OPERATOR OWNERSHIP AND CONTROL REQUIREMENTS IN REAL ESTATE JOINT VENTURES

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One of the more common ways that an institutional investor (Investor) invests in real estate is by teaming up with a local operator or developer (Operator) in a joint venture (Venture) to acquire, and sometimes develop or refurbish, real estate. More often than not, in the authors' experience, the Investor will contribute at least 90 percent of the required equity capital to the Venture with the Operator contributing the balance and being given more than a 10 percent share of the profits if certain economic hurdles are satisfied. This structure is sufficiently common that forms have been published to document such an arrangement.[1] This article will briefly address the desire of many such investors for assurances regarding the ownership, control, and continuity of the Operator and how the Operator may react when asked to provide these assurances. For convenience, this article will assume that in the Venture under consideration the Investor will contribute 90 percent of the required equity.

THE INVESTOR'S PRIMARY OBJECTIVES

The Investor's decision to team up with the Operator is, in effect, a wager by the Investor that the Operator will be able to successfully produce a profitable project if the Investor provides 90 percent of the required equity investment. Prior to forming the Venture and making the investment, the Investor will typically seek to identify who owns and runs the Operator, the sources of the Operator's 10 percent investment, and the individuals who will be critical to the project's success in order to reassure itself that investing capital with the Operator makes sense.

The Investor's review of the Operator will likely also seek to satisfy the following Investor objectives and concerns:

- That the Operator is capable of bringing the project to fruition;
- That the Operator's team will be able to comply with the Investor's strategic, operational, and regulatory requirements;

- That the Operator's team will be sufficiently incentivized to care about the project for the duration of the project;
- That the Operator has a good reputation; and
- That the Operator's team is of good character.

These objectives and concerns may bring to mind familiar concepts in the fund context of sponsor due diligence, alignment of interest, skin in the game, and key persons.[2] The consequences for failing to satisfy these objectives and concerns may vary but the intentions are similar and the requirements for the Venture may go beyond those imposed in the fund context.

The Investor's primary objectives may be achieved in a number of different ways such as:

- Requiring a minimum level of investment in the project from the Operator's own capital;
- Requiring the owners of the Operator to maintain majority ownership and control of the Operator for the duration of the Venture;
- Requiring the active involvement of the critical individuals in the project for a specified period of time; and
- Requiring the disclosure by the Operator of significant problematic information regarding the Operator or the Operator's team.

As with most venture issues, the devil is in the details.

ALIGNMENT OF INTEREST AND SKIN IN THE GAME

The Investor may require the contribution and maintenance of a minimum investment by the Operator. This ownership requirement is frequently due to the belief that the Operator will be more likely to pay greater attention to the project if the Operator's own capital has been, and remains, invested in that project. Many investors feel this is the best way to ensure an alignment of interest between the parties and prevent the Operator from simply gambling with the Investor's money. The Operator's ability and willingness to satisfy a minimum investment requirement may depend on the Operator's track record and size, the type of project that will be undertaken by the Venture, and the Operator's investable resources.

If the Operator is part of a new or smaller organization, it may argue that satisfying a minimum investment requirement is onerous because it has fewer owners, or a limited amount of investment capital, or both. If the project involves development or refurbishment, the Operator may resist requirements that could result in its investment capital being tied up in the Venture for an extended period of time. However, if the Operator is part of a larger or more established organization, it may not have a problem satisfying a minimum investment requirement because it may have more owners, a larger staff, and more investment resources or outside co-investors.

As part of the minimum investment requirement, the Investor may want the "key owners" of the Operator (i.e., the owners who are viewed by the Investor as key to the success of the project) to use their own money for the minimum investment. The Investor may wish to avoid an investment by others who may be more of a distraction with opinions and requirements that might conflict with the Investor's. As a result, the Investor might prefer that the Operator make a smaller minimum investment with the money of the key owners who have more skin in the game, rather than a larger minimum investment using the money of other investors.

The Investor may seek to maintain this alignment and skin in the game until the key owners have recouped their investment from a sale of the project. This approach may effectively preclude the Operator's key owners from syndicating the Operator's interest, selling a partial interest, or financing their position.

Such requirements do not always sit well with the Operator or the key owners for a variety of reasons:

- The Operator may have other investors with whom it has worked for a number of years. Those other investors may be friends, family, or other important people who helped the

Operator's parent organization start the business and acquire the skills, experience, and reputation that led the Investor to the Operator;

- If the Operator is a start-up, the key owners of the Operator may not have sufficient capital to make or maintain the required co-investment of the Operator (or even a substantial part of it), and, if they are pressed to invest too large a share of their net worth, it may impair their judgment. Requiring the Operator to concentrate its capital in a single project could end up resulting in increased or decreased risk-taking;
- Eliminating other investors may require the Operator to limit its activities to a reduced number of projects and its ability to spread operating costs over several projects. Limiting the Operator's ability to recapitalize its organization or investment may impair the Operator's ability to control its own destiny, especially if the Operator does not control the sale or recapitalization of the project. Such requirements might preclude the Operator from doing other deals and reaching the requisite scale to be a successful company;
- The Operator may need to have access to additional capital from co-investors if the Investor controls when that additional capital is called; and
- If the owners of the Operator provide any loan guarantees, then the Operator may need to have access to co-investor capital to comply with lender net worth and liquidity requirements because many, if not most, lenders will not count the Operator's investment in the project.

Sometimes the Investor and the Operator will reach a compromise on these requirements by agreeing on the continued maintenance of a minimum investment that is meaningful to the key owners of the Operator. However, what is meaningful to the owners of the Operator will vary from deal to deal and will often depend upon the Operator's organization, operating history, resources, and the investable assets of its owners. Sometimes, the Operator may be part of a seasoned company, with an established track record, that stands on its own rather than a start-up or a mere aggregation of individuals; and sometimes, the Operator's parent entity might even be a public company. In such situations, the Operator may push to make the Operator's parent entity the only key owner. There is no single solution to this concern that will work in all transactions.

CONTROL

The Investor may not feel like they truly have skin in the game if the key owners can be second-guessed because someone else controls the Operator. Consequently, the Investor may want the key owners to control the Operator. However, such control may not always be possible. For example, the Operator's parent organization may have been established with an investor who controls major decisions and is unwilling to relinquish this control for the project of the Venture. Sometimes, this issue is solved by requiring control by the key owners over the day-to-day operations of the Operator (and perhaps adding change in control provisions to address others with control).

ACTIVE INVOLVEMENT

Aside from the control of the Operator as discussed above, the Investor may also want to define a set of "key persons" who will remain actively involved with the project. Even with skin in the game and some level of control, the key owners are not likely to influence the project as much if they are not involved in the day-to-day operations of the project. Consequently, the Investor may also want assurances that certain or all key owners will stay actively involved for the duration of the Investor's investment.

The type of project that will be undertaken by the Venture and the nature of the Investor's investment may also impact the Investor's requirements. For example, the Investor might require the key persons of a newer Operator or the Operator of a project that involves a large investment to devote significant time and attention to the Operator and the project for some specified minimum period of time. The Operator will of course prefer to maintain flexibility to grow and change over time. Unless the Investor's investment is essential to the Operator's success, the Operator may view these requirements as the tail wagging the dog.

The Operator may have a number of concerns (similar to those discussed earlier for a continued investment) with requirements that the key persons spend a specified amount of time and attention on the project including concerns that:

- Compliance with such requirements may reduce the Operator's capacity to generate alternative sources of revenues to support the cost of operating the Operator's organization;
- Failure to adequately address the type, scope, and duration of the project and the different roles of each key owner (e.g., entitlement, construction, operations, etc.) may overly limit the activities of the key persons;
- Provisions that fail to address uncontrollable events (e.g., death, disability, etc.) could end up penalizing the Operator for circumstances and events that the key persons can't control;
- Designation of a non-owner as a key person may complicate the Operator's employment relationship with the non-owner because of the importance of a key person designation; and
- Inclusion of a non-owner as a key person unless the Operator is either confident that the non-owner will be a long term employee or has the ability to replace a departing non-owner.

There are a variety of different approaches that the parties can take to address the Operator's concerns and more finely tune the Investor's "time and attention" requirements. These requirements can be tailored to the size of the Operator's organization. If the Operator's organization is capable of managing multiple projects, the parties can negotiate carve-outs for pre-existing and future projects. The parties can also separately address key persons who have different roles in the Operator's organization or individuals who are important to the project's success but who are not key owners. If the Operator is part of a sufficiently large and established organization, then it may resist any such requirements, arguing that it should control the amount of time and attention any particular individual devotes to its projects. It may also seek to tie any time and attention requirements to the active involvement of the Operator's parent organization instead. Again, there is no single solution. The relative bargaining strength of the parties may significantly impact the negotiations and the ultimate resolution of the negotiations and requirements.

REPUTATION AND CHARACTER

More important than any legal document establishing a joint venture (or any requirements imposed under that document) are the quality of the relationship between the parties and, from the standpoint of the Investor, the quality of the Operator. Naturally, the Investor doesn't want to team up with a venture partner who is, or is viewed as, criminal or unsavory. To that end, the Investor may also require assurances that the Operator and the key persons associated with the Operator will not be indicted for a crime and will not cause a violation of any money laundering statutes. If the Investor has "know your customer" or other similar ownership requirements, it will want those satisfied as well.

The Operator may be willing to accommodate the Investor, but may be concerned if the requirements are too extensive. For example:

- If the Investor wants assurances about *any* criminal conduct, the Operator may be concerned about misdemeanors, DUIs, and the like;
- If the Investor wants assurances that extend beyond a small group of individuals, the Operator may want knowledge limitations;
- The Operator may want the ability to cure problems with employees by removing them from the project and making the Investor and the Venture whole; and
- The Operator may be more comfortable giving assurances regarding past facts, in contrast to having future events trigger a violation of the ownership/control requirements.

CONCLUSION

The Operator's failure to comply with the Investor's ownership, control, and continuity requirements may have far-reaching consequences including the right of the Investor to remove the Operator from the Venture's management or to reduce the Operator's share of the Venture's profits. Because these requirements are so important to both parties, they are frequently the subject of extensive negotiation and can impact a number of provisions of the joint venture agreement. The Investor's pre-investment review of the Operator can make these negotiations more productive and less contentious and serve as a guide for the establishment of the Investor's requirements for the Operator. The objectives of both parties can be satisfied in a mutually beneficial manner if the resulting joint venture agreement and the Investor's requirements for the Operator consider and address the unique aspects of the Operator's reputation, organization, key persons, and track record, as well as the type, scope, and duration of the project.

Notes

1 See, e.g., Practical Law Real Estate, Real Estate Join Venture Toolkit (90/10 Real Estate Joint Venture), available at https://content.next.westlaw.com/Document/If02946ef3edd11e798dc8b09b4f043e0/View/FullText.html?transitionType=Default&contextData=%28sc.Default%29.

2 See, e.g., Private Equity International and Schulte Roth & Zabel, Fund Formation and Incentives Report, A Research Study, Apr. 2014, available at https://www.srz.com/images/content/5/7/v2/57490/SRZ-PEI-Fund-Formation-and-Incentives-Report.pdf.