FORMING A REAL ESTATE FUND

strategy, structure and investment Terms

CAPITAL FUND LAW

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 do 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 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 properties in a blind pool. At the largest and most complex end of the spectrum are non-traded and traded Real Estate Investment Trusts (REITs), 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.

REAL ESTATE FUND STRATEGIES

As is the case with investment funds in general, real estate funds are trending toward greater levels of specialization. Specialization may be by asset class, strategy, or both. Examples of asset class-specific firms include: office, retail, medical, industrial, 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.

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.

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.

REAL ESTATE FUND STRUCTURE

The structure of a real estate fund is dependent on a number of tax, regulatory, and financial considerations. Fund structure is driven in large part by tax needs of the investors.

Closed-End Structure

Real estate funds are almost always closed-end funds. A closed-end fund is an investment fund intended to last for a fixed term, usually between five and ten years. Investors in a closed-end fund are generally not permitted to make withdrawals or additional capital contributions during the life of the fund. 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-end, once an investment is sold, it cannot be reinvested in the fund. Rather, the fund sponsor would create a subsequent fund as assets are sold and investment proceeds returned to facilitate reinvestment. Successful private equity fund sponsors typically develop a portfolio of various funds. Fund sponsors can form subsequent, analogous real estate funds at substantial cost savings to the initial funds, because less legal structuring is required.

Domestic Real Estate Fund Structure

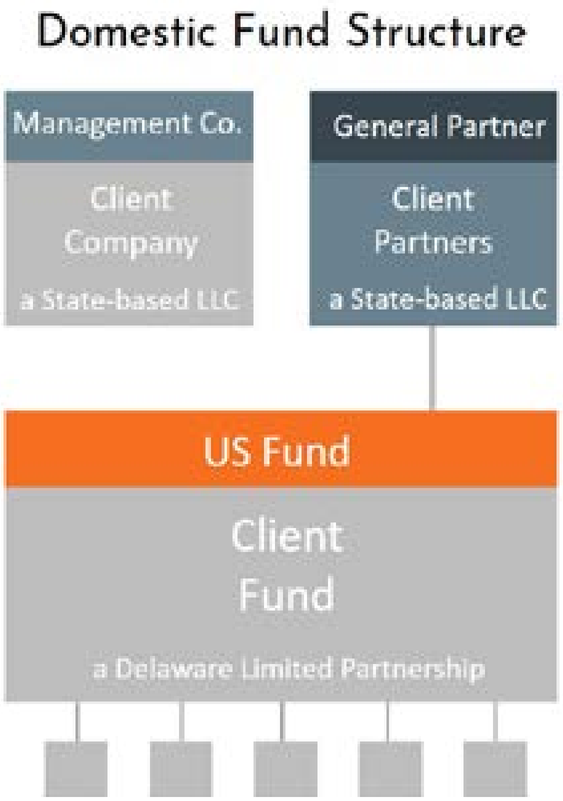
A domestic-only investment fund structure is typically comprised of the following entities:

- a limited partnership, typically formed in the state of Delaware, to act as the fund entity (although LLCs are becoming increasingly popular);

- an LLC to act as the investment manager of the fund, formed in the jurisdiction of the sponsor; and

- a general partner of the fund (managing member in the case of an LLC), also formed in the jurisdiction of the sponsor.

The investment manager and general partner entities are typically formed in the jurisdiction of the fund 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. Management fees are paid to the investment manager, while carried interest is allocated to the general partner.



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.

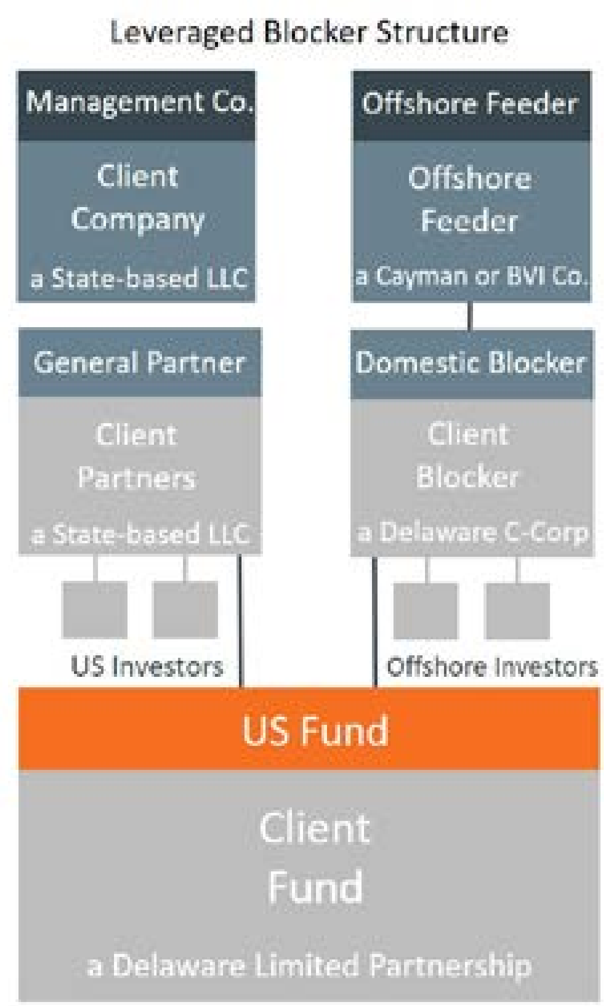
Offshore Fund Structures

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 leveraged blocker structure and the side-by- side structure.

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: the leveraged domestic blocker.

Leveraged Blocker Structure

A leveraged domestic blocker is a US corporation (usually set up in Delaware) 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 that FIRPTA (as defined under FIRPTA Considerations) imposes, while reducing non-US investors' effective rate on the real estate fund investment. The mechanics of the leveraged 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 blocker to reduce the leveraged blocker's income subject to US tax.

The protection afforded by the blocker will vary depending on the particular investor and investment. With the proper structuring, there is a potential to eliminate offshore investors from being subject to FIRPTA consequences.

Parallel Fund Structure

A side-by-side structure has an offshore. fund and domestic fund that parallel each other in trading and have the same investment manager but maintain separate investment portfolios.

Offshore Jurisdictions

There are number of locations in which an offshore fund can be formed, including Luxembourg, Malta, Cypress, Singapore, and others. However, the vast majority of funds are formed in the Cayman Islands or the British Virgin Islands for the reasons set forth below.

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 has gained the reputation for being a cost-effective and convenient offshore jurisdiction. BVI's regulatory structure has sought to create a flexible jurisdiction with streamlined processes and strong legal certainty. BVI regulatory filing fees are considerably 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. 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.

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 to the IRS's investigatory and subpoena powers. Fund sponsors are also required to make ta withholding on offshore fund investments.

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.

Sponsor Fees

A real estate fund sponsor's compensation includes the carried interest (generally approximately 20% of the fund's capital appreciation) and certain fees. There are a number of fees that real estate sponsors can charge, depending on the fund's negotiating position with investors and the extent of involvement required by the particular strategy. We recommend that the shorter the track record of the sponsors the more streamlined the fee structure should be. The most basic fee is an investment management fee. The investment management fee is assessed annually, typically ranging from 0.5% to 2%, (based on committed capital during the commitment period and based on capital contributions thereafter). Other potential fees include property management fees, leasing fees, financing fees and other administrative fees.

Capital Commitments

When real estate fund investors subscribe to an investment in the fund, they usually do so by entering into an agreement committing them to invest a certain sum (a capital commitment) when called for by the fund sponsor (a capital call). Upon the capital call by the sponsor for a specific percentage of the investor's capital commitment, the investor has a fixed period of time in which to satisfy the capital call. 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.

Preferred Return

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 in accordance with the distribution provisions upon capital events.

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.

Distribution waterfalls typically follow the following three phases:

(i) preferred return and recovery phase;

(ii) catch-up phase; and

(iii) carried interest phase.

Preferred Return/Recovery Phase

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.

Catch-up Phase

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 50-60%). In the catch-up phase, the general partner receives allocations at the catch-up rate until the carried interest allocations are caught up.

Carried interest Phase

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%.

General Partner Clawback

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.

Side Letters

Most offering documents allow the management team to negotiate special terms (known as side letters) that are not applicable to other investors. Often the special arrangement involves better economic terms, such as reduced management fees. Care must be taken, however, not to allow side letters to prejudice other investors. For example, side letters that provide additional information rights or preferential allocation should be avoided.

About the Author:

Mr. Lore advises emerging fund managers throughout the United States, Europe, and the Middle-East in forming and operating real estate funds, hedge funds, private equity funds, and other alternative funds using varied strategies; including equity, fixed income, distressed debt, and sector funds. Mr. Lore also advises real estate funds during the soft-commitment pre-capital raising stage.

Mr. Lore has advised hundreds of investment fund managers and real estate fund sponsors on all aspects of their business, from capital raising and fund formation to implementation of their business models. His representation of a broad range of managers allows him to keep abreast of emerging trends, regulations, and key business issues in the capital raising process.

Mr. Lore is a frequent speaker at investment management events in the US and Europe, and at some of the world's leading universities. Mr. Lore is regularly called on to provide insights on emerging hedge fund and private equity legal topics to institutional investors and has been quoted in more than 100 media articles in over a dozen countries.

Call 212.203.4300 or visit our website to schedule a consultation with one of our attorneys.