

The argument for audits

Financial forensics on rise for real estate players, as partners seek protection before teaming up

By Vanessa Weiman

While the ailing economy has hindered some real estate firms in the last few years, it has spelled opportunity for others. Among the beneficiaries? Auditors, who say they've seen an increase in demand for their services, especially among real estate investors involved in joint ventures.

In recent years, industry experts said, some real estate players have turned to underhanded methods to increase their income and ease financial woes, often without the knowledge of their partners. And tough times tend to make indiscretions more noticeable.

"The economy brings out bad behavior in people," said Steven Koppel, an attorney in the real estate practice at law firm Jones Day. "When things were going well, no one may have noticed money going [out], but now there's nothing to replace it."

These disputes mean more work for auditors, especially since firms are now doing "proactive auditing," and taking other measures to protect their assets before entering into partnerships.

David Landau, CEO of the New Jersey-based real estate and financial services advisory firm David Landau Associates, said his company has seen a 40 percent increase in real estate audits over the past three years, and has hired more forensics experts at the firm to accommodate that growth.

The firm said it now does about 60 real estate audits annually, compared to roughly 40 two years ago.

Money in, money out

Since the downturn began, a number of high-profile real estate partnerships have gone awry. Maurice Mann, for example, famously joined forces with Africa Israel to convert the Upper West Side's landmark Apthorp into condos, but Africa Israel later sued to remove Mann as managing partner.

And developer Yair Levy made headlines for striking his onetime partner, Kent Swig, with an ice bucket after a deal went south.

Real estate joint ventures are vulnerable to fraud because "the control over money and bank accounts and documents has historically been primarily vested in the general partner, to the exclusion of the investor partner," explained Koppel.

If cash flow dries up at a project, the general partner may start diverting funds to other areas of the business, taking out unauthorized loans, or stopping payments on mortgages or real estate taxes — all without the investing partners' knowledge.

To cover up this behavior, they can use "inflated invoices, inflated contracts, no-show jobs or just fictitious transactions" from landscapers, cleaners and other contractors, said Philip Ramacca, senior managing director of internal audit and forensics at David Landau.

Most of the real estate audits DLA sees are in hospitality and

retail ventures, areas that require more active management — and thus provide more opportunity for fraud — than commercial and industrial properties, Ramacca said.

In one recent incident DLA investigated, a partner in a retail project "borrowed" \$100,000 from the venture over 14 months to help pay off debts at his other projects, Ramacca said. At first he paid back the money he took, but as his financial problems deepened, he was no longer able to replace the funds.

To uncover irregularities, auditors go through a venture's books with a fine-tooth comb.

"We might look at money going out to one partner at the beginning of the month and the other partner receiving it at the end of the month, and [find that] the managing partner is taking more than their fair share," Ramacca explained. They also investigate "what our client may not know about who their partner is doing business with."

But in many cases, the wronged partner doesn't realize anything is amiss for months or years.

Alan Fried, a partner at Manhattan-based real estate law firm Braverman & Associates, said some partners in joint ventures "hadn't really been looking closely at books and records" until recently.

Preemptive strike

Now that many ventures "are fighting over books and expenses," he said, that relaxed attitude has changed, and "people are learning to be more careful."

An increasing number of firms are now doing "proactive auditing," or taking certain precautions before teaming up with others, Ramacca said.

Often, that means putting more protections into their partnership agreements, such as requiring both partners' signatures on checks above a certain amount. And some joint ventures now put the investor partner — rather than the general partner, as has usually been the case — in charge of filing tax returns.

"I see an increased awareness in newer partnerships about reporting, and a bigger exercise of control," Koppel said, while investors who previously had little role in the day-to-day functioning of a project now have "beefed-up asset management."

In one of his recent cases, for example, a builder who was selling homes in a joint venture kept the proceeds of a sale instead of distributing them to the partnership. His partner found out because they had put a monitoring system in place for sales.

When controls are agreed to in advance and a problem arises, Koppel said, then a partner can require that the terms of the agreement be lived up to, "and they're not accusing anyone of anything."

