17 Steps To A Successful Joint Venture

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A Successful Joint Venture

Webinar Transcript

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Webinar Transcript

Host: Robert Helms
Speaker: Jeffrey Lerman

September 30, 2004

All right, well, I think we are ready to get started. Let me introduce you to our featured speaker today: Jeffrey Lerman is the real estate investor's lawyer. He has been an attorney for 24 years, former general counsel to major real estate companies. He is the co-chair of the real estate litigation section of the State Bar and the co-chair of the real estate section of his County Bar. Jeff is an active real estate investor and a real estate broker and Jeff and I go back several years. He is not only a regular guest on the *Real Estate Guys Radio Show*, which I host, but is also a weekly contributor now with *Lerman on the Law*, a segment that he does weekly there. Jeff has not only been a very integral part of the radio program though, he has also been my personal counsel along with my partners in several real estate related matters, so he is not only *an* attorney, he is *my* attorney and let's welcome Jeff Lerman. Good afternoon Jeff.

Jeff Lerman: Good afternoon Robert, how are you doing today?

Robert Helms: Good. How are you?

Jeff Lerman: Good, good.

Robert Helms: We can see that we have lots of folks who have called and logged in so that is great.

Jeff Lerman: Yeah it is. Good afternoon to everybody who is listening in today. Welcome to my virtual conference room. I guess that is what we have here. I wish we could all be together in the same place but this is the next best thing. I was conflicted about doing this webinar I have to say at the outset. On the one hand what we are going to be talking about is what I usually cover in that critical first meeting with new clients. I love those first meetings because that is where I get the opportunity to meet you, know you, learn your objectives, your dreams, your hopes, your fears as they pertain to your real estate investments. It is where we have an opportunity to develop a rapport, a working relationship. Now obviously since this webinar is a one-way communication I miss out on that. However, since the same questions seem to come up over and over in those meetings, which usually last about an hour, this really is the easiest, least threatening and most economical way for many people to take that critical next step from thinking about doing a deal to actually doing it. So I am thrilled that we have such a great attendance and I look forward to hopefully meeting you all some day. Now please understand, what you are about to hear is no substitute for a customized, one-on-one dialog where we can really hone in on your specific situation. But with this preparation what we are going to go through for the next hour, when you finally do meet with an attorney, whether it is me or anybody else, it will go much faster, be more focused, time and cost efficient and productive. And we can probably compress what usually takes three meetings into just one. And I commend each and every one of you for taking an important step to staying out of court. I cannot tell you how many disputes and lawsuits I have handled, and how many hundreds-of-thousands of dollars in attorney's fees that could have been avoided if the fighting parties would have done precisely what you are doing right now; educating yourself on what to discuss before

embarking on a new business venture together. And by the way, that is the operative phrase here, business venture together. What we are going to be talking about today is not just for real estate. If you are in any kind of business, these principles that we are going to be talking about apply to any co-venture business situation.

So let's get started. Robert, you and I have been through a number of these discussions together. Why don't you play the role of the new client and we will just walk through that hypothetical first client meeting?

Robert Helms: Great Jeff, that will give everyone an opportunity to imagine that we are just sitting across from you, at a meeting and that these are the kinds of things that are exactly what you would ask and what everyone needs to be thinking about. So to get started, maybe you could point out some of the biggest potential areas for disputes when it comes to joint ventures so we know the kind of landmines that we are trying to avoid here.

Jeff Lerman: Sure, a great place to start and that is, this is really, I guess, if you want to think of it, this is one of the main - you start thinking about maybe the benefits of being in on this call, what are you getting? What you are hopefully doing is avoiding some of these situations. So over the years, and again, I have been doing this for over 20 years, we see that certain disputes happen more often than others. These are the ones that come up the most frequently. Breach of fiduciary duty, that is the duty to exercise good faith, duty to exercise due care, duty of loyalty. Two, whether a partner has fulfilled promised commitments of time or effort. What was it that you were supposed to do and when were you supposed to do it by? Expulsion, if somebody does not do what they did obligate themselves to do, what they did promise to do, in what situations can we kick them out. Buy-out amounts, if somebody - we will get into this a little bit later in the call - but there are certain, what we call, trigger

events, certain things that could happen that could trigger an opportunity, either an opportunity to buy somebody else out or an obligation to buy somebody else out and - but then the issue is, how much should you buy them out for. Some of the other disputes: profit-loss allocations and distributions and the interpretation of those provisions in the agreement. Next, admitting new partners. If somebody - you start out, Robert, say you and I start out, we are going to do a deal together and at some point down the road, let's say, for whatever reason, we want to bring somebody else into the deal. Maybe we are short on money; maybe we decide we need somebody who has expertise that we don't. What is going to determine who comes into this new deal? It is, you know, it's like a marriage and you want to bring somebody else into the marriage; very serious. Reallocations due to changed circumstances. Let's go back to that situation we just talked about. We start out in the deal thinking things are going to be one way, and as the deal develops, things change, things come up. It happens all the time. On development deals it happens more often than others, and you can only foresee so much. So if something comes up and it turns out, Robert, maybe you had to put more money in the deal when I did not have it and you think that you should be able to get more out of the deal because of it, we are going to have to have a sit-down and talk about that. Unauthorized acts. You, for example, Robert, do something that is, I believe, outside the scope of what I agreed that you had the authority to do. Then, I try to take action against you because you acted outside your authority. Those are the most common types of disputes that we see and as we go through this, you will see that if you cover the issues that we are going to cover, how you can either eliminate or mitigate the chance of any of these coming up in your business venture.

Robert Helms: Yeah, and you know Jeff, this is that whole thing about beginning with the end in mind. If you think about the way things might go wrong, that lets you

move forward. So what is the most important thing for us when it comes to setting up a joint venture?

Jeff Lerman: And that is usually the first question that gets asked in these meetings and if the client does not ask it, I do. Because - and if anybody has ever seen me talk at any of the seminars I do - that is the key question in any transaction, what is most important to us in this _______ (fill-in-the-blank). What is most important to us in this purchase agreement, what is most important to us in this lease, what is most important to us in this joint venture? And you don't need a lawyer to tell you what is keeping you awake at night. You need to look inside, or talk to your spouse and ask your spouse, what they are most concerned about. But these are certain common sense things that you need to answer for yourself. In most cases, what people are most concerned about, what is most important to them when they do business together is, asset protection, privacy. And when I say privacy, I am talking about if somebody is going to do an asset search on you, being able to somehow hide or cloak the assets you actually own. Control, control within the venture. And flexibility: you don't want to be locked into too regimented a way of having things come down, because a business venture needs to be fluid.

Robert Helms: Right, and of course the answer to those very issues may be different depending on what it is that you are trying to accomplish. Let's keep with me in the role of, let's say that I am with the participants, and we are going to form a joint venture. What is the best business relationship for us to work together?

Jeff Lerman: Right, and before I answer that question, let me just point out one other thing I forgot to mention. Now, some people listening may say, "Gee, all of those sound good; asset protection, privacy, control, flexibility, I want it all." And that is a perfectly understandable reaction. The point is though there are so

many - think of it as going into a restaurant, and they hand you the menu - there are so many different choices that you need to make, not only can make, but need to make in this whole process that at some point, the only thing that distinguishes one alternative from another is one alternative may offer you better privacy, better asset protection, better control. So at some point, even though you may say, "I want it all," at some point you may say, "I think asset protection is *the* most important thing for me," and that may drive where we end up. But let's go to your next question.

Robert Helms: Well, and on that point, Jeff, you know people should be thinking about having those discussions with their potential partners beforehand too, because it may be that what is of primary importance to you, might be different than your potential partner.

Jeff Lerman: Absolutely, absolutely.

Robert Helms: We talked about the best business relationship. Say you have a couple of people who want to come together and do a project, do a deal. What is the best kind of relationship to talk about?

Jeff Lerman: This is a very common starting point. I had a client come in to my office just a couple of weeks ago. She was doing a development deal and she has somebody who wanted to be an investor. And she said, "I don't know if I want him to be my partner. He is willing to just lend me the money. Is it better if we set it up as a lender/borrower relationship?" The other possibility is an active investor/passive investor. I am using some terminology that has real significance, not only in setting up these organizations, but specifically under the Securities laws. For example, if somebody is just putting money into your deal and that is it, then they may be viewed as a passive investor which could trigger certain Securities laws issues. That does not necessarily

mean it is going to cost you an arm and a leg to deal with it because there are exemptions available. But it is something you need to be aware of. But that is another potential way to do it. Do you want to be where one person is active, one person is passive or do you want to be both active? That loosely describes that whole basket of possible choices there as joint venture partners.

Robert Helms: Right, I think that is a crucial point. Even before we talk entity structure of any kind, we have to talk about what is our relationship. That is huge. Make sure that you talk about that with your partners *before* you come to see Jeff.

Jeff Lerman: Right. And with each one of these, by the way, different legal rights and responsibilities and potential liabilities - the legal relationship and what flows in a lender/borrower relationship - is so vastly different than joint venture partners. That, in itself, is beyond the scope of this discussion.

Robert Helms: Let's talk about entity selection. We have decided we are going to get in business, we have talked about the reasons that we need to get together with you, or with someone like you, we have talked about what our relationship is going to look like. Now, let's talk about forms of ownership.

Jeff Lerman: Right. Now, this offers the potential for the most confusion out there. There is so much out there; so many different ways to go. So many people have their own bias or agenda. You talk to somebody who is selling land trusts and they think land trust is the only way to go. You talk to somebody who is selling family limited partnerships; they say FLPs are the only way to go. So to really go through each and every possible type of ownership form, again, we could spend a whole hour talking about that. So what I want to do is stay consistent and true to the title of this, which is to talk about what the investors must discuss now, assuming they have already made this fundamental decision. I want to identify what the forms of ownership are. Then I want to

tell you where most deals usually end up. But I also want to hit on some of the most common questions that come up here. So we are going to blow through these next few slides and then I will explain to you how you can distill all this information. So one way to go is individual ownership. Robert, you are going to go out and buy a piece of property. You can hold title as Robert Helms, an individual. If you and I wanted to do a deal and we did not care about asset protection Jeff and Robert as individuals could hold it as tenants in common, we could hold it as joint tenants with right of survivorship, or if I wanted to buy the property with my wife, we could hold it as community property. That is individual ownership.

Robert Helms: Right.

Jeff Lerman: Next there is the partnership form. Robert, you and I could be general partners, we could set up a limited partnership, a family limited partnership - which is just a variation on the limited partnership theme, primarily in estate planning situations that is where the FLP provides the most advantages over other choices – or an LLC. Now, you see the word "company" in LLC but it is in the partnership section here. Why is that? Because most people who set up LLCs opt to have <u>partnership</u> tax treatment of those entities. They do it to get that flow-through partnership tax treatment, so that is why we have it there.

Robert Helms: Okay.

Jeff Lerman: The next is corporate forms. You can own property as a subchapter S-corp, as a C-corp or as a real estate investment trust. And trust forms. And look at all these, look at all the different ones you have here...

Robert Helms: Wow.

Jeff Lerman: …you can do it as a living trust, a land trust, we will get to that in a second, business trust, bypass trust, Q-TIP trust, disclaimer trust, grantor retained income trust, private annuity trust, foreign trust, charitable leads trust, charitable remainder trust. This is what keeps my wife, the estate planner, in business.

Robert Helms: Wow.

Jeff Lerman: By the way, I want to make clear to people here. This decision, as far as which way to go, is just as much a tax-driven decision and an estate planning-driven decision as it is a non-tax or legal-driven decision. And so you need to have a team. I will tell you which form you can use and legally you can use so many different ones. But ultimately, you need to get these other professionals dialed into the process to make sure you are getting a comprehensive approach to this.

Let's talk about land trusts for a second. I get the question a lot: why not land trusts?

Robert Helms: Right.

Jeff Lerman: And there is nothing wrong with land trusts. Land trusts are a perfectly valid and legitimate way to hold property. They have been around for years; longer than LLCs. Here's the reason I - not that I don't like them - but I think there are better alternatives. The number one reason most people like land trusts is for privacy. If I want to buy a piece of property, and if somebody wanted to do an asset search on me, say they were thinking of suing me and trying to see if I was collectible, I want privacy. People use the land trust because they think at that point it will be "invisible". That is true. It will be

invisible. But if you read any credible, accurate land trust reference material, it will tell you it is only effective as a deterrent. If you, in fact, end up getting sued, now you are a judgment debtor. There is a judgment creditor who is going to come after you. That judgment creditor puts you under oath, as they have the right to do. They can take your judgment debtor exam, pull you into court, put your hand on the Bible, have you swear to tell the truth, the whole truth, nothing but the truth. If I am taking your judgment debtor exam, I am going to find out about that land trust and any attorney worth their salt is going to find out about that land trust. So whatever privacy aspect of it you had is gone, and there is zero asset protection there. It is a zero shield. So, what I say to people is, if privacy is so important to them, then what they should consider is going with maybe a Nevada or Delaware LLC - not California as much. Because in Nevada and Delaware they have more privacy protection; two of the best states for privacy protection in the country. So, you can accomplish that same privacy objective. But now, when somebody finds out, puts you in the judgment debtor exam and you tell them that you own this interest in this Nevada or Delaware LLC, you have that shield in place. Not only do you have that shield in place, but also Nevada and Delaware have two of the best statutes and sets of common law to protect you from piercing the corporate veil. So, if people want privacy, I say instead of spending x dollars for the land trust, spend about the same amount of money and get a Nevada or Delaware LLC and you get more bang for your buck. So that's…

Robert Helms: Jeff, why do you think land trusts are such the hot topic? Why is everyone talking about them?

Jeff Lerman: I think it is because there is a wave of people rushing into the real estate investment market. Every time the stock market goes through its cycles, this is what happens. We have both seen it happen. It happens over and over.

Every time a certain someone starts bicycling around the country with his *No Money Down* seminars, you know there is one of those waves going on and because there are a lot of people out there who are selling these educational products, trying to sell a particular fix-it solution, that is the latest one they are talking about, even though they have been around forever.

Robert Helms: Yep, I was going to say on my side, the real estate acquisition side, we have no money down; on your side, the legal side, and we have land trusts so…

Jeff Lerman: Right.

Robert Helms: …there you go.

(Crosstalk)

Jeff Lerman: Before we leave this topic, although you see all this mass of choices, the most common form chosen is LLC, by far. If I could show you graphically on a curve how much the rate of growth of the LLC entities vs. corporations, it is like the Las Vegas appreciation market vs. anyplace else in the country.

Robert Helms: Right.

Jeff Lerman: We go through all this, but LLCs are usually the choice – this is the market speaking, not Jeff Lerman.

Robert Helms: That most clients and most of the market ends up using that form of entity.

Jeff Lerman: Yeah, we are not saying it is right for you…

Robert Helms: Right

Jeff Lerman: …but just understand, that is where the market is.

Robert Helms: Now, you mentioned tenants in common, TICs, as a way for individuals to own title, but you can use those if you use entities too, right?

Jeff Lerman: Right, right that is true. We brought it up in the individual context but you are absolutely right. Let's say, Robert, you and I, again, are going out to buy a piece of property. And to borrow what you just said a few minutes ago, begin with the end in mind. If we decide, up front, that we want flexibility at the back-end of our deal, we want to preserve the option at the end of the deal - I am using the word "option" here not in the legal sense, but to preserve the right, preserve the flexibility…

Robert Helms: Yeah.

Jeff Lerman: …at the back end of the deal to go separate ways. I take my money and I want to go into a 1031. You want to take your money and you want to put it in your pocket. That is where TIC probably makes the most sense. And in that TIC situation, now all of a sudden Robert, you and I have another discussion we need to have. Because we don't have any asset protection if it is Jeff and Robert as individuals. So each individual tenant in common, again, confronts this whole entity question. So here, it leads us to the sole-member LLCs, SMLLCs, sole-member LLCs. In California, as of a few years ago, you and I could each form single member LLCs. The issue that we have to talk about before we go down that road is that as of recently, over the last few years, there is now risk with sole-member LLCs. We do not have time to go into the long version, the short version is this: the asset protection shield in a sole-member LLC is not as 100% and is not as strong as it is if you had just one more member. And that one-more member could have as little as a 5 to

10% interest. The point is that, if you go into this deal, it would be much better if you bring in your brother-in-law, your cousin, whatever. You can bring a child, as long as they are not a minor, into the deal for 5 or 10% interest and now we have much better protection than a sole-member LLC. That is also true for a husband and wife. A husband and wife are treated as a single member. That is an essential discussion because a lot of people we see are in a position where they could do a sole-member LLC.

Robert Helms: Well, let's talk about some of the different groups of people that might be out there. You have done a great job so far getting our heads spinning, but give us some real-life examples and how you would structure them in some cases.

Jeff Lerman: Great. That is what I wanted to do because part of what I am trying to do here, part of my promise at least, was to try to synthesize and demystify some of this stuff. What I want to do is illustrate for you some typical situations that I see and I would imagine from seeing some people who signed up for this call, they are confronted with the same thing. Let's say you are either a single person, or you have a husband and wife situation. I am generalizing here now, this is not saying one-size-fits-all. I am absolutely not saying one-size-fits-all. But in these situations, an LLC or an S-corp are typically the two alternatives that make the most potential sense and the ultimate decision is going to be, again, probably dictated by your tax advisor. But for flexibility, ease, and lack of formality, LLCs are often referred to as the "lazy man's corporation" because you have to do so much less than a corporation. That is why, again, LLC is probably going to be the way to go. Let's say you are two or more active investors. You remember we talked about active vs. passive.

Robert Helms: Yep.

Jeff Lerman: Let's say we are both active. Let's say Robert, simplest situation, you and I are both going into a deal. We are 50/50 partners. We each put the same amount of money in. We are both going to do some work in the deal. We are two active investors and for that situation, the setup that makes the most sense is what we call a "member-managed" LLC. Once you decide you are going to do an LLC, you need to decide, are we going to be member-managed or manager-managed? "Member-managed" means all the members are also managers; all the members have the rights and powers of managers. "Manager-managed" is different. "Manager-managed" means you have one or more people who are going to be the managers and other people are going to be members but non-managers. We will get to that in a second. That is for two or more active investors.

Robert Helms: Okay.

Jeff Lerman: Now let's say you have active investors but four or more deals. Let's say Robert, that you and I started out and we are making a commitment to build this business. We know for sure that we are going to be rolling out deal after deal after deal, but we don't want to have the formation costs and all the transactional costs with setting up entity after entity after entity. Recently, in California, we have seen more people considering and using what is called a Delaware Series LLC. Delaware is the only state in the Union currently that offers a Series LLC. Delaware always leads in these corporate matters and they are doing a great job with that. And what it is, is essentially this: instead of setting up a separate entity for each deal, what we do is set up –think of it as an umbrella entity if you will - but underneath it you have all these separate, individual LLCs, as many as you want, no limit, where the legal liability is compartmentalized. Imagine a firewall between each one. You can have different members, different properties. It is absolutely a cost-effective way to go if you are pretty clear that you are going to start doing multiple

deals. It is a little bit more expensive to set up initially but if you plan on doing three, four, five deals, you are going to be better ahead using the Delaware Series LLC.

And then finally, we have a situation where we have active and passive investors. This is where I go out and I found a deal, I am just going to raise money and everybody is just putting in the money and that is it. So now we have the Securities laws issues that go with it. This is the typical situation where you are going to do a manager-managed LLC where either I as an individual am the manager, or I will set up an S-corp or another LLC to be the manager in the deal. Those are the typical scenarios we see and those are the general end-points where you are most likely going to be when you are confronted with those situations.

Robert Helms: Okay, well, I think the next natural question would be: if we are going to form an entity, in what state should we form the entity? You mentioned some different states and some reasons for that. Where does it make sense to form an entity?

Jeff Lerman: Right, and this is another area where it is kind of like the land trust thing. All of a sudden everybody is so confused about which is the right state for me. And to add to the confusion, the state law keeps changing and the fees keep changing. So whatever the answer may have been last year may not be the answer today.

Robert Helms: And I am guessing about which direction the fees are changing.

Jeff Lerman: Yeah (laughter) you got that right. And so we are not going to go through all the states but the ones that we see the most here in California are: California, Delaware, Nevada, Arizona - Arizona may raise some eyebrows; I will tell

you why we have got Arizona thrown into the mix there - or someplace else. So let's talk about why you might end up one place vs. the other. Let's start, and again, we are just talking here about non-tax factors. I am not going to talk about the tax structure of each state. Leave that for your tax advisor. However I do talk about gross receipts tax in a second. Here is a table, which is showing how the fees stack up for California, Nevada, Delaware and Arizona. We are not going to take the time to go through it now. People can look through that later. But if you look, what you will see, to summarize it, is that if you are in California, that gross receipts tax is on a larger deal, "larger" meaning if you have over $250,000 in gross receipts, that means any money coming into the deal, either rents or when you sell the property. On the smaller deals it is a non-issue; total non-issue. It is a sliding scale and you can check the Secretary of State website or the FTB website and you can see how the scale slides or if you want, send me an e-mail, I will be happy to send you a chart that shows how the scale slides. But that is what makes California the most expensive state. We will get to why you would use California in a second. Nevada, Delaware and Arizona, they do not have that gross receipts tax so any one of those states are going to be less expensive on the *larger properties*, on the *larger properties* - I emphasize that - than it would be in California. So you say, "Why would I ever set up a property in California?"…

Robert Helms: Yes, why would I?

Jeff Lerman: Here is what I am going to do. I am not going to give you a litany, a list for each and every state. You can go on the Internet and see why the Delaware companies say Delaware makes the most sense, why Nevada makes the most sense. Everybody says their state is the best. What I have tried to do is to distill all of that noise and give you the two, three, four or five reasons why I think it makes sense, given your particular fact situation, you would set up in

one state vs. another. So the best reasons to chose California is, if you live in California and the property you are investing in is in California. If that is your situation then California makes a lot of sense. Now, if it is a huge property and you are concerned about that gross receipts tax, one way to possibly get around it is set up a limited partnership with an LLC as your general partner. That is one way to get around that gross receipts tax. But those are the reasons that you would typically choose California.

Robert Helms: Let's talk about the state of Nevada, why would you choose Nevada?

Jeff Lerman: Nevada. Nevada makes their claim of privacy. It is pretty good. Nevada is a good state to choose if you want privacy. It is not the only choice; Delaware has very good privacy as well. If the property you are investing in is in Nevada, great reason to be forming there. The fees are lower than California. It is harder than California to pierce the veil in Nevada and, hey, it's Las Vegas. How would you like to write off all your trips to Las Vegas from now on?

Robert Helms: You had better discuss that with your tax professional.

Jeff Lerman: Yes. Now Delaware.

Robert Helms: …Delaware?

Jeff Lerman: Delaware does also offer privacy. A big reason why you might end up in Delaware is if you are working on a larger deal. Institutional lenders prefer Delaware; they just do. Dealing with conduit lenders, any sophisticated lenders, they just like Delaware because they have always liked Delaware. They have got business courts set up, they are more sophisticated, they are used to corporations, so on a larger deal you may have that choice made for

you. The next one is really important. You can limit the fiduciary duties without members' informed consent. Let me explain what I mean by that. Let's say I was in that deal where I am bringing in a lot of investors, passive investors. And I want to limit my liability to my investors. I could do that in California; I can add language that modifies my fiduciary duty but I have to get the members' informed written consent to that. In Delaware you do not have to do that. You can just go ahead - you can't eliminate it - but you can modify it, you can restrict it, you can reduce, downgrade, whatever you want to say. There is not a lot of case law as to what will hold water or not; you just have to use some basic common sense in how you are dealing with people. But you can stack the cards, you can stack the deck more in your favor on that issue in Delaware. The series LLC is available - we talked about that - the fees are lower than California and it is, again, harder than California to pierce the veil. Indemnification of managers - Delaware is better than any other state. It allows the LLC, the entity, to indemnify the managers from any kind of liability whatsoever. It is beyond the scope of this call to really go deeper, but if that is an important issue to you, it goes back to protecting your personal assets. So those are the reasons why it might make sense to choose Delaware.

Robert Helms: Okay, and finally let's talk about Arizona.

Jeff Lerman: Arizona. You say why are we talking about Arizona.

Robert Helms: Why, why Arizona?

Jeff Lerman: First, if the property is in Arizona it makes sense. Secondly, more importantly, Arizona is one of the few states where a charging order is the exclusive remedy for creditors. A charging order is, let's say that I get a

judgment against me, and let's say, Robert, you are the judgment creditor, you are trying to go after me.

Robert Helms: Yep.

Jeff Lerman: You could get a charging order against my membership interest, which is like a lien against my interest. What happens is that in Arizona, that is your exclusive remedy. There is nothing else you can do. Just sit and wait. What's worse, the way the law is set up you are going to have to pay taxes on phantom income. Even though no money may be distributed from the LLC, you are going to have to pay taxes on it <u>as if it were distributed</u>; that is not true in California, Nevada, Delaware. Not true. So, in California, Nevada and Delaware, you Robert, could go to court and you could make a motion to the court and ask them to foreclose on that charging order; foreclose on that lien. And you could use that to get a better settlement from me than if we were in Arizona. So that is why I bring Arizona up.

Robert Helms: Okay, well there are at least four states; I imagine that there might be specific reasons to look at other states if you have projects there or something like that.

Jeff Lerman: Right.

Robert Helms: Well good. So there is a great basis of entities and formation, the types and locations. Now let's get back to this joint venture we are putting together, you know, me and the participants. How do we decide who will be doing what in the deal?

Jeff Lerman: Right. That is the question you need to ask: who is going to be doing what in the deal? Here, details, details and specifics is what you want to look at and I would err on the side of more, and you really have to just say, "What are you

doing, what am I doing?" If it is services, quantify it and try to use dollars. What I mean by that is, quantify what is expected whenever possible. Robert, I have got a deal, a client with a deal. It is a development deal. One of the partners in the deal is a real estate broker, and their contribution, the real estate broker's contribution does not come in until the end of the deal. They are going to be marketing the end product, the homes for sale. Well, what is better? To just say, "You the broker, are going to market the homes for sale," or is it better to say, "In order to market the homes for sale you are going to stage it, you are going to do three model homes, you are going to have an advertising budget of x dollars, we expect you to do this, that or the other?" And you know, you really try to put some meat on that skeleton and understand, because when that time comes you are going to be very disappointed if that broker does not have the same ideas you do about what they are going to be doing.

Robert Helms: You know Jeff; this is a key, key point. You need to talk about these things before you are in a transaction or in some sort of development with somebody and so you have an understanding what everyone's role is. You kind of assume sometimes, well my partner, his background is sales so, he is probably going to do the sales, my other partner, well, he has done a lot of rehab so he is probably going to, be in charge of that. You need to talk about these things and be very specific about that.

Jeff Lerman: Absolutely.

Robert Helms: The next thing I think you need to talk about is who is going to have authority to manage the day-to-day business and operation of the entity?

Jeff Lerman: Absolutely. This is one of those issues that is easy to gloss over, forget, ignore, whatever but it is critical, because you have to drill down to a deeper

level on the last issue. It is saying, "Let's look at everything that has got to happen in order for this deal to be successful and who is going to manage that?" And so in a development deal, that may be very different than in an existing income property. In a development deal it might be there are entitlements we need to get. There are 50 different reports that we have to administer and orchestrate and coordinate and be on top of and there are a lot of different balls you have got to keep in the air. You feel like a plate spinner sometimes. Who is going to be in charge of that? And if you don't have an existing income property, it is going to be a very different deal. You have to really think it through, itemize what is involved. Is somebody going to get additional compensation as a manager's fee because they might be doing more or is that just folded in as part of your contribution in the deal?

Robert Helms: Right. And if everyone is contributing in a somewhat equal fashion then maybe not. If someone is contributing differently, maybe that is a percentage, maybe it is compensation that is outside of the transaction. You have got to talk about those things beforehand.

Jeff Lerman: Right.

Robert Helms: So I guess the next question to ask is, who gets to vote on what issues, does everybody vote, does the manager make decisions?

Jeff Lerman: Right, and before we leave this one point, the other thing that you should think about is, if one of you is going to get the loan, get the refinancing, if one of you is going to take responsibility for leasing up the property or interfacing with these people, it is not unusual for those people to get additional compensation according to the market. If I happen to be a real estate broker and I say, "Robert, I will take care of getting the loan but because I am going to do that I think I can split the points with the outside guy, are you okay with

that Robert?" And you might say, "Yeah," or you might say, "No, I am not." It is something to talk about. Same thing with leasing. A lot of times the brokers will split commissions. It is on the table. If you don't talk about it, that could be something that could be misunderstood.

Robert Helms: The key is to talk about it up front.

Jeff Lerman: Right, so who gets to vote on what? Lets assume we are still in California. This issue comes up most often in manager- managed deals because, Robert, if you and I are together, active and we are in a member-managed deal, we both get to vote on everything.

Robert Helms: Right.

Jeff Lerman: But in a manager-managed situation, now you have non-manager members. What do they get to vote on? In California, by statute, certain things require a majority in interest vote. That is not a majority of the members; it's a majority in interest, at least 50% of the people have to agree on this. And that is, you have to agree on amending articles of organization, dissolving the LLC, approving any agreements of merger and electing and removing managers. That can't change. That is always going to be the same in every deal. It is other major voting issues that really come into play here in the planning stage, in the talking stage, at the outset. How much do you want to hear from your non-manager members on these other issues; on loans, purchases, refi's, cash calls, if more money is needed, when to sell, major leases, handling claims (if the entity has a claim against a third party or vice versa, third party is asserting a claim), settling those claims (which can be big dollars), admitting new members? These are all very important issues. Robert, if I represent you and you are my client and you are the manager and you are bringing investors into the deal, I am looking out after your interest. I

am going to say, "Hey, you know what? I say give the members no vote on this stuff." If you tell me, "Jeff, in this situation I want you to represent the whole entity, I want you to be as fair as possible to everybody," then we are going to be talking about giving the members a say in this stuff. I can tell you, a lot of members don't <u>want</u> to hear from you. They will say, here is my money, send me a check when we are done and I will count my money. They really don't want to be bothered with this stuff. But again, it is a talking point.

Robert Helms: Right, you have five or ten or twenty partners, there are going to be people that have skills and time and interest in getting involved and there may be people who don't want to be. So that is why the emphasis today is, these are the issues you are going to discuss before you form your entity. Before you make your decision.

Jeff Lerman: Right.

Robert Helms: I guess another question to ask is, who is authorized to act on behalf of the entity or the company?

Jeff Lerman: Absolutely, and this is something that again is one of those stealth issues that you just may not be focusing on. That is my job; to focus you. That is to say, "You know what, Robert, in some situations I am okay with you going out there and doing whatever you want to do. But in other situations, I am not." It is something we have to sit down and talk about. Now if we are member-managed, both of us, ostensibly, as far as the world is concerned, either one of us can act on behalf of the entity. If it is a manager-managed deal and we are the managers, same thing. But again, if it is member-managed, do both of us have the same right to act on behalf of the company or are certain contractual obligations so important, so major, either in terms of the dollar amount or the type of contractual obligation they might represent, that we want to require

everybody - all member-managers - to act in unison; you have to have two signatures. The important point to remember here is, that whatever we agree upon and put in our operating agreement, the third party, the world at large, is not going to know about. Whatever we agree, most people do not ask for a copy of the operating agreement so you can't expect that. You have to realize that if there is going to be a problem, you are going to have to enforce your rights and remedies against each other based upon what you have in the operating agreement.

Robert Helms: Right, and think through the practicality of this. There will be decisions that need to be made by somebody in a quick amount of time and if everything has to go to committee it is going to bog down your project. Every $10 check we have to write has to have multiple signatures for instance.

Jeff Lerman: Exactly.

Robert Helms: There are definitely important issues that you are going to be confronted with that you probably do want everybody's agreement. At least you need to set up: is it going to require a majority? Is it going to require unanimous decisions? Who has the ability to act independently of that?

Jeff Lerman: Right, my comfort level is going to be fluid too. If it is a first deal, you may not be as comfortable as you are going to be on the next deal. Again, flexibility is the key.

Robert Helms: It is like figuring out how to get out of the house in case there is a fire. There is not going to be one, but you have to know. So what we are talking about may seem negative in some ways but really these are the things you talk about ahead of time so everything is smooth sailing.

Jeff Lerman: Right.

Robert Helms: Now imagine we get a situation where we don't all agree, how do we break some kind of a deadlock and how do we set that up ahead of time?

Jeff Lerman: Right, let's talk about that. You and I go into a deal 50/50. Now we disagree. You got the tie, or let's say that we have investors but you and I are the managers and we control the deal, and again, we disagree. A lot of people don't talk about it. They don't think about it. They don't like to think about it. It is awkward. It is uncomfortable. You don't want to even suggest at the beginning of a deal that you are ever going to have this, but you have got to talk about it because it could happen. If it ends up that you just can't resolve it, at least you don't kick yourself later for not even trying to work it out. But you know it could depend on the specific issue. Smaller issues may have a different process than bigger ones, or certain types of issues may have other deadlock-breaking alternatives available. In a lot of them, what you can do is simply designate a neutral third party. I have had several of my clients designate me as a third party tie-breaker. It has got to be somebody who you trust to be neutral, unbiased and you trust their business judgment. As a matter-of-fact, I think a couple of my clients have designated you as the neutral third party…

Robert Helms: Right.

Jeff Lerman: …because, you know, you are in the business and they trust your judgment and they trust that you will be neutral. But if you don't do that, then you can always do ADR, alternative dispute resolution. Typically, what you do there is mediation first, if that is unsuccessful, then arbitration. I even had one client who said, "Let's just flip a coin." And I said, "Well, you know, that may not be the best way to go when you are talking about multi-million dollar

deals," which we were, and they said, "Let's just flip a coin. Who's right? Who's wrong? It is hard to tell." There is even a website where you can do virtual coin flips. This is the world we live in.

Robert Helms: Of course there is.

Jeff Lerman: Yes! So those are the things you look at.

Robert Helms: Speaking of coins and money, what about the money? How do we decide who gets to write the checks?

Jeff Lerman: Another important stealth issue. You got a checkbook. Who is going to hold onto the checkbook? Who has got the right and authority to sign those checks and how much? What you can do is talk about it. Okay, maybe up to $5,000 - $10,000 in any particular month, any one check, or any cumulative checks during that month, we could have one signature, but after that point we need two signatures. But again, caution here. Do not trust that the bank is going to monitor that for you. They might. You might have a great relationship, you might know the teller, you might be able to - my experience is, this is very individual. So don't trust the bank. It is like the other thing we talked about. Put it in the agreement but understand that ultimately it is up to you to enforce it. Your partner could still go out and write checks exceeding their limits.

Robert Helms: Okay, along the lines of the dollars we talked earlier about who is doing what in the deal. I guess the next question to ask is, who is contributing what?

Jeff Lerman: Absolutely. Everybody who comes to a deal has a reason for being there. They are coming with something that the other person values. Sometimes it is money. Sometimes it is property. Maybe I have got a piece of property. You come to me, say, "Hey Jeff, I think you are under utilizing your property."

"That's great Robert, that is the best I can do." And you say, "No, I think I have a better way. I will come in and I will put in my expertise and I will put in the money to fix it up if you put your property into our partnership." I say, "It sounds good Robert, let's do it." So that is one way to do it. Or services; the sweat equity situation. The important thing here is, when you have these non-cash contributions, you have to value them and here is where you really have to talk to your tax adviser because there might be some special allocation issues. I am not going to have time to go into it, but just understand that if I am putting in $100,000 and you are putting in zero but you are getting 70% of the deal and I am getting 25%, there is a special allocation issue there. And time of contribution; it is not only who is putting up what, but also who is putting up when.

Robert Helms: Yeah, exactly. And here is a big question, what happens if there is more money needed?

Jeff Lerman: A huge issue that a lot of people, especially the newer investors, overlook either because they don't think of it or because they don't want to think about it. But you have to. You have to think about and talk about this. What do we do if more money is needed in the deal? Are we going to require that we both put in whatever money is needed? I issue a cautionary note here; that if a third party creditor comes against your interest and gets to step into your shoes and you have got language in your operating agreement that says there may be cash calls, that third party creditor may be in a position to require a partner to put in a cash call. So if you don't want cash calls, just say no cash calls. If there is more money needed, you have to talk about who is going to decide if more money is needed. What is the procedure? Who decides that more money is needed? Are you going to decide or am I going to decide or how are we going to do that? Timing, you know, how much time do we have from the time we decide more money is needed to put up that additional

money? What is going to be the consequences if there is a cash call but one of us cannot come up with the bucks? Is there going to be a loan that is made, and if so is that loan going to be made to the entity? In other words, Robert, say you have the money; I don't. Are you going to make the loan to the entity or are you going to make the loan to me? What are the terms of that loan going to be? At what point, if I am the weak guy and I have not put up my share, at what point will my interest be diluted, shrunk? And at what point should the venture be terminated because it is requiring far more money than either of us bargained for? In this regard you might want to consider having each person represent and warranty of their respective financial condition if you are counting on them to be there for future cash calls. You might say, "Tell me that when we need a million bucks next year, you are going to have it."

Robert Helms: Yeah, very important. And if you don't think that you might need more money, go rent *The Money Pit* and watch that a couple of times and see what kinds of things might come up. Well, okay, so we might need more money to put into the deal. But now let's talk about when we are done, how do we split the profits? How do we decide, that is the next question you want to ask is, how will the profits and losses be shared?

Jeff Lerman: Right, very key, obviously you have to talk about it, is it going to be according to dollars in or is it going to be something else? Think back to the example I gave a couple of minutes ago about one person putting in money, the other person putting in expertise. Does somebody get their money out first? A lot of times the hard money person, the person who puts in hard money vs. services gets their money out first. Discuss that up front. The same thing about preferred return. Sometimes the person who puts the hard money in might get a preferred return of eight, nine, ten percent before the other person gets to take any money out. And does anybody get a fee? We talked about

this before, maybe a development fee or a fee for putting together the deal. These are all on the table.

Robert Helms: Now we said earlier to begin with the end in mind. So I guess the next question to ask when forming a joint venture is, what are the exit strategies involved?

Jeff Lerman: Right, exit strategies. We talk about this a little during your "Profitable Real Estate Investing" seminar. What we say there is, this is the most frequently overlooked and the most frequently litigated area. I am not going to go into the long version of it here. But what you need to talk about is: how do you get out? What happens if one of us dies? What happens if one of us becomes disabled? What happens if one of us wants to get out? What happens if one of us wants to kick the other person out? What happens if we go bankrupt, one of us? What happens if I get a divorce and you are going to have to now worry about whether my wife is going to get her interest and, if so, is she going to do something with it? And anything else that is important to you. Now these are the ones that are most commonly discussed. Are there any other trigger events, if you will, that you want to address up front?

Robert Helms: Okay. But something to talk about ahead of time is, how would you value somebody's interest on an early withdrawal?

Jeff Lerman: Right. If one of those trigger events occurs, how do you get paid and how much? It is a two-level analysis. The thing you are going to have to look at is how are we going to value the underlying asset, the real estate? And the second is: how are we going to value my interest? If I have a 50% or less than majority interest, what kind of a discount, if any, are we going to apply to my interest? What formula are we going to use for the underlying asset, are we going to use a cap rate, a multiplier, are we going to defer it to a broker like

yourself? What is the procedure going to be? Are we going to use an appraiser? Are we going to use multiple appraisers? If you don't talk about it up front, you can talk about it in front of a judge. It is just going to cost you tens-of-thousands of dollars more.

Robert Helms: Talk about it up front.

Jeff Lerman: Yes.

Robert Helms: Jeff, you said that this was going to be 15 questions but I know that in your usual way to give more than you promise we have a couple of extras. And I think another question we want to ask ourselves up front is, how are going to resolve any disputes that come up?

Jeff Lerman: Right. This is a little different than the tiebreaker question. This goes beyond tiebreaker, this goes into, we just have a real all-out dispute - how are we going to resolve it? We already talked about mediation, arbitration. The critical issue I want to focus on in the little time we have here is: should we have an attorney's fees provision? A lot of attorneys put this in without thinking in all their documents. Don't do it that way. Maybe what you want to think about is, look, I want it to be a disincentive to the other side to take me to court. So let's take out the attorney's fees provision so that we know it is going to cost to go to court, no matter, even if we win, we could end up losing. So don't just automatically include the attorney's fees clause.

Robert Helms: Yeah, good point. And then what about litigation risk?

Jeff Lerman: Right, here's the thing. If I am going to go into a partnership with you, I want to know that you don't have 15 people about to file a lawsuit against you, because if you do, then your problems are going to become my problems.

You are going to get distracted by it, I may end up having to deal with your judgment creditor and so I might want to get a representation and warranty from you about any claims or litigation they might have, either in the past, pending or threatened.

Robert Helms: All right. Well believe it or not you came in under the one hour there, which is pretty amazing …

Jeff Lerman: Yeah.

Robert Helms: …but we have some more information for you, so if you are able to stay with us please do. Because I know that some folks were able to e-mail in some questions ahead of time.

Jeff Lerman: Yeah, I think we can probably, if people can hang with us for like five more minutes I think we can wrap up everything so if you can, that would be great.

Robert Helms: Excellent. All right, so let's look at some of the questions that came in.

Jeff Lerman: Okay.

Robert Helms: The first question we had came from David. He asked, "Is there any way I can use an LLC in California without paying the gross receipts tax?"

Jeff Lerman: This is what we talked about earlier. The way to do it would be, if it is a big enough deal, to set up that limited partnership where the general partner is an LLC. But in that situation, you are still going to have the gross receipts tax on the LLC that is the general partner, so it does not work in every situation. What you have to look at is, to make sure that you are not putting all the income that would otherwise flow to you in the LLC, going to that LLC

general partner. It is a case-by-case situation. It is a more sophisticated strategy but it is something to be understood, and that is out there and available.

Robert Helms: Okay, excellent. Next question. Darcy asks, "When you sell a property under an LLC, can you just replace it with another property?"

Jeff Lerman: Yes you can and again it is case-by-case. It is how comfortable you feel with the fact that that property you sold may have any lingering potential of future claims. If I sold a property, I got all my profits, I take the profits out and now I replace those profits with the profits of my next deal and somebody from the first deal comes back and sues that LLC, now I am exposing the profits of my new LLC to the liabilities of the last deal, with no firewall on that. That may not be what you want.

Robert Helms: So if your intention is to do more than one deal and you talk about it ahead of time, that strategy could work.

Jeff Lerman: Right.

Robert Helms: Okay, great. Do we have another question?

Jeff Lerman: You know what? I think that is all the questions we have the time for. We definitely have more questions, we just don't have time for it, and I want to get people out of here.

Robert Helms: Well thank you sir. And thanks of course to the folks who were on the call today. We would also love to have your feedback. So if you like this format, if there is information that you were hoping that we would cover that we

didn't, if there is anything that you would like to let us know, go ahead and just send an e-mail to Jeff, jeff@lermanlaw.com.

Jeff Lerman: Thank you very much. Thanks to everybody else.

Robert Helms: Thanks guys.

Jeff Lerman: All right, bye-bye.

THE END