# Real Estate Funds, Deals and Financing

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Joseph A. Smith represents private equity fund sponsors in connection with fund formation, the acquisition of portfolio investments and the implementation of exit strategies. In this capacity, Joe advises clients on securities, governance, ERISA, Investment Advisers Act and structural issues. He has extensive regulatory expertise, and wide-ranging experience with all alternative asset classes, including LBO funds, venture capital and later-stage growth equity funds, energy and infrastructure funds, credit funds, real estate funds and joint ventures, fund restructurings and other complex secondary transactions, and funds of funds. Joe has also represented many fund managers in connection with spinoffs and consolidations.

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Michele is consistently recognized by *Best Lawyers* and *The Legal 500 US*. She received her J.D., *cum laude*, from the Georgetown University Law Center and her B.S.F.S., *magna cum laude*, from Georgetown University.

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Julian has a reputation among his peers and clients as a terrific negotiator and an excellent strategist. He is consistently recognized as one of the country's leading real estate lawyers by *Chambers USA*, *The Legal 500 US* (listings of the top lawyers in the US) and *NY Super Lawyers*. *Chambers USA* describes Julian as offering "a wealth of expertise across the real estate spectrum," "creative," "solution-oriented," "very practical, very thoughtful and very thorough" and as being "highly commended" for his "extensive lending experience." *The Legal 500 US* includes the following words of praise from a major investment banking client: "An awesome attorney — my first choice on all deals." Julian is a prolific writer, publishing numerous articles in the *NY Law Journal* and other publications, including the "Commercial Real Estate" chapter of *Business and Commercial Litigation in the Federal Courts*. He is also a sought-after and active speaker at conferences on a wide array of topics, including real estate private equity, restructurings, financings, distressed debt and trends. He recently moderated a discussion on "Capital Market Activities Impacting the Real Estate Market" at the iGlobal Forum Real Estate Private Equity Summit. Julian received his J.D. from Fordham University School of Law and his B.A. from Emory University.

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Heather N. Wyckoff focuses her practice on advising private investment funds and has provided comprehensive legal services to institutional and emerging asset managers, proprietary trading firms, family offices and financial institutions on a wide range of issues. She advises on the formation of private equity funds (including private credit and real estate funds), hybrid funds, hedge funds and managed account platforms, among others, and provides regulatory advice to investment managers. Heather has extensive experience representing funds and advisers who employ a wide range of investment strategies across all asset classes. She also represents fund managers and institutional investors in connection with the negotiation of seed deals, co-investment vehicles, "funds of one" and other strategic relationships. Heather received her J.D. from Fordham University School of Law and her A.B. from Dartmouth College.

# Real Estate Funds, Deals and Financing

## I. Introduction

A. Real estate funds operate optimally when both fund counsel and deal counsel understand fully the documents governing both the funds and the real estate investments.

B. When structuring real estate funds, fund counsel should be mindful of provisions that will allow the client's deal team to make investments and obtain financing on the target investments as flexibly as possible.

C. Similarly, once the fund is closed, deal counsel should be familiar with the terms of the governing fund documents. Deal counsel that is accustomed to working closely with fund counsel will structure investments that do not present issues under the fund documents.

D. Note that real estate investment issues may arise in a variety of contexts beyond real estate funds, such as distressed debt funds that acquire real estate when foreclosing on debt instruments or venture capital funds that invest in real-property holding corporations.

## II. Investment Considerations

A. Is the fund's capital sufficient to make an investment?

1. The governing fund documents will cap the size of a single investment (including follow-on investments) and may cap the amount that may be invested during a calendar year. Thus, as investment sizes begin to outpace available fund commitments, fund counsel and deal counsel should anticipate the client's need to arrange financing through one or more of the alternatives discussed below.

   (a) Possible alternatives to fund restrictions on a single deal size include: (i) the right of the LP Advisory Committee to increase the concentration cap; and (ii) the right of the fund to close on deals during the marketing period of the fund based on an assumed size of fund.

   (b) Available capital may be increased by including broad rights to recall distributions. For example, many funds are permitted to recall all distributions of capital made during the investment period.

2. If the deal size exceeds the fund's concentration limit, then the general partner will likely seek co-investors.

   (a) Investors may have negotiated for co-investment rights up front in their side letters.

   (b) Strategic co-investors may make sense for the transaction.

   (c) Co-investments may be structured as joint ventures, in which case the joint venture partner is likely to seek significant rights.

      (i) Control of the joint venture may shift from the fund (and its general partner) to co-investors or the operator/manager of the property.

      (ii) The party/investor who does not control the joint venture generally retains veto rights over "major decisions." Examples of "major decisions" include merger, change of company purpose, acquisition of additional property, dilutive issuance, additional capital contributions, annual plan, material agreements, loans, bankruptcy and tax matters.

      (iii) Unlike funds, documents governing joint ventures are likely to contain more restrictive transfer provisions, including rights of first offer, rights of first refusal, drag along rights, tag along rights and buy/sell provisions.

B. Is the type of property to be acquired restricted under the governing fund documents?

1. In most cases, the investment strategy of the fund will be sufficiently clear (e.g., development, residential, unimproved land, office, hotel or retail). However, mixed-use properties and investments in debt securities could be restricted. Deal counsel should work with fund counsel to confirm that gray areas are evaluated.

 

2. Governing fund documents may restrict not just the type of asset a fund may acquire, but also how the asset may be developed or operated, or the manner in which it may be disposed of. Accordingly, both fund and deal counsel must understand the contemplated business plan for a fund's investments.

C. The Location of the Investment

1. Confirm that the property is located in a permitted geographic area.

2. Geographic restrictions may be included in governing fund documents and sometimes may be so narrow as to specify in which metropolitan sub-markets a fund may invest.

3. Some funds are subject to geographic diversification requirements, prohibiting excess exposure in geographic areas.

4. As discussed below, if a fund manager causes more than one fund under management to invest in properties competing for the same tenants, fiduciary conflict issues may arise.

D. The Timing of the Investment

1. If the investment is not being made during the investment period, then the investment should be a permitted follow-on investment or an investment that was committed to be made during the investment period.

2. Broad definitions of follow-on investments will facilitate investments in complementary properties.

3. Follow-on investments are likely to be capped after the investment period.

4. The timing of the closing of an investment will need to take into account capital call notice periods.

E. Other Fund Considerations

1. Expenses to be incurred to pursue the transaction may not be permitted to be borne by the fund.

   Fees and expenses of the organization of project entities should be borne by the fund. Ongoing taxes payable by project-level entities may also be payable by the fund.

2. An investment structure could affect management fees payable by the fund to the manager.

   The definition of "net invested capital" should be carefully drafted so that a dividend recapitalization will not trigger management fee reductions if the dividend is treated as a return of profits, not capital.

3. If the fund will be paying a third party a management fee or carried interest, confirm that the fund partnership documents permit such arrangement.

## III. Debt Considerations

A. The Amount of Debt that Is Recourse to the Fund

1. The governing fund document will generally have a limit on recourse indebtedness, which is typically a percentage of the acquisition cost or fair-market value of the fund's portfolio.

2. Permitted guarantees should include "bad boy" guarantees, completion guarantees in connection with construction loans and environmental indemnities.

   (a) Even though the fund may have the authority to enter into certain guarantees, if there is a property-level joint venture, the fund should consider requiring the operating partner to provide guarantees, due to the operating partner's day-to-day management responsibilities.

   (b) The property-level joint venture agreement or separate reimbursement agreement will generally allocate guaranty payment obligations to the party that is at fault.

B. Parallel funds and alternative investment vehicles may be required to provide joint and several guarantees of indebtedness for a project.

1. Internally, the associated fund vehicles should enter into contribution agreements with one another to achieve proportionate debt exposure. In some cases, it may be necessary to provide several, but not joint, guaranties.

2. Generally, investment vehicles that are not required by their organizational documents to invest in tandem should not guarantee indebtedness in respect of each other's investments. That is, while it may be appropriate for "Fund II A" and "Fund II B" to enter into a joint and several guaranty, "Fund I" should never guarantee indebtedness of "Fund II."

C. Financing/Lender Requirements

1. Restrictions on Transfers

   Deal counsel should ensure that loan documents take into account the intricacies of a fund. For instance, lenders typically will seek to restrict "direct and indirect" transfers of interests in the borrowing entity (the property owner). If not negotiated, such restrictions could restrict transfers of interests in the fund. These transfers should be carved out from the restrictions provided under the loan documents.

2. Fund as a "carve-out" or other guarantor under loan documents.

   Lenders generally will require the fund, as a guarantor, to satisfy certain ongoing financial requirements (i.e., net worth/liquidity) and other covenants. The very essence of a fund is to acquire and to dispose of assets. Therefore, it is imperative that the loan documents do not restrict the fund from operating in its ordinary course or impose financial covenants that are overly restrictive given the fund's capital or operating structure.

3. ERISA Covenants in Loan Documents

4. OFAC Representations in Loan Documents for Limited Partners

**IV. Tax Considerations**

A. U.S. and non-U.S. tax considerations at the fund, investor and SPE level are complex and change frequently. Therefore, it is imperative that fund and deal counsel interact regularly with tax counsel to confirm compliance and optimal structuring.

B. UBTI Issues

1. Assuming the fund is subject to restrictions on the incurrence of UBTI, consider whether the fund's allocations are "fractions rule" compliant

   (a) Limited applicability: only for pension plans, educational organizations, 501(c)(25) organizations and church retirement accounts

   (b) No sale-leaseback investments

   (c) No seller-financed investments

   (d) No contingent purchase price

2. Common aspects of an investment (other than leverage) that could give rise to UBTI

   (a) Use of leverage

   (b) "Flipping" a property

   (c) Converting a property to condominiums and disposing of the condominium units

   (d) Developing and disposing of a property

   (e) Operating a parking facility or a similar "service" business

C. Use of REITs

1. 100% excise tax imposed on REITs for income earned from prohibited transactions: e.g., "flipping a property," converting a property into inventory, such as a conversion of a fee interest into condominiums and disposing of the condominium units, developing and disposing of a property.

2. Operating a parking facility or a similar "service" business which is over and above those services customarily furnished or rendered in connection with the rental of real property.

3. Pension-held REITs and closely held REITs present their own sets of issues.

D. Structuring the transaction should take into account the tax needs of non-U.S. investors.

1. *Leveraged-Blocker*. A single leveraged-blocker is the simplest structure for non-U.S. investors to use but is not the most tax efficient. The use of such a blocker avoids the need for a non-U.S. investor to file a U.S. federal income tax return or to pay branch profits taxes. Non-U.S. investors who own less than 10% of the blocker may receive interest payments from the blocker free of U.S. withholding tax. Non-U.S. investors who own 10% or more of the blocker need to rely on tax treaties or they will be subject to a 30% withholding tax. The blocker is subject to U.S. corporate income tax at regular corporate rates reduced by allowable interest deductions. During the life of the fund, cash can be repatriated through: (i) interest payments (as described above); (ii) tax-free principal pay-down (at the cost of reducing future interest deductions); or (iii) dividends subject to 30% withholding tax, or lower if a treaty rate is applicable. Upon the liquidation of the fund, the blocker can also be liquidated, so that it can distribute cash without being subject to a 30% withholding tax.

   (a) In structuring the leverage for the blocker, attention needs to be given to the AHYDO rules and the new Section 163(j) limitation on interest deductions. In many scenarios, a blocker invested in a real estate fund will be able to rely on the "real property trade or business" exemption from the Section 163(j) limitation.

   (b) A disposition of an interest in the fund by a non-U.S. investor during the life of the blocker entity may subject such investor to: (i) net income tax in the U.S.; (ii) branch profits tax (to the extent that the investor is a corporate entity); and (iii) U.S. tax filings.

2. *Multiple Leveraged-Blockers*. In this variation of the leveraged-blocker structure, each property investment of the fund is made in a separate leveraged-blocker. The advantage of the multiple leveraged-blockers is that at the end of the life of each investment (as opposed to the liquidation of the fund) the blocker liquidates, allowing the cash to be repatriated tax-free.

3. *Domestically-Controlled REITs*. Under an exception to the FIRPTA rules, a non-U.S. investor that disposes of shares in a domestically controlled REIT is not subject to U.S. tax. Ideally, each REIT owns a single property to facilitate the disposition of each property. Disposing of a REIT is more complex than a disposing of the actual real estate asset itself. Distributions from the REIT that are not attributable to the disposition of real property, however, are subject to a 30% withholding tax or lower treaty rate.

E. Unblocked fund investments may, however, result in investors having to make filings in multiple states.

1. Investors will most likely be required to file a tax return in each state in which the fund owns a property.

2. Investing through a REIT or a leveraged blocker may avoid the need for investors to file tax returns in multiple states.

## V. ERISA Issues

A. Many real estate private equity funds have limited partners that are pension plans that are subject to the Employee Retirement Income Security Act ("ERISA"). This can have significant implications for the manner in which the underlying investments by these funds must be structured.

B. If a private fund raises capital from an ERISA-regulated investor and fails to satisfy certain regulatory exceptions, the private fund may be deemed itself to hold directly the assets of the ERISA-regulated investor ("plan assets"). If this happens, the fund manager is deemed to be an ERISA fiduciary and will be subject to complex conflict-of-interest rules and transactional prohibitions that may make the fund very difficult to operate.

C. There are three exceptions to these rules that real estate funds typically rely upon:

1. *The "25% test."* A fund with one or more ERISA investors will not be deemed to hold "plan assets" if, immediately after the most recent acquisition of any equity interest in the fund, not more than 25%of the value of any class of equity interests in the fund (each tested separately) is held by ERISA investors. There are a few interpretive tricks in applying these rules. Among other things, each class of interests must be tested separately, which means limited partner interests are tested separately (i.e., excluding the general partner's interest), and if there are deemed to be different classes of limited partner interests issued by the fund, each class is also tested separately. Also, affiliates of the general partner (including entities managed by the general partner) holding interests in any class are normally excluded from the denominator for purposes of testing that class. In the case of an arrangement involving related funds that invest in parallel, each fund is tested separately, but they may need to be tested together if investors' capital commitments appear to be divided among the parallel vehicles to get around the rule.

2. *Real Estate Operating Company* ("REOC"). A private fund will be deemed to be a REOC, and therefore will not be deemed to hold plan assets, if, among other things, more than 50% of its investments, valued at historical cost, are real estate assets over which it obtains the right to participate directly in their management and development (so-called, "qualifying investments"), and the fund actually is engaged directly in real estate management or development activities in the ordinary course of its business. Hence, not every investment made by a REOC must be a "qualifying investment." Once again there are several nuances that must be understood by deal counsel. Among other things:

   (a) These so-called "management rights" must be substantial. Hence, a typical triple-net sale/leaseback deal would not be a "qualifying investment," because these investments typically contemplate that the tenant, not the owner/landlord, will manage and operate the property. Investments in real estate related indebtedness are also often challenging to structure as qualifying investments.

   (b) The "50% test" in respect of qualifying investments must be met at the time at which a fund makes its first long term investment (i.e., investment other than in cash equivalents). Hence, if the first investment is not qualifying, the fund can never qualify as a REOC.

   (c) The "50% test" must be met once, annually, thereafter, during a 90-day window known as an "annual valuation period." However, care must be taken to attend to the timing of this testing, especially if not every investment is qualifying. This is especially true once the fund seeking to qualify as a REOC begins disposing of its investments.

3. *Venture Capital Operating Company* (*"VCOC").* The VCOC requirements are similar to the REOC requirements, but with slightly different nuances. A private fund will be deemed to be a VCOC if, among other things, more than 50%of its investments, valued at historical cost, are in operating companies as to which it obtains direct contractual management rights (so-called, "qualifying venture capital investments"). Once again, there are several nuances that must be understood by deal counsel. Among other things:

   (a) The fund must actually exercise such management rights in the ordinary course of business, as to at least one operating company.

   (b) Once again, the "50% test" in respect of qualifying investments must be met at the time at which a fund makes its first long-term investment. If the first investment is not qualifying, the fund can never qualify as a VCOC.

   (c) Although the DOL regulations use the words like "venture capital investments" in "operating companies," we and most other practitioners in this area believe that REOCs can constitute qualifying investments for VCOCs, because REOCs are treated as "operating companies" under the regulation. Hence, a real estate private equity fund can be structured so that, for example, the fund itself is a VCOC and its underlying joint ventures with local operating partners are REOCs. Note that a REOC, however, cannot treat an investment in an underlying REOC as a qualifying investment.

(d) Once again, the “50% test” must be met once, annually, during a 90-day annual valuation period.

(e) VCOCs have an advantage over REOCs in that they no longer have to pass the “50% test” once they are in their “distribution period.” For these purposes, a VCOC can elect to enter its distribution period once it has sold, and distributed the proceeds of, assets representing (by cost) 50% or more of the maximum amount it had ever invested (other than short-term investments). Hence, if a real estate fund is structured as a VCOC, rather than a REOC, and not all of its investments are qualifying, once the fund has sold most of its qualifying investments (measured at cost), it can still hold non-qualifying investments without being deemed to hold plan assets. This advantage affords more flexibility in managing a fund’s exit strategies.

(f) *The Takeaway*. In connection with each acquisition and disposition (as well as documents containing ERISA representations and/or covenants), deal counsel should be aware of a fund’s ERISA compliance strategy and should consult with fund and ERISA counsel should any of the foregoing issues arise.

## VI. Conflict Issues

A. Duty to Provide Investment Opportunities

1. The fund must be given the opportunity to make an investment before the general partner or its affiliates are allowed to participate in the investment.

2. Parallel funds typically invest pro rata, except for designated exceptions.

3. If the fund reaches its concentration limit, the general partner could participate in co-investments if expressly permitted by the governing fund agreement.

B. Expense Allocation

1. If multiple funds participate in the same investment at different times during the life of the investment, allocating expenses equitably may provide conflicting incentives. Additionally, funds that have not yet begun their investment periods may be asked to bear broken-deal expenses for unconsummated investments in which they have not yet, but would have, participated.

2. Allocating expenses proportionately to co-investors may not always be possible or reasonable, depending on the circumstances surrounding the applicable co-investment and the financial and other terms (including the timing of the investment) governing the relationship of the co-investor to the funds with respect to the portfolio investment.

C. Property Servicing Arrangements With Affiliates

1. If an affiliate of the general partner will provide property management or other services, the governing fund agreement should allow for such arrangement without offsets to management fees.

2. The governing fund agreement may require that such services be provided at market rates.

3. Consider defining property servicing rates up front with the right to seek approval from the LP Advisory Committee.

D. Other Transactions With Affiliates

1. If an affiliate of the fund already has an investment in the property, proper conflicts clearance is required.

2. If the seller of a property to be acquired by a fund is an affiliate of the fund, proper conflicts clearance is required.

E. Investments in Different Elements of the Capital Structure

1. The fund and an affiliate of the fund may invest in different layers of the capital structure of a portfolio investment.

 

2. Equity holders and debt holders of a particular investment may have conflicting interests during the term of such an investment, especially if the investment is underperforming.

3. Holders of different tranches or types of debt or equity of an investment may face conflicting interests, as well, including with respect to liquidating an investment.

F. Valuation

1. Given the often illiquid nature of real estate investments, valuation of a fund's investments may present conflicts for a fund and its manager, especially when the valuation affects compensation.

2. Fund managers may want to provide investors with access to their valuation policy and allow transparency into any future revisions. The use of broker price opinions should be expressly disclosed if applicable.

3. Valuation matters are especially crucial for open-end real estate funds.

**VII. Regulatory Considerations**

A. Investment Company Act of 1940

1. The fund may not meet the real estate fund definition under the Investment Company Act.

2. Investments made through tiered structures are likely to result in the fund's not being able to take advantage of the real estate fund exemption ("3(c)(5)(C)" exemption) under the Investment Company Act. Reliance on this exemption also results in limitations on the composition of a fund's portfolio that do not arise for funds relying on the 3c1 exemption or the 3c7 exemption described below.

3. Thus, if the fund does not qualify for the real estate fund exemption, it will need to rely on the "3(c)(1)" exemption (i.e., the fund must not have more than 100 beneficial owners) or the "3(c)(7)" exemption (i.e., all of the fund's investors must be qualified purchasers) to avoid having to register as an investment company.

4. Investors subject to the Volcker Rule are likely to be sensitive to the fund's choice of exemption, as the Volcker Rule prohibits certain investors from participating in funds that rely on 3(c)(1) or 3(c)(7) exemptions and can result in limitations on a fund's ability to engage in transactions with counterparties affiliated with the relevant Volcker rule-subject investor.

B. Investment Advisers Act of 1940

Because the assets under management in a 3c1 or 3c7 fund count as regulatory assets under management for Advisers Act purposes, the majority of fund managers advising real estate funds are registered with the SEC as investment advisers.

C. CFIUS

Enacted in late 2018, the Foreign Investment Risk Review Modernization Act ("FIRRMA") expands the jurisdiction and powers of the Committee on Foreign Investment in the United States ("CFIUS"), the U.S. interagency committee that conducts national security reviews of foreign investment in the United States. FIRRMA authorizes CFIUS to review certain transactions by foreign investors in certain real estate in close proximity to air or maritime ports, military installations or other sensitive national security facilities. Accordingly, certain investments by a fund that include non-U.S. investors could be subject to CFIUS jurisdiction.

D. Insurance Companies

One relatively new structure involves offering rated debt securities in a real estate fund to insurance companies. If structured properly, these investments can enable insurance companies to invest in a traditional fund structure while taking advantage of the favorable regulatory capital treatment of debt.

 

## VIII. Conclusion

A. When structuring a real estate fund or venture, many complex, interrelated and multidisciplined issues can arise that make it critical for investment managers to select a team of fund and deal counsel who work closely with one another, as well as specialized tax, ERISA and Investment Company Act counsel, as necessary.

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