CBIG Law White Paper: Many Common Components of Private Real Estate Fund Offerings

Real estate securities offerings span a broad continuum of size and complexity. The most basic structure is a single-asset acquisition vehicle. This is a company formed to hold a single real estate investment property. Next is the private real estate fund (sometimes known as a real estate private equity fund, which is the subject of this white paper). A private real estate fund is a pooled investment fund structure intended for the acquisition of multiple real estate properties. At the largest and most complex end of the spectrum are private, non-traded, and publicly-traded real estate investment trusts (REITs), which are pooled investment vehicles requiring a large number of investors to satisfy regulatory and tax requirements and generally requiring a substantial asset base to justify the costs of formation and operation.

The private real estate fund strikes a balance between the two ends of the spectrum, enabling a sponsor to raise capital in a pooled fund without being constrained to conduct successive securities offerings on a deal-by-deal basis, and without the complexity, scale and substantial regulation of forming a REIT. This white paper discusses some of the key considerations in forming a private real estate fund, including strategy, structure, and investment terms.

REAL ESTATE FUND STRATEGIES

Real estate funds are trending toward greater levels of specialization. Specialization may be by asset class, strategy or both. Examples of asset class-specific funds include office, retail, medical, industrial, warehouse, agricultural, storage, hospitality, etc.

Real estate fund strategies can be loosely categorized into one or more of the following groups:

Distressed Asset Funds.

Distressed asset funds seek to identify undervalued assets that are over leveraged, suffer from cash flow issues, or are otherwise unable to access needed debt financing. Distressed asset funds tend to be cyclical, following general real estate market patterns.

Structured Finance Real Estate Funds.

Structured finance funds, often referred to as leveraged buyout funds, seek to use substantial leverage to purchase real estate that has fairly stable value projections. Structured finance funds are also cyclical in nature, as they rely heavily on inexpensive access to debt financing.

Multi-Strategy Funds.

Multi-strategy funds are the exception to the specialization trend. Multi-strategy funds are not confined to a single investment strategy or objective (although they tend to be more asset-class specific). Multi-strategy real estate funds tend to have a low risk tolerance and maintain a high priority on capital preservation. Even though multi-strategy funds have the discretion to use a variety of strategies, we have found that fund sponsors tend to focus primarily on one or two core investment strategies.

Joint Venture Real Estate Funds.

Joint venture real estate funds use a strategy of co-investment with other funds in a syndicated investment. Joint venture funds can sometimes subject the investment advisor to investment advisor registration requirements, as the co-investment relationship can be considered a security.

Real Estate Development Funds.

Development funds are funds that acquire unimproved land or demolish existing property for re-development. These funds require substantial management involvement in working through the various municipalities permitting complexities as well as coordinating the various stages of real estate construction. Accordingly, development funds require substantial and complex offering document disclosures.

Opportunistic/ Special Opportunity Funds.

Opportunistic funds, closely related to distressed asset funds, focus on special circumstances where assets are selling at a discount, such as through buying foreclosed real estate, unfinished construction, surplus or damaged real estate.

REAL ESTATE FUND STRUCTURE

Investment Terms.

One of the most important aspects of forming a real estate fund is setting the terms of the investment. When properly structured, real estate fund offering documents contain terms that adequately protect the fund sponsor and are attractive to investors. Real estate fund terms are driven by the fund's strategy, the market trends within the fund's specific asset class and the particular needs and objectives of the fund. It is crucial that the investment fund legal counsel have an in-depth understanding of current investment market trends and how those trends affect the strategy the fund will employ. Fund Expenses During the formation process the fund sponsor designates which of the expenses of the fund will be borne by the manager and which will be borne by the fund. Typically, the fund bears expenses directly related to forming and operating the fund, including: legal formation costs, accounting and administrative services, regulatory filings, brokerage costs, clearing costs, etc.

Closed-End Fund

Private real estate funds are typically formed in the same manner and share many of the same components and aspects as private equity funds. Real estate funds that invest in hard assets, such as real property, are best suited as closed-end vehicles, meaning that the fund will be closed as to the number of limited partners or investors, amount of total capital contributions, amount of time the fund will exist, number of time periods (commitment, investment, seasoning, and harvest periods), restrictions on withdrawals, etc. For tax and other purposes, real estate funds should be arranged so that the fund vehicle is a pass-through entity. The most common vehicle is the Delaware limited partnership where investors are limited partners to the partnership and the general partner is an entity managed and owned by the fund's sponsor.

Once funded, an investor's capital will be returned only upon the sale or refinancing of a fund asset, or upon positive cash flow from rents and other operations. Most real estate funds, private equity funds, venture capital funds, and other funds investing in illiquid assets are structured as closed-end funds.

Successive Funds with Closed-Ends.

Once an investment is sold, its proceeds likely cannot be reinvested into the fund. Rather, the fund sponsor would create a subsequent fund as assets are sold and investment proceeds are returned to the limited partners, thereby facilitating further investments. Successful private equity fund sponsors typically develop a portfolio of various and successive funds. Fund sponsors can form subsequent, analogous real estate funds at substantial cost savings to the initial funds because less legal structuring is likely required, so long as the strategy remains similar.

Domestic Real Estate Fund Structure

A domestic-only real estate fund will likely contain

- A limited partnership to act as the fund vehicle;
- A limited liability company ("LLC") to act as the investment manager of the fund, formed in the jurisdiction of the sponsor; and
- An LLC to act as the general partner of the fund and also formed in the jurisdiction of the sponsor.

For real estate funds, the general partner and the investment manager are formed as two distinct entities to allow subsequent funds to maintain separate general partners, for liability purposes, and for the investment manager to maintain its track record of advising private fund offerings.

Offshore Fund Structures

When properly structured, an offshore fund structure blocks offshore and tax-exempt US investors from direct US tax liability. The most common offshore fund structures are the master-feeder structure and the side-by-side structure. Master-Feeder Fund A master-feeder structure consists of a domestic feeder fund and an offshore feeder fund (in a tax-free jurisdiction) that feed into a single offshore master fund, where all the trading activity of the fund takes place.

Parallel Fund Structure.

A side-by-side structure has a U.S. fund and offshore fund that parallel each other in trading and have the same investment manager but maintain separate investment portfolios. This is primarily because of the tax complication faced by offshore investors and considerable structuring that needs to be put in place to avoid negative tax consequences.

US Tax-Exempt Investors-UBTI Issues.

Tax-exempt entities, including IRAs, 401Ks, pensions, charities, etc., are subject to the unrelated business income tax (or "UBTI"), a tax on certain business income that is imposed notwithstanding the organization or exempt status. Under Sect. 512(b) of the Internal Revenue Code, investment income, including income from real estate, is subject to UBTI if derived from debt-financed property (acquisition indebtedness). Such distribution may subject the fund to UBTI.

Cayman Islands.

The Cayman Islands has historically been the top choice for offshore funds because of its business-friendly structure, stable government and well-developed investment laws. The Cayman Islands is the world leader as a jurisdiction for investment fund domicile.

British Virgin Islands (BVI).

BVI is a popular jurisdiction for offshore funds. BVI has recently gained the reputation for being a cost-effective and convenient jurisdiction. BVI's regulatory structure has sought to create a flexible jurisdiction with streamlined processes and strong legal certainty. BVI's regulatory filing fees are typically lower than those of the Cayman Islands.

Offshore Investors.

An initial consideration when structuring a real estate fund is whether to admit offshore investors or rely solely on investment from US persons. There is admittedly an underrepresentation of non-US investors in US real estate funds.

FIRPTA Considerations.

The primary concern for offshore investors in US real estate funds is the US Foreign Investment in Real Property Tax Act of.1980 (known as FIRPTA). Under FIRPTA, non-US investors are taxed on income from US real property investments, including gains from real estate investment funds, at extremely high effective rates. Additionally, FIRPTA requires that offshore investors file US tax returns and become subject to the IRS's investigatory and subpoena powers. Fund sponsors are also required to make tax withholding on offshore fund investments. For most funds, an offshore master-feeder structure set up in a tax neutral jurisdiction (Cayman Islands, British Virgin Islands, etc.) would be sufficient to shield offshore investors. Not so with real estate funds. The principal method used to mitigate tax consequences to offshore investors is a more complex solution, hence the *domestic blocker*.

Domestic Blockers.

A domestic blocker is a US corporation (usually set up in Delaware) that is used to house non-US persons as shareholders so that the corporation (which is treated as a US person for tax purposes) may invest its capital into the fund and shield offshore Investors from the US-tax filing obligations that FIRPTA imposes, especially the withholding taxes that would otherwise be due to the IRS at the time of disposition of the assets held by the fund. Domestic blockers, when formed correctly, have been very beneficial to private real estate funds for many years and will likely continue to be, barring any changes in the IRS Code to the contrary.

A leveraged domestic blocker is a US corporation that is capitalized with a mix of loans and equity. The aim of the leveraged domestic blocker is to shield offshore Investors from the US-tax filing obligations, while reducing non-US investors' effective rate on the real estate fund investment. The mechanics of the leveraged domestic blocker are beyond the scope of this white paper, but the primary benefit is the interest deduction available with a leveraged investment that is used by the leveraged domestic blocker to reduce the leveraged domestic blocker's income subject to US tax.

The protections afforded by a domestic blocker will vary depending on the circumstances of particular investors and investments. While there is no failsafe method to shield offshore real estate fund investors from FIRPTA, domestic blockers generally provide significant protections from FIRPTA and other consequences for many non-US investors.

COMPENSATION AND OTHER FEES

A Private real estate fund typically pays management fees to its investment manager, which are treated as an expense to the partnership. Management fees range from fund to fund but are likely to be between 0.5-3% per annum (based on the committed capital during the commitment period and then the total value of the fund or of the amount actually contributed to the fund by the limited partners thereafter).

A Private real estate fund also typically allocates to its general partner shared profits known as carried interest (generally 20% of the fund's capital appreciation).

Private real estate fund sponsors can also find other creative ways to charge additional fees, depending on the fund's negotiating position with investors and the extent of involvement required by a particular strategy. We recommend that the shorter the track record of the sponsors the more streamlined the fee structure should be. Other potential fees may include property management fees, developing fees, real estate brokerage fees, leasing and reletting fees, financing fees, and other administrative fees.

Capital Commitments

Private real estate funds typically have a commitment period wherein the investment manager will find potential investors that could become limited partners to the fund. When real estate fund investors subscribe to and become limited partners to the fund, they usually do so by entering into a subscription agreement that commits them to contribute a certain sum (a capital commitment) when called for by the general partner (a capital call). The commitment period is likely to last 3-6 months after the first closing or subscription to the fund.

After the commitment period ends, private real estate funds typically transition into the investment period, a period that usually lasts 18-36 months, wherein the investment manager locates certain assets that may be considered by the partnership as a reasonable investment. It is during the investment period (and sometimes including the commitment period) that the general partner issues capital calls to the limited partners. Upon the capital call, limited partners have a fixed time period to turn their capital commitments into capital contributions and satisfy each capital call. The general partner must make all capital calls during the investment period. Any unallocated portion of the limited partners’ capital commitments at the end of the investment period must be released back to the limited partners. The fund then transitions into the seasoning period.

The seasoning period is the time in which the general partner will develop, rehabilitate, improve, maintain, and manage the partnership’s assets in preparation for the dissolution or sale of such assets. The seasoning period can last for 3-7 years, depending on the fund’s strategy and demand in the marketplace for the partnership’s assets. After the assets are ready to be disposed of, the partnership will enter into the harvest or wind-up period.

The harvest period is the time when the partnership will dispose of and sell off or transfer its assets and then wind-up the affairs of the fund and partnership, followed by winding up the general partner. At the time of disposition of each asset (in a deal-by-deal fund) or at the time of disposition of all the partnership’s assets (in a total-liquidation fund), the partnership will make distributions to the limited partners according to its distribution waterfall.

Distribution Waterfall

The distribution provisions control the priority of distributions from capital events. The priority of distributions between limited partners and the general partner is referred to as the "distribution waterfall." The distribution waterfall can be pictured as a set of allocation pools. When a higher priority allocation pool is filled, the capital flows into the next pool. Distribution waterfalls vary significantly from fund to fund, depending on a number of factors, but generally follow the following conceptual framework.

Once contributed, an investor's capital will be returned only upon the occurrence of a capital event, such as a sale or refinancing of all or a portion of the fund's assets, recognizing income, or other events resulting in positive cash flow from operations.

Distribution waterfalls typically follow the following three phases: (i) preferred return and recovery phase; (ii) catch-up phase; and (iii) carried interest phase.

<u>Preferred Return/Recovery Phase</u>.

The first phase in the distribution waterfall is the preferred return and recovery phase. Generally, investors receive distribution first, until their preferred return and capital contributions have been repaid in full.

<u>Preferred Return</u>.

Many real estate funds include a preferred return. Preferred returns can range from 6% to 12% of the initial capital contribution. The preferred returns are accrued and compounded annually. The preferred return is distributed m accordance with the distribution provisions upon capital events.

<u>Catch-up Phase</u>.

After the preferred return and capital contributions are recovered by investors, the remaining funds are split between the investors (typically 80%) and the sponsor, in the form of carried interest (typically 20%). However, since the limited partners have already received substantial distributions, the distribution waterfall now accelerates allocations to the general partner according to the catch-up rate (often 100%). In the catch-up phase, the general partner receives allocations at the catch-up rate until the carried interest allocations are caught up.

<u>Carried interest Phase</u>.

Following the catch-up phase, capital allocations will be distributed based on the carried interest (typically 20%). The general partner will then receive 20% of the distributed amount, while the limited partners will receive 80%.

<u>General Partner Clawback</u>.

Upon liquidation of the fund, limited partners are sometimes distributed less than the agreed-upon allocation (due to early positive performance and lagging performance toward the end of the fund). When this occurs, the limited partners "claw back" the unpaid amount from the carried interest distributed to the general partner. Since the clawback provision is only activated at end of the fund, fund sponsors must be cautious to maintain reserves to satisfy any such contingencies. Reserved funds are sometimes held in escrow for investor protection.

Other Aspects

There are likely to be other nuances of any private real estate fund that are beyond the scope of this white paper but are worth mentioning. They include income vs. disposition distributions, refinancing and other distributions realization events, tiered distributions, reinvestment during the commitment phase, specific clawback provisions and limitations clauses, preferred terms, and more, just to name a few.
