

October 25, 2011 - By Susan Piperato, Managing Editor

## Robbing Peter to Pay Paul: Fraud in Real Estate JVs

**Economic stress** is causing more frequent inappropriate handling of funds by managing partners in joint venture partnerships, according to market experts.

Robbing from Peter to pay Paul is always a concern for joint venture partnerships, says William E. Hughes, a San Francisco-based senior vice president and managing director for national brokerage firm Marcus & Millichap Real Estate Investment Services. "But you tend to see it in a marketplace like this, particularly when you've got a client who has multiple types of assets, when one asset class is performing better than another asset class."

What's happening is that developers that set up joint ventures with different partners on disparate properties are sometimes using income generated by strong assets to prop up partnerships where the underlying buildings are distressed. As a result, the maneuvers are hiding problems and misleading partners on all sides of the equation.

"I won't say it's stealing, but it's utilizing the money from the good projects to carry the bad projects," says attorney Leo Leyva, who chairs Cole Schotz's Litigation practice in its New York office.

Other common tactics used to hide troubled properties include the senior partner stopping payment on mortgages or real estate taxes or, if possible, further leveraging the property in order to generate the funds necessary to pay the passive investor.

What eventually happens is the partnership's last remaining assets become the real estate itself, "but they're leveraged up, so you're left with entities that are without cash and without the ability to satisfy judgments," Leyva says.

On the other side—in cases where a partner may be using cash from a strong partnership to fund a weaker one—funds may be moved through subtler means like overstating management fees or allocating funds for nonexistent legal, marketing or adding fictitious employees to the payroll.

In either case—whether on the side of the strong or weak partnership—because the sponsor may have been get-

ting paid all along, they may not be aware of the issues until it is too late.

Leyva, who has represented firms on both sides of sponsor/developer arrangements that have gone bad, says he noticed an uptick in fraudulent transfers in joint venture partnerships in 2008 to 2009, when the capital markets crashed and the ability to obtain cheap capital and refinancing dwindled. That behavior has continued up to the present day. Consequently, Leyva adds, there is now a wave of litigation pending.

### INCREASED MONITORING

Philip Ramacca, senior managing director at forensic accounting firm David Landau & Associates, LLC (DLA), headquartered in Fairfield, N.J., advises that to avoid these situations, passive investors need to become more active in monitoring assets to ensure they see the warning signs of inappropriate asset management.

In one of DLA's recent cases, says Ramacca, a joint venture partner was called to satisfy a personal portfolio debt and utilized the joint venture to repay it, despite the fact that the joint venture partnership agreement called for no distributions.

"The partners actually began making loans to themselves," says Ramacca. "They'd borrow \$100,000 on Monday, pay it back on Tuesday; they'd borrow \$150,000 on Wednesday, pay it back on Thursday. Then they started paying back most of it, but not all of it. This continued until they owed about \$8 million to the joint venture."

Although the loans were recorded in the partnership's financial statements, the passive investor's asset manager didn't catch them because they were noted subtly on the documents, says Ramacca. By the time the investor found out about the inappropriate loans, the bank was foreclosing on all the assets of the joint venture partnership.

Plus, he says, although investors might feel comfortable with the fact that payment applications and withdrawal requests must be approved by the lender, "the bank's review tends to be very superficial—at the end of the day, the bank has got the property."

*Continued...*

## Robbing Peter to Pay Paul: Fraud in Real Estate JVs

### PROBLEMS WITH PASSING THE TORCH

Joshua Stein, sole principal of Joshua Stein PLLC, a New York-based commercial real estate practice, says that another contributing factor to the increase in misappropriation of funds by joint venture partners is the passing of the torch to the next generation in partnerships formed 20 to 30 years ago.

In these cases, partnership documentation may be informal, inadequate or nonexistent.

"The enterprise was run on the back of an envelope and out of the back pockets of friends," he says. But second-generation partners can be unfamiliar with each other, busy with their own careers or unsophisticated about monitoring. So "whoever's running the show can do a lot of things you'll never find out about, and you have to peel off all the layers of the onion in order to find it."

Another reason that misappropriation can continue unchecked is because, according to partnership law, one partner cannot sue another based solely on one issue. "Courts don't want to get involved with partnership administration until it gets to the point of divorce," Stein says. "It's kind of like you have to drop a nuclear bomb or do nothing at all."

### WHAT TO DO

So what is a passive investor to do? Don't wait until you have a concern—take a proactive approach, DLA President and CEO David S. Landau advises. "Sometimes this is done after the fact, after [an investor has] learned that there's an issue," he says. "But companies are becoming more vigilant these days, using firms to actually go in for a week or two or even longer to be onsite with the manager and actually go in and perform these forensic services."

In every state there's an obligation of good faith and fair dealing, says Leyva. "That's in every contract, so while the contract or LLC agreement may not provide you with the specific rhyme and remedy, there's also a common law remedy."

In the meantime, all non-managing investors should insist on audit, review and accounting rights information on a monthly basis, rather than a semi-annual or annual basis, Leyva says. "With all the challenges we face in the marketplace, one would want to know for sure that if you invest in a real estate project your money is going to stay in that project," he says.