating equity, as its name implies, participates in profits above the preferred return. Often, the bearer will share in a preferred return, but once the preferred return hurdles are met (as will be discussed below), the bearer will also have a claim to the residual profits.

The most basic participating equity structure is one where the equity partners (generally the members to the governing LLC) share the profits on a “pari passu” basis according to their initial membership interests until a predetermined IRR has been achieved by the investor. After this “return hurdle” has been met, the sponsor will likely be “promoted.” This term refers to the action of increasing the sponsor’s share of the residual profits it will receive (obviously, this means the other members’ shares will decrease accordingly). The amount of increase is called the “promote.” While the promote is often described in terms of a percentage increase, there is not an industry-wide consensus with respect to its technical definition and how it is actually calculated. The most technically correct (non-quantitative) answer defines the promote as the percentage interest given up by the investor and contributed to the sponsor after meeting a pre-determined hurdle, thereby enhancing the sponsors' claim to residual profits.

Quite commonly there will be more than one IRR hurdle and more than one promote scenario. For example, the members may split profits pari passu according to their initial membership interests, say 90/10 in favor of the investor, until the first IRR hurdle, say 10%, is achieved. After that, the members may split profits 80/20 in favor of the investor (a 10% increase for the sponsor, the amount of which is the sponsor's promote) until the investor has achieved a 15% IRR. Then, after this hurdle has been met, the members may split the profits 70/30 in favor of the investor (increasing the sponsor's promote) until the investor has achieved a 20% IRR, and so on. Each of these different profit split scenarios represents a different return "tier." Sometimes these tiers are referred to as different "profit percentages." For example, the members might refer to the revised splits within the first promoted scenario (after the first IRR hurdle has been met) as the "first profit percentages." The next promoted scenario, after the second IRR hurdle has been met, would be referred to as the "second profit percentages."

A common variation to the simple participating equity model is one where the concept of "carried interest" or a "carried distribution" is incorporated. This concept provides for the sponsor to take a percentage of the profits, after a given hurdle has been met, even before the promoted splits are paid. The profit percentage that is taken “off the top” is referred to as carried interest or a carried distribution. To illustrate this, let’s expand the example above to incorporate this concept. In this case, after the initial IRR hurdle of 10% is hit, the sponsor would be paid a carried distribution before splitting the profits according to the promoted split scheme. A typical carried distribution in this case may be 20%. So, upon achieving the 10% IRR, the sponsor would be paid 20% off the top of all additional profits, and the remaining 80% would be split 80/20. This scheme would hold true until the investor hit the next return hurdle of 15%, after which the sponsor might be paid another carried distribution of 30% off the top of all remaining profits and the rest would be split 70/30 until the next IRR hurdle was achieved by the investor. In many cases, carried interest is collect by the sponsor, but in order for the sponsor to keep all carried interest, the investor must maintain its negotiated return levels throughout the close of the transaction. If, for example, the property was sold and capital proceeds were not sufficient for the investor to maintain the IRR’s achieved throughout the deal, the sponsor would likely have to contribute additional capital (out of its carried interest funds) until the investor again hit its required return level.

Another common twist (although less common than the carried interest scheme), is the concept of a “current promote.” This concept allows the sponsor to collect a promote from current operating income prior to the investor achieving its’ required return. This structure is generally set up to focus the sponsor on achieving a satisfactory level of current income with less emphasis on the back-end promote that would be more indicative of a value-added type of opportunity where capital appreciation was the focus.

Negotiating the variables

There are a host of other variations to these models. The concepts outlined above, as well as other less traditional concepts, are tailored in various ways to meet the needs of investors and sponsors alike as they negotiate terms for different projects. In any case, the participating structure, with IRR hurdles, promotes and carried distributions, which looks much like the carried interest structure common in the private equity industry, is designed to fairly "incentivize" and compensate the equity partners. This structure provides a mechanism by which the investor can achieve its desired returns (as a function of the preferred return and IRR hurdles negotiated into the agreement) and the sponsor has adequate incentive to maximize the returns of project (as it will benefit from the promote(s) negotiated into an agreement).

The key negotiated variables under this participating equity model are of course the return hurdles, the profit percentages (the promoted splits), and the carried interest payments. Sponsors, as you might expect, will attempt to maximize the promote and minimize the time it takes to get "into the promote" by minimizing the preferred returns and hurdles. Investors, on the other hand, will try to maximize their returns and minimize the promote to the sponsor which ultimately maximizes their claim to residual profits and enhances their total return.

In addition to maximizing their total return, equity providers will commonly attempt to set some sort of a minimum profit amount. This ensures that the equity provider receives, at a bare minimum, enough profit from the transaction to make the investment worth their time in the event of an untimely disposition or other unplanned circumstance. Sometimes this is defined as a dollar amount and other times it is a percentage tied to capital contribution. Further, equity providers may set a “minimum equity multiplier,” which effectively will limit the amount of residual profits that can be earned by a sponsor prior to the investor achieving their target multiplier.

There are advantages and disadvantages to both primary equity structures (preferred and participating) from both the sponsor’s and investor’s perspective. For the sponsor, the straight preferred equity model limits the sharing of residual profits with the investor, which can be a huge benefit. On the other hand, it typically will require that the sponsor pay a higher preferred return on the invested capital, making it more difficult to get into the residual profits. For the investor, preferred equity is less risky because it gets repaid before the remaining equity and provides a loss-buffer much like mezzanine debt. Further, it generally offers a higher current preferred return. However, with no back-end upside profit potential, the total return to the investor from the project under this model is limited to the negotiated preferred return. Participating equity is riskier, but may offer better total return potential. Again, it boils down to the party’s assessment of the project’s risk-return profile and what their goals are for that particular investment. In many cases today, as a result of the extremely competitive acquisition environment, many investors are forced to consider preferred equity interests in cases where they normally wouldn’t simply because that is the only way they will be able to get into some of the deals on the market.

The governance provisions surrounding these different equity structures will vary as well. Often, investors in preferred equity positions will require less direct decision-making control because they are in a more secure position. The parties' equity positions may also affect the nature of other financing for the project. For example, some funds (opportunity or otherwise), which might otherwise source the primary debt for the project and provide some recourse for the lenders, may not do so under the preferred equity structure. With no back-end upside opportunities, they may not be willing to expose themselves to that additional risk. While the sponsor often has a "bigger box" to work within before the preferred equity provider can step in to make decisions, the sponsor will also often be responsible for sourcing and securing such debt.

Like the other key points in the operating agreement, return structures are highly negotiated and highly variable. In particular, the return structure appears to be endogenous with the governance structure. Different sponsors and different investors have different motivations and different points of leverage in every situation. The result is a huge diversity in structural techniques across the spectrum of joint venture real estate projects.

Order of Distributions

As noted earlier, the returns earned by the parties to a project are generally governed in the distributions section of the operating agreement. The distributions section will outline the administration of such payments, the most critical aspect of which is the order in which profits are paid (as this ultimately determines the nature of the equity interest).

Quite often this section will simply list the order of priority in which payments will be made. As noted in the previous chapter, distributions will sometimes be ordered differently for operating proceeds and capital proceeds. Also, sometimes an investor will require full payment before a sponsor even sees a dollar. But while the distribution plans coincide with the splits and return hurdles mentioned earlier (which may vary widely), there may be subtle differences in payment priority as well. For example, some agreements may call for all member loans and additional capital contributions to be repaid prior to the initial capital contributions. Further, they may call for all returns to be paid before capital is repaid. Others will not differentiate between these items. Many agreements will also contain what is known as "clawback" language, which allows one or more equity partners to claim cash from a capital event in order to pay themselves back for past unachieved returns before any other current returns are paid.

CHAPTER 6: CONCLUSION

Summary of Findings and Thoughts on Further Study

This paper has taken a focused look at joint venture real estate projects and the return structures and control provisions that govern the equity investments behind them. Further, it has looked carefully at the bilateral sponsor-investor relationship that lies at the heart of many of these projects. Through the creation of a project-level entity (typically an LLC) and the formulation of the operating agreement that governs that entity, the equity partners in these real estate transactions are able to formalize their relationship. Guided by the operating agreement, this relationship is characterized largely by the allocation of decision-making control, which is a direct determinant of risk allocation.

In looking at contractual control allocation, this paper explores the 18 primary components of joint venture operating agreements and further outlines the six critical governance issues that tend to define the nature of the projects' decision-making control profile. Further, the paper explores the primary additional governance concerns that emerge in ground-up development projects versus those that are common throughout the majority of real estate joint ventures – operating and development alike.

In addition to the analysis of governance issues, this paper looks closely at the equity return structures that are common in modern real estate practice. It further explores the typical negotiated variables within those return structures as well as the common methods of distribution.

In light of this analysis, this paper offers the following seven conclusions:

- There are six primary governance issues that transcend most joint venture operating agreements, regardless of product type or risk profile of the underlying real estate. These include financing and capital structure, cash management, leasing, investment horizon, dispute resolution and defaults, and certain administrative issues.
- With respect to ground-up development projects, there are three additional governance issues of critical importance. These include contractor control,

construction process control and development-related cash management and capital calls.

- The *level of control* required by investors does not necessarily change across properties of different risk, instead, the *quantity of issues* that must be controlled for increases.
- There appears to be a strong positive correlation between the level of control demanded by an investor and that investor's level of investment in a project (as a percentage of total equity).
- There are two primary types of return structures in wide use today with respect to real estate equity investments. They include *preferred equity investments* and *participating equity investments*. These basic return structure models are often tailored to meet the needs of the parties to a given project.
- Investors with preferred equity positions in real estate projects will generally require less direct decision-making control as a result of their more secure equity position.
- The primary negotiated variables with respect to real estate equity returns are the hurdle return rates, profit percentages (promotes), and carried interest amounts. The actual values of these variables differ significantly by transaction and are largely a result of the equity partners' negotiating leverage upon entering into the venture.

Having spent many weeks sifting through volumes of legal documents and speaking with a variety industry experts, the author acknowledges that he has merely scratched the surface of this intriguing topic. Much more rigorous study could be pursued in attempting to measure risk allocation as a function of decision-making control and how it is tied to an investor's equity investment. An interesting comparison in this vein, for example, would be to evaluate governance provisions and control rights within syndicated real estate projects versus those within traditional joint ventures. It would be interesting to explore the relationship between the control rights of an investor in a syndicated project as a function of that investor's equity investment versus a joint venturer's control rights as a function of its equity investment. In doing so, one might be able to make some generalizations about which investment type is inherently more or less risky (as a function of each investors ability to control the outcome of their investment), and perhaps, based on the returns associated with the different investment models, which investment provides a better risk-adjusted return for underlying projects that may contain the same risk profile.

Similarly, more rigorous study with respect to real estate equity return structures would certainly yield fruitful results. While there appear to be two dominant models, as discussed in this paper, one might be able to more systematically categorize the different variations on these models and perhaps identify factors that result in certain variations. Such information would be valuable for investors and sponsors alike as they negotiate ever more complex joint venture relationships.

In any case, the world of real estate equity is an important one - one that warrants continued careful attention. History has proven that there will likely always be an “equity gap.” And as long as there is, real estate practitioners will be looking for better ways to fill it.

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Additional Sources

Fifteen interviews were conducted with a variety of real estate industry professionals whose identities must remain confidential.

Eight joint venture real estate operating agreements currently in use by a range of reputable institutional and private real estate investment entities were analyzed for the purposes of this study. The sources and identifying features of such operating agreements must remain confidential.