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Five reasons real estate development joint ventures go bad

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Having represented real estate developers and investors in partnership disputes for 20 years, I've recognized certain patterns of behavior that lead to partnership conflicts. An understanding of these patterns can help you avoid disputes, and costly litigation, in your real estate development deals.

Here are five sources of conflict that real estate developers and investors must keep in mind.

The focus on "joint ventures." Real estate developers and investors typically refer to their deals as "joint ventures." However, they sometimes forget that the law considers joint ventures as partnerships, and partners owe each other fiduciary duties. It is critical to remember that a joint venture is a partnership, and whether your joint venture document says it or not, you owe your partner fiduciary duties of loyalty, full disclosure and care.

Duty of loyalty. Staying loyal to your partner isn't just the right thing to do

— it's your fiduciary duty. Unless otherwise specified in your agreement, you should never pursue a business opportunity for yourself that is related to the joint venture and could benefit the joint venture. For example, imagine you are part of a joint venture to develop an apartment building. Without telling your partner, you buy the property next door to develop a parking lot because you know the apartment's residents will need parking. Before you take action, you must first advise your partner of your intentions and ensure agreement.

Duty to disclose. Nondisclosure occurs when one partner does not share material information concerning the project with the other partner. Maybe the developer doesn't tell investors about delays or doesn't disclose cost overruns or other problems that arose during construction. That's a bad idea, as secrets among real estate partners can destroy relationships and doom development

projects. Keeping key players in the loop throughout your project is the best way to avoid disclosure conflicts.

Fee agreements. Partners sometimes agree that the developer partner can charge the joint venture fees for certain services provided to the joint venture, such as property management or arranging mortgage refinancing. However, these fee agreements can be a source of controversy when financial terms are not carefully spelled out in the initial agreement. Because problems often stem from vague contract terms, always use language that is as specific as possible in your agreements. Watch out for words such as "reasonable" and "market" when they are used to describe compensation, as these terms invite litigation.

Deadlock. Having two parties with equal voting rights in a real estate joint venture can be a recipe for disaster. A tie vote on important decisions concerning the partnership results in "deadlock," which can be grounds to dissolve the partnership. To avoid deadlock, deals can be structured with a 50-50 compensation split between two partners, but with one partner having superior voting rights over the other. Another alternative is to set up a 48-48-2 voting structure, whereby the two partners each have 48 percent voting rights, and the remaining 2 percent is given to a neutral third party.

Also include deadlock provisions in your partnership agreement that specify how you will handle a deadlock between equal partners. Your agreement should identify which issues are considered material and what required actions you will take to resolve a material dispute. For example, you might specify that, in the case of deadlock, three face-to-face settlement meetings must occur, after which third-party mediation will take place. Then, if all dispute resolution efforts fail, your agreement will trigger a mechanism for one party to buy out the other. Even the terms of the buyout can be contractually set.

If you address the conditions and expectations of your partnership contractually – and all parties meet their fiduciary responsibilities in the partnership – keeping the peace becomes easier.

Keep in mind that any terms not spelled out in your contract will default to the laws governing partnerships in your state. For example, joint ventures in Illinois are subject to the Illinois Partnership Act unless otherwise specified in the contract. Make sure that you and your attorneys insist on a real estate joint venture agreement that will serve your interests and expectations, and keep you out of court.

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