

Introduction and Background

Past experience may not have saved real estate professionals from the impact of the recent economic downturn, but past experience certainly has real estate professionals looking for the inevitable rebound and recovery of the real estate market. Currently, any real estate professional that is not overwhelmed with workouts is spending his or her time trying to position their company or investment group to be ready to buy quality assets when the market begins to turn. Real estate professionals justifiably believe that there are going to be opportunities to buy discounted debt and/or discounted real estate and want to be in cash ready positions to do so when the market provides those opportunities. Only a fortunate few have kept their powder dry and have the cash to react quickly in this market. For most, in order to be in a position to take advantage of a market rebound, they are going to need to raise new equity capital. To raise that capital, many real estate professionals are going to sponsor "real estate funds." While real estate funds are nothing new and have been a driving force in the real estate market since the 1990's, this downturn appears to be motivating many real estate professionals who traditionally did not need to raise capital, or did so on a one-off basis, to form and sponsor real estate funds. This article is directed to those real estate professionals who are contemplating forming and sponsoring a real estate fund, but want to more fully understand what that entails. This article provides a primer on real estate private equity fund formation and operations to enable a real estate professional to determine whether or not he or she wants to become a fund manager by sponsoring a real estate fund.

Preliminary Considerations

Before starting down the long, costly and time consuming path of forming and sponsoring a real estate fund, the real estate professional should consider some very basic preliminary issues. Most notably, the real estate professional should consider the following:

A. Capital Requirements

First and foremost, the real estate professional should estimate the minimum amount of capital that he or she will need to raise to have a viable fund and whether, realistically, he or she has the contacts and relationships to attract that amount of capital. It is often beneficial for the real estate professional to estimate the minimum amount of capital necessary to complete the investment objectives of the fund and to make a list of prospective investors and the likely amounts those investors might invest. If the minimum amount of capital necessary

cannot be obtained from the list of prospective investors, then the real estate professional needs to determine what additional investors, gatekeepers to pools of investors, broker-dealers and other sources of capital need to be contacted to raise the required capital to fulfill the fund's investment objectives.

B. Time, Effort and Monetary Commitment

Another critical preliminary issue for the real estate professional is to evaluate whether he or she is prepared to commit the time, effort and money necessary to raise capital for the fund. Marketing the fund to investors requires many meetings with, and presentations to, prospective investors and gatekeepers to pools of investors. First, a set of marketing materials (notably, the private placement memorandum) must be prepared. Second, representatives of the sponsor (including the key real estate principals and investor relations personnel, as applicable) must spend time soliciting subscriptions from prospective investors during the offering period. Even after completion of the offering, the sponsor should continue to maintain a regular level of investor communications including financial reporting and other investment updates. At a minimum, these communications should occur annually, but practically, sponsors should communicate at least quarterly with their investors. Accordingly, in addition to the infrastructure and overhead required to operate a real estate investment firm (e.g., office space, equipment and staff), the firm may wish to retain personnel suited to facilitate investor communications and relations.

The sponsors of a fund should also recognize that the expenses of conducting an offering are not insubstantial, and include legal fees, accounting fees, printing expenses and travel expenses. The sponsors typically advance the start up costs and are reimbursed once capital is raised. For a sponsor's first fund, these expenses may run towards the mid to high five figures. The actual cost depends upon the sophistication of the sponsor and its ability to define the terms of the deal and provide legal counsel with the materials necessary to prepare the offering documents. The cost is also tied to the number of and specific states in which the offering will be marketed, as further explained in Section III. Once a sponsor successfully completes the offering for an initial fund, the sponsor's subsequent funds should be less expensive, less time intensive and more attractive to investors.

C. Investment Strategy

There are several basic components to the characterization of a fund's investment strategy and objectives. These include

identification of targeted investment opportunities by real estate asset classes (e.g., office, industrial, retail, hotel and other real estate investment categories), method of investing (e.g., equity, debt or some combination), and investment strategies. Investment strategies might be grouped within the following overlapping categories, among others:

- (i) **Structured Finance/LBO:** Structured finance or LBO funds acquire high quality real estate at more or less market pricing with the use of significant borrowing. Where a high proportion of the investment can be debt-financed and the property is expected to perform at a significant spread between the investment yield and the borrowing rate, attractive returns may be realized. Highly leveraged funds may be difficult to implement if, as is currently the case, debt financing is expensive and difficult to obtain.
- (ii) **Distressed/Under-Performing/Non-Performing:** Value investment funds invest in distressed, under-performing or non performing assets at a favorable price with plans to reposition the asset for resale at a higher price. The projected high returns of these funds and the prospect of future refinancings may allow a value fund to succeed even if debt financing is difficult to obtain.
- (iii) **Development/Entitlements:** Development funds acquire real estate for development or land entitlements. Entitlement investments involve navigating complex municipal constraints and local political challenges to obtain proper approvals and authorization to develop raw land, demolish and redevelop existing structures or rehabilitate historic structures.
- (iv) **Co Investment/Joint Ventures:** Co-investment funds, similar to joint ventures, are formed to pool investment dollars with other sponsors and usually require either additional capital or industry expertise to execute their investment strategies.
- (v) **Opportunistic:** Opportunity funds acquire surplus real estate at a discount from financial institutions and other motivated sellers. Many opportunistic acquisitions are made for cash with the intent of obtaining financing at a later date.

The expression of the fund's investment strategy and objectives may also include other fundamental terms such as the targeted internal rate of return (the "IRR") for prospective investments, leverage ratios, leverage restrictions, level of diversification, a time schedule within which the fund will deploy investment capital, and a time schedule within which to liquidate those investments and complete distributions of realized proceeds to fund investors.

D. Prior Performance and Sponsor Compensation

Another important preliminary factor to consider when getting started is the extent to which sponsors will market a proposed fund by reference to the operating history or prior performance of the fund sponsor. Traditionally, more experienced sponsors have less difficulty raising "blind pool" funds (i.e., funds in which the specific properties or assets to be acquired are not identified in the investor documents) and less experienced sponsors may find it easier to approach investors with the properties and assets to be acquired already identified. Because investors in real estate funds generally qualify as accredited investors, there is no requirement for a sponsor to disclose prior performance (although the securities laws "materiality" requirements may suggest that a sponsor at least disclose its negative performance). It may, however, be unrealistic for a sponsor to expect to raise a significant amount of capital without an extensive table of past deals, which includes the good, the bad and the ugly. To the extent there is any disclosure of prior performance, the disclosure given will need to be carefully prepared to ensure that it is complete and not misleading. Furthermore, to the extent there is a long list of underperforming deals, a sponsor may find it difficult to proceed with an offering.

For purposes of determining sponsor compensation, it is worth noting that the economic structure of a fund, especially the pooling of multiple investments, may effectively defer the sponsor's participation in the upside of profitable transactions until the assets are sold and the fund is liquidated (in the absence of an interim sponsor distribution and clawback provision discussed in Section IV). Because real estate professionals typically realize profits on a deal by deal basis, the sponsor must carefully consider what compensation (i.e., fees) it may require in order to fund its overhead until it is able to realize the upside of profitable transactions. Sponsor fees, which are generally carefully reviewed by investors, may include management fees, acquisition fees, construction fees and other fees.

Securities Laws, the Private Placement Memorandum and the use of Broker-Dealers

Compliance with applicable securities laws requires consultation with expert securities professionals and careful monitoring of the manner in which the sponsor conducts the fund's offering and carries on the fund's business. Violations of securities laws (or colorable claims that violations occurred) may give unhappy investors the leverage to demand a return of their investment plus interest (known commonly as the right to rescission), not only from the fund, but potentially also from the fund's sponsors.

A. Securities Laws

Typically, because the alternative (i.e., an offering registered under state and federal securities law) is cost prohibitive, most real estate fund offerings will seek to qualify as a "private placement" pursuant to an exemption from the requirement

to register the offering under the rules of Regulation D of the Securities Act of 1933 and under applicable state securities laws. There are five basic requirements for the private placement exemption:

- (i) **Private Placement:** The offering must be conducted as a private placement, meaning that the fund engages in no general solicitation and no advertising, and that the fund offers the investment only to persons with whom the sponsor has a pre-existing substantive relationship.
- (ii) **Accredited Investors:** The sponsor must reasonably believe that all investors are “accredited” investors under Regulation D of the Securities Act of 1933. (While technically unaccredited investors may invest in a private placement, other complex requirements to comply with the “private placement” exemption would be triggered if that occurred. Additionally, the legal fees associated with drafting an offering to include unaccredited investors may outweigh the benefit of receiving funds from the unaccredited investors.) Accredited investors are defined as individuals having a net worth of at least \$1 million or a regular annual income of at least \$200,000 (\$300,000 when combined with spouse), business organizations which have total assets of at least \$5 million and other less common qualifications involving trusts, benefit plans and executive officers and directors of the fund.
- (iii) **Resale:** The sponsor must exercise reasonable care to ensure that each investor is investing in the fund for investment purposes and not for resale.
- (iv) **Reg D Filing:** The sponsor must file electronically within fifteen days of the receipt of the first subscription for investment a form under Regulation D summarizing some key data about the fund and the offering.
- (v) **Blue Sky Filings:** The fund must comply with the applicable laws of each of the states in which the fund’s investors reside. Typically, this means timely completing a filing similar to the electronic filing with the SEC and paying filing fees ranging from \$200 to \$1,400 per state.

Regardless of whether a fund offering is exempt from registration requirements pursuant to securities laws, applicable federal and state securities laws prohibit both the making of any untrue statement of a material fact and the omission of any material fact that is necessary in order to make the statements made not misleading. Compliance with this requirement involves careful review of all statements included in marketing and offering literature to ensure that those statements are appropriately balanced, and that the offering materials include a listing and description of the risks of an investment in the fund. Any disclosure that details prior performance or investment results of the sponsor or that makes related claims about the sponsor’s

performance should be presented with complete disclosure (e.g., the sponsor should not selectively disclose some investments while omitting other investments), using a consistent methodology in calculating that performance, and including enough detail to allow investors to understand the value and limitations of the data presented. If any material adverse developments in the prior performances disclosure occurs while the offering remains in process, the offering literature may need to be supplemented to disclose those developments prior to the acceptance of subscriptions.

Besides the Securities Act of 1933, other securities laws and regulations contained in, among others, the Securities and Exchange Act of 1934, the Investment Advisers Act of 1940 and the Investment Company Act of 1940, which are beyond the scope of this article, need to be evaluated for each fund offering and for fund operations going forward.

B. Pre-Offering Materials and the Private Placement Memorandum

Prior to the acceptance of subscriptions for investments from prospective investors, the sponsor and legal counsel typically prepare a private placement memorandum (the “PPM”) describing the investment opportunity and the risks of the investment. One tool which may be used to manage the offering expense is to test the market through a pre-offering process. There is nothing unlawful about pre-offering activity provided it complies with certain requirements. The key issues in this pre-offering activity are that the sponsor neither requests nor receives any binding commitment to invest, and that the pre-offering marketing activity is conducted in compliance with the requirements for conducting a “private placement” described above. For practical reasons, it is almost always advisable to limit the scope of pre-offering materials to a limited number of investment considerations and to keep the content of the materials simple. Confusion to investors or subsequent changes to investor expectations can greatly harm the capital raising process. For these reasons, pre-offering materials are typically limited to an abbreviated or executive summary portion of a business plan, possibly coupled with bullet points of key terms.

While the substance of the PPM may vary significantly from fund to fund, the scope and structure of PPMs generally follow similar formats. Some of the key components to the PPM are set forth below:

- (i) **Executive Summary:** The executive summary sets forth the key investment considerations for prospective investors and the operating history of the sponsor, including a description of the qualifications and expertise of the sponsor organization and its principals and prior performance discussion and prior performance tables.
- (ii) **Summary of the Offering:** This represents the most important section for investors and offers a

comprehensive summary of the terms of the investment including, for example, minimum required capitalization, capital commitments, distribution hierarchy, conditions to the release of subscription proceeds, investment strategies and objectives, sources and uses of funds, expenses of the offering and compensation payable to the sponsor and its affiliates. Essentially, this is a summary of the rights and obligations of the investors and the fund's sponsors.

- (iii) **Investor Suitability Disclaimers:** This section describes the criteria for investors to be considered accredited and further discusses the restrictions on transferring membership or partnership interests and other conflicts of interest.
- (iv) **Risk Factors:** The risk associated with the investment is set forth in this lengthy section which offers many reasons why the fund may not be successful and how investors could potentially lose all funds invested. The disclosure, in addition to complying with securities laws, serves to defend the sponsor from future claims by disgruntled investors.
- (v) **Tax Considerations:** Federal tax, state tax and ERISA considerations are set forth with an emphasis on federal tax and ERISA analysis, since the state tax considerations of investors will vary.
- (vi) **Exhibits:** A set of exhibits which typically include the fund's operating agreement or partnership agreement, form of promissory note evidencing capital commitments, if any, form of subscription agreement, and the management or services agreement, if any, with the sponsor or its affiliates.

C. Use of Broker-Dealers

Sponsors of real estate funds may need to use or consider using third parties to help them raise capital, which is particularly true in real estate cycles following recessions and other economic downturns. The use of third parties (i.e., persons who are not the initial sponsors of the real estate fund) raises a number of securities issues. Securities laws generally prohibit issuers from compensating persons for referring or procuring potential investors unless those persons are appropriately qualified and registered as broker-dealers under applicable federal and state laws. Compensating unregistered finders in violation of these requirements can result in the offering failing to qualify for exemptions from applicable registration requirements, which, along with other violations of securities laws, can result in investors seeking a refund of their investment. Unwary promoters and sponsors may not realize that compensating a friend for referring an investor is a violation of applicable securities laws unless that friend is a registered broker-dealer. There are also practical limitations on the effective utilization of registered broker-dealers. Among these limitations are

that broker-dealers may not be successful in finding suitable investors, especially absent a special relationship with the fund sponsor. Also, broker-dealers typically charge a fee of three to eight percent or more of the funds they raise (and potentially all funds raised by the fund). This compensation to broker-dealers may make the investment less attractive to prospective investors by reducing the amount of capital available to be invested by the fund and the ultimate return on the investor's investment.

Terms of the Offering and Fund Operations

A. Terms of the Offering

The economic terms of a real estate fund are ultimately going to be dictated by market conditions and in certain circumstances, as noted below in Section V, the tax considerations of the fund's investors. While the terms of the offering vary widely from fund to fund, the following is an outline of the three primary economic terms contained in real estate funds:

- (i) **Contributions:** Upon the sponsor's formal request to the investor for a specific percentage of the investor's capital commitment, as set forth in the subscription agreement, the investor will have a finite amount of time, usually about two to three weeks, to wire or send a check to the sponsor as a capital contribution to the fund for the requested amount. Once contributed, an investor's capital will usually only be returned upon the occurrence of a capital event, such as a sale or refinancing of all or a portion of the fund's assets, or upon the fund's payment of dividends to investors resulting from positive cash flow from operations. Note, the investor is under a contractual obligation to contribute all or a portion of its capital commitment at specific times throughout the life of the fund, as requested by the sponsor and set forth in the subscription agreement.

Traditionally, investors have demanded an annually compounded preferred return between 8% and 12% for their initial capital contribution. The preferred return generally begins to accrue upon a capital contribution and cumulates in years that the fund does not have adequate cash flow to pay investors the accrued preferred return.

Usually, investors are not obligated to contribute capital in excess of the amount they initially agreed to contribute, although investors may be diluted if a fund requires capital and such investors decline to contribute.

- (ii) **Distributions:** The distribution provisions of a real estate fund effectively control the economic relationship of the investors and the sponsor. Generally, distributable cash generated by the fund (which includes both cash from operations and capital proceeds generated by capital events such as the sale or refinancing of assets) is distributed in the following priority before the sponsor receives any compensation (except for fund fees):

- a. First, to investors who made a requested, non-mandatory, additional capital contribution until their additional capital contribution and any preferred return on their additional capital contribution has been paid;
- b. Next, to investors until the preferred return on their initial capital contribution has been paid; and
- c. Next, to investors until their capital contributions have been paid.

After the investors have received their cumulated preferred return and the return of their initial capital contribution, then the remaining allocations are based upon the agreed upon back-end percentage split between the sponsor and the investors. The back-end percentage split for the remaining proceeds has typically been 20% to the sponsor (sometimes called the “promote” or “carried interest”) and 80% to the investors, but varies depending upon the nature of the fund and the projected performance of the fund’s assets.

Distribution provisions may also include a “waterfall” whereby the back-end percentage split payable to the sponsor would increase (and the back-end percentage split to the investors decrease) as the overall IRR realized by the investors surpasses certain milestones. For example, back-end proceeds could be distributed 20% to the sponsor and 80% to the investors until the investors’ overall IRR reaches 15%, at which point the remaining back-end proceeds would go 30% to the sponsor and 70% to the investors until the investors’ overall IRR reaches 20%, at which point back-end proceeds would be distributed 40% to the sponsor and 60% to the investors.

The concept of a “catch up” distribution to the sponsor is an optional distribution tier, effective only after the investors have received certain distributions, which allow the sponsor to potentially “catch-up” to an agreed upon percentage of total cash distributions utilizing an accelerated “catch-up” percentage. For example, if the goal of the parties, after payment of preferred returns and investors capital, is to strive for an ultimate percentage split of 20% to the sponsor and 80% to the investors, then subsequent distributions of cash might be made 60% to the sponsor and 40% to the investors until the sponsor has cumulatively received 20% of the total cash distributed by the fund. When structuring the fund, the sponsors must determine what the expectation of its investors will be and whether they will tolerate a “catch-up” provision or whether the investor’s expectation is that the sponsor’s promote or carried interest is simply 20% of the back-end proceeds.

While considering distributions, it is also worth noting the concept of a “clawback.” This concept

establishes the obligation of the sponsor to return cash previously received as interim distributions. The concept is triggered when, as a result of excellent early performance, the fund generates sufficient distributable cash to meet the investors’ distribution requirement, sometimes measured by IRR, and also make interim distributions to the sponsor. If the fund’s final results fail to generate overall returns that justify the amounts previously distributed to the sponsor, then the fund would require a retroactive adjustment to distributions made to the sponsor and the return of cash by the sponsor. In structuring a fund, the sponsor needs to balance its desire to receive cash resulting from excellent early results against the risk of having the fund “clawback” all or a portion of that cash if the fund ultimately does not meet anticipated performance goals. Clawbacks are often secured with personal or corporate guaranties of the sponsor.

As set forth above, there are many variations of the distribution structure that may be considered during formation of the fund. Most of the negotiations surrounding the distribution structure depend on the expectations of the sponsor and its perceived ability to raise funds.

- (iii) **Fees:** There are a number of fees typically payable to the sponsor or its affiliates which impact the economic structure of a real estate fund. One fee that may be included is an asset management fee, which usually ranges from 0.5% to 2.0% per year of the fund’s committed capital, until the capital draw down period expires and the asset management fee is then based on invested funds or funds accruing a preferred return. Other fees that might be charged by a fund include leasing fees, property management fees, financing fees, loan guarantee fees and other administrative fees.

Once again, it will be up to the sponsor to establish a fee structure that he or she believes will be acceptable to its potential investors.

B. Fund Operations and Management

Since investors usually have only the minimum management rights required under applicable law and since investors need to understand how the fund sponsor plans to operate the fund, the management provisions of a real estate fund should be straightforward, transparent and non-controversial. The fund itself will be managed and all decisions made generally by a single decision maker which may be an individual or an entity controlled by the sponsor. A fund may also include an investment committee or board of directors to provide additional input for certain major decisions, which gives credibility to less experienced sponsors. Since the investors are delegating to and relying upon one or more named individuals to make all material decisions for the fund, most funds will include provisions

prohibiting the sponsor from engaging in competitive activities. Additionally, the securities laws applicable to the fund PPM require disclosure of any compensation being paid to affiliates of the sponsor and its principals.

Tax Issues Affecting Real Estate Funds

While state tax issues and tax issues impacting foreign investors are beyond the scope of this article, the following section should provide prospective sponsors with a base of knowledge of selected federal income tax issues affecting domestic real estate funds with domestic investors. The tax issues associated with the formation and operation of a real estate fund will depend both upon the investment strategy of the fund (e.g., development versus rental properties and whether debt is going to be used to acquire properties) as well as the type and number of investors the sponsor is seeking to invest in the fund (e.g., tax exempts, pension funds, foreign persons and/or U.S. taxable persons). As discussed above, a real estate fund will typically be structured as a pass-through entity for U.S. income tax purposes as either a limited liability company or limited partnership in accordance with state law. As a result, the fund will not pay an entity level tax and the income of the fund will pass through directly to the investors.

In forming the fund, and ultimately in structuring the investments of the fund, special consideration must be given to the following tax issues set forth below as they may impact the ultimate economics of both the fund itself and the underlying investments of the fund, as well as the mix of investors from whom the sponsor may ultimately solicit funds. Note, this discussion does not address all of the issues associated with the formation or operation of a real estate fund.

A. Unrelated Business Taxable Income (UBTI)

A significant amount of capital is often available from tax exempt investors, including university foundations, governmental entities, pension funds and other tax exempt investors. Tax exempt entities are generally not required to pay tax on passive types of income such as dividends, interest, royalties and rents or gains from the sale of non-dealer property. However, tax exempt entities are required to pay tax on income that is considered unrelated business taxable income or “UBTI”. In the context of a real estate fund, an investment by the fund will result in UBTI to a tax exempt investor if the fund is a dealer in real property (e.g., home or condo sales), or has active business income (e.g., service income from management or development fees, or percentage rents based on the net income of a tenant’s operating business). In addition, passive income that is generally not considered UBTI (e.g., dividends, interest, rents or gains from the sale of non-dealer/inventory property) may be treated as UBTI if the fund (or its subsidiaries) uses leverage to acquire its real property investments.

In most circumstances the recognition of UBTI may not be avoidable; however there are exceptions to UBTI treatment

depending upon the type of tax exempt investor and alternative structures for avoiding or minimizing the recognition of UBTI by tax exempt investors. Some tax exempt entities may accept UBTI and pay the tax if the expected return from the fund is high enough. However, the sponsor should be clear upfront with its potential tax exempt investors as to what its obligations are with respect to the investor’s tolerance to recognizing UBTI.

B. Additional Considerations for Investors Subject to ERISA (including State Pension Funds)

If the fund is seeking investments from benefit plan investors, such as employee benefit plans and pension funds that are subject to ERISA, the fund may want to structure the ownership or operations of the fund in a manner that avoids the assets of the fund from being treated as “plan assets” under ERISA.

Generally, when a benefit plan invests in a fund, the benefit plan’s assets include its equity investment in the fund but does not include any of the underlying assets of the fund. However, if the benefit plan acquires an equity interest in a fund that is not publicly traded or issued by an investment company registered under the Investment Company Act of 1940, then the “plan assets” of the benefit plan includes its equity interest in the fund and an undivided interest in each of the underlying assets of the fund. If the assets of the real estate fund are considered “plan assets” for purposes of ERISA, then the general partner of the fund and its controlling persons are considered ERISA fiduciaries and are subject to the responsibilities and liabilities of ERISA fiduciaries which can significantly curtail the ability of the fund to make certain investments. In addition, some states have adopted ERISA-like statutes for investments made by state pension funds (which are not subject to ERISA) which can result in the general partner of the fund becoming a fiduciary under the rules of the states from which the fund receives investments.

The most common method for a fund to avoid its assets being treated as “plan assets” is to limit equity ownership in the fund by benefit plan investors to less than 25% of the outstanding equity interests. However, if the fund intends to obtain a significant amount of its capital from benefit plan investors, “plan asset” status can only be avoided if the fund establishes that it is either a “venture capital operating company” or “real estate operating company” under ERISA. A fund will be a “venture capital operating company” if at least 50% of its assets (other than short-term investments pending long-term commitment or distributions to investors), valued at cost, are invested in operating companies (including “real estate operating companies”) and the fund has the right to substantially participate in or substantially influence the management of each of the operating companies. A fund will be a “real estate operating company” if at least 50% of its assets (other than short-term investments pending long-term commitment or distributions to investors), valued at cost, are invested in real estate which is managed or developed and with respect to which the fund has

the right to substantially participate directly in management or development activities, and the fund is engaged directly in real estate management or development activities.

Practically speaking, if the fund's strategy is to invest in a portfolio of shopping centers with long-term master leases under which substantially all of the management and maintenance activities are the responsibility of the lessee, then the fund will not qualify as a "real estate operating company" because the fund is not engaged in management activities with respect to the properties. As a result, in order to avoid "plan asset" status the fund will need to limit equity ownership in the fund by benefit plan investors to less than 25% of the outstanding equity interests.

Contrast this to the situation where the fund is investing in a portfolio of shopping centers where the properties are subject to short term leases and all aspects of the properties, including negotiating leases, maintaining common areas and property maintenance, are conducted by a property manager, which the fund retains the right to hire and fire. This control over the hiring and firing of the property manager is sufficient management control such that the fund could qualify as a "real estate operating company" and therefore 25% or more of the equity interests could be held by benefit plan investors.

Where a real estate fund has benefit plan investors the organizational documents of the fund typically contain provisions that allow the benefit plan investors (including state pension funds) the right to redeem all or a portion of their interest in the fund if the fund's assets become "plan assets" under ERISA. Although the general partner is typically granted a cure period, some benefit plan investors will attempt to negotiate an immediate exit right if the fund's assets become "plan assets."

Conclusion

The purpose of this article is to educate the real estate professional who is contemplating forming a real estate fund. After reading this article, the real estate professional should have an understanding of the questions which need to be answered as he or she decides whether to proceed with a fund and an overview of the complexities of structuring and operating a real estate fund. Ideally, the issues discussed above will provide an excellent starting point for the real estate professional who elects to move forward with sponsoring a real estate fund.

Please feel free to contact any one of us with questions regarding the formation and operation of real estate funds.

Scott A. Fisher
(404) 873-8618
Scott.Fisher@agg.com

Stephen D. Fox
(404) 873-8528
Stephen.Fox@agg.com

Matthew T. Harris
(404) 873-8118
Matthew.Harris@agg.com

Heather L. Preston
(404) 873-8722
Heather.Preston@agg.com



Arnall Golden Gregory LLP is an Atlanta law firm, founded in 1949, that serves the business needs of growing public and private companies. Through mergers and acquisitions, capital markets financing, strategic alliances, joint ventures, litigation and other business-related guidance, the firm helps clients across a broad range of industries turn legal challenges into business opportunities. For more information on the firm and the Real Estate Private Equity Practice Group, please visit www.agg.com.