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Structuring Real Estate Joint Ventures, Part 2

Note to the reader: I'm sorry that I took so long to get Part 2 of this article to you. I have attached Part 1 to this email if you are still interested in the topic.

In Part 1, I introduced a formal structure for real estate joint ventures. First, I discussed how you control the venture, including the votes needed to make decisions and day-to-day operational control. Second, I discussed how you split the profits of the venture, including how you compensate managers and other service providers.

In this Part 2, I will discuss your exit. All business partnerships end sometime, usually sooner than you think. You should have a structure in place for the end-game.

Exit. You need a structure that permits an economic divorce among the members in a venture. Essentially, if the venture or the relationship among the members falls apart, all members should receive their fair share of the venture. No one should be able to short-change anyone else.

Trigger Events. The precondition for the exit is some bad event. Examples of bad events are irreconcilable dispute among the members, the need to remove a member from the venture, or the death of a member. These bad events trigger the economic divorce. The economic divorce can either be (1) the complete liquidation of the venture, or (2) for an individual member, the buy-back of the member's shares.

> *Liquidation of the Venture.* The value in most real estate ventures is the real estate itself. There is little goodwill value in the venture, in contrast to other types of business. Nor is there much sentimental value in the real estate – the venture holds the real estate on a short-term basis with an eye to flipping it for profit as soon as possible. With this in mind, if the members cannot get along, it is very easy to liquidate the venture's assets, distribute the profits and let the members go their separate ways. This is the economic divorce.
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> *Buy-out of Individual Members.* Sometimes you only need to deal with one member and don't want to liquidate the whole venture. For example, an individual member might get a

better job and stop putting time into the venture. This member becomes a freeloader, and the other members might decide to remove him before he benefits unfairly from their hard work. Or a member might be such an irritating malcontent that the other members decide to be rid of him. In all these cases and other cases, the venture needs a structure for the orderly and fair removal of members.

Buy-out Price. The buy-out price is crucial. A high buy-out price gives the exiting member a windfall. A low buy-out price is unfair and leads to litigation. The trick is finding a procedure that ensures a fair price – for example, using a neutral appraisal process to fix a price. Further, deciding to buy out a member is the easy part – paying the purchase price is harder. You will need cash to pay off the member. There are many methods to handle these problems, and ultimately all methods derive from the specific structure of the venture. Here are some general concepts, however:

Liquidation of the Venture. A straight liquidation of the venture can be clean and simple, because the real estate will sell at its fair market value and thereby produce cash profits. The members will distribute the cash profits per their ownership percentages and dissolve the venture. That's the end of it.

Buy-out of Individual Members. If you only want to buy out a single member without liquidating the venture, you will need a source of funds. From whence the money? One structure that I use is to make the buy-out price the net equity value of a member's interest in the venture. The other members then finance this amount. As another example, for buy-outs upon death, the venture can put in place life insurance on the life of the deceased member, then use the proceeds to fund the buy-out. This is classic buy/sell work. In any case, your structure will have to handle these issues down to the last detail.

This article only gives a brief outline of issues. Please get competent legal and tax counsel when you set up your venture. Call me if you want to discuss these topics more.

Ideas

Creditors have better memories than debtors. –*Ben Franklin.*

Those that are most slow in making a promise are the most faithful in the performance of it. – *Jean-Jacques Rousseau*

Love conquers everything except poverty and toothache. –*Mae West.*

Most of us love from our need to love, not because we find someone deserving. –*Poet Nikki Giovanni.*

Funny Papers

By popular demand, the lawyer jokes:

If a lawyer and an IRS agent were both drowning, and you could save only one of them, would you go to lunch or read the paper?

What do you throw to a drowning lawyer? His partners.

The Post Office just recalled their latest stamps. They had pictures of lawyers on them, and people couldn't figure out which side to spit on.