Show Me the Money: A Primer on Real Estate Private Equity Funds

By Jennifer Morgan

Jennifer Morgan is a partner at King & Spalding in New York City. She specializes in real estate private equity and advises clients on structuring and negotiating fund formations and other capital transactions, including private real estate investment trusts and other structured investments.

The modern era of real estate private equity funds grew from the savings and loan (S&L) crisis of the late 1980s. Closed-end private equity-style funds were formed to buy assets from the Resolution Trust Corporation, which Congress had created to sell the real estate assets of closed S&Ls. Shortly after that, a number of real estate opportunity funds were formed to take advantage of the real estate market distress of the early 1990s. Those funds were largely successful, achieving large equity multiples and internal rates of returns, and many other sponsors joined the market. The real estate fund market has continued to grow; even after the slowed real estate investment activity at the end of last year, according to Preqin, during the final quarter of 2022, 76 real estate funds closed, raising a total of $46.9 billion.

A real estate private equity fund provides a sponsor with a discretionary pool of capital with very few required investor consents. The fund sponsor is relieved of raising capital on a deal-by-deal basis and does not have to seek the consent of its equity capital investors concerning a multitude of "major decisions" that are typically required in the single asset joint venture context. What's not to like? This article provides an overview of the real estate private equity fund formation process, including common terms that govern the structure and regulatory considerations.

Fund Terms

A real estate private equity fund is a commingled investment vehicle established to deploy investors' capital on a blind pool basis in various real estate assets. The terms of the fund result from a negotiation process between the sponsor and the fund investors. Still, there are certain key terms customarily included in the fund documentation. The sponsor typically seeks freedom in its investment process and operations and the ability to earn fees (including for affiliated services providers) and promote. The investor wants a good return on its investment but also wants protections around fees and expenses and some control over the investment and management process. Many investors also desire access to co-investment opportunities alongside the fund, which typically come with better economics through reduced fees and promotion.

As with any negotiated transaction, what is "market" changes over time and depends on the parties' relative bargaining power. A mega-fund manager with a successful track record and tens of billions of dollars of real estate assets under management is largely going to be able to dictate terms to its investors. In contrast, a smaller or newer manager must offer more investor-friendly terms. Despite that potential range, the basic terms of each fund typically include the following:

Purpose, Exclusivity

As with any venture, the stated purpose of the partnership provides the general partner with legal authority to cause the partnership to take specific actions. Although the sponsor wants broad authority, the purpose provisions often tie to exclusivity, which the sponsor will likely want to be narrow. To

Published in Probate & Property: Volume 37, Number 5 ©2023 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

make exclusivity work, all parties need to think about the fund's investment horizon and other potential competing products or strategies that may become relevant during that time.

Marketing Period, Subsequent Close Mechanics

Most funds have a marketing period during which the sponsor can continue to close on additional capital commitments. This marketing period is typically around 12 to 18 months. The fund may invest and close on more capital commitments during that time. Investors coming in at later closings may have visibility on actual investments they will be buying into and get the benefit of knowledge of any market changes that may have occurred since the first closing. To induce investors to commit to a first closing, sponsors often offer those investors certain economic benefits, such as a management fee holiday. Investors in subsequent closings must compensate the investors who made commitments in earlier closings in the form of the return of the applicable portion of any capital contributions made by the original investors, plus a cost of carry thereon (typically the first hurdle rate for the promotion). If values have increased significantly, the general partner usually has the discretion to charge investors making commitments at later closings for their pro rata value of the investments instead of cost-plus carry, though that is rarely exercised. Investors committing at later closings will also be subject to management fees as if they had entered the first closing (with an interest component).

Fund Size, Investment Period

A key component of a fund's investment strategy is often market timing, which means that the sponsor sees the investment strategy as providing for the deal flow of a certain amount of investment over a certain period. The fund's investment period is a set timeframe (often two or three years) during which the general partner can deploy capital for new investments. That period also ties to the fund's overall size, and investors may seek to impose a cap on the amount of capital that may be committed to the fund to ensure that all capital is deployed on time.

After the investment period, the uses for which the general partner may call capital are more limited; typically, the general partner can call capital for investments in process and follow-on investments but not otherwise for new investments. Development and value-add fund sponsors should be careful to ensure they can access funds for projects that extend beyond the investment period.

Term

Fund investors are mainly passive and do not have control rights over investments or the disposition thereof. In addition, investor transfer rights are usually subject to the approval of the general partner, and there is no liquid market for limited partner fund interests even if a transfer is approved. The fund's term is, therefore, critical, as it provides investors with some time horizon for the return of their capital. A typical closed-end fund term is ten years, with some extension rights for the general partner. Most fund documents also permit orderly liquidation to avoid a "fire sale" situation, so investors should not expect a return of capital by a fixed date.

Investment Limitations

Most fund documents will provide for limitations on investments that may be made within the defined strategy. These cover a typical range of topics such as geography, product type, and leverage restrictions but are customized to each sponsor and strategy. The limitations provide a box around the discretion afforded the fund sponsor and should be reviewed carefully to ensure clarity for the sponsor and investors.

Distribution Waterfall

Most real estate funds have a fully pooled distribution waterfall, so all capital plus a preferred return

Published in Probate & Property: Volume 37, Number 5 ©2023 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

must be returned to the investors before the sponsor is paid any promotion. There is still a chance of overpayment if there is an early sale of an investment, so most fund agreements will provide for a clawback of any excess from promotion from the general partner (and some may also ask for a guaranty from the sponsor for the clawback). Real estate fund waterfalls are generally less complicated than single-asset development joint ventures. Most funds end with an 80/20 split in favor of the sponsor. The availability of a “catch-up” tier to get the general partner to the 20 percent faster depends on the market and bargaining power.

Fees and Expenses

Most funds pay an asset management fee to the sponsor, typically a percentage of capital commitments during the investment period, switching to a percentage of invested capital afterward. Many sponsors have affiliates who provide real estate services, such as property management, development management, and construction, and the fund documents will permit the sponsor affiliates to deliver those services at agreed fees.

The fund document will also govern which expenses are to be borne by the fund (and, therefore, the investors) and which are to be borne by the sponsor. Recent SEC scrutiny of expenses has led to tremendous detail and disclosure around these provisions. The sponsor will bear organizational and offering costs incurred in connection with the fund’s formation over an agreed cap and any placement agent fees.

Advisory Committee

Fund investors have limited rights concerning the investments and operations of the fund. Still, many funds have an advisory committee of representatives of select limited partners (often those who commit above a certain amount of capital to the fund). The advisory committee can weigh in on conflicts of interest or consent to waiving an investment limitation, but it does not function as an investment or other governing committee.

Key Persons

We all know real estate is a management business. Because fund investors have limited rights, they may seek to ensure the sponsor’s investment team remains in place by negotiating a key person provision. A typical key person provision will provide specific time and attention requirements for certain principals (or replacements approved by the advisory committee). The traditional remedy for breach of a key person provision is suspending or terminating the investment period.

GP Removal

Investors will typically require the right to remove the sponsor (or its affiliate) as a general partner of the fund in the event of “cause.” The definition of cause will be negotiated but typically includes fraud, gross negligence, willful misconduct, and material breach of the fund partnership agreement. A court determination may or may not be required for a finding of cause. The removal will not be automatic but usually will require a vote of at least a majority of the nonaffiliated fund investors. Consequences to the sponsor may include reducing the amount of promote payable to the general partner and automatic termination of any affiliate service agreements.

Given the high standard for demonstrating cause, investors may also seek the right to remove the general partner without cause but with a higher voting standard (supermajority or higher). If agreed, this removal would not typically result in a reduction to the promote (though in either case, if there is a removal, it seems unlikely that the fund is providing sufficient returns to generate a substantial promote).

Published in Probate & Property: Volume 37, Number 5 ©2023 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

Documentation of the Fund Offering

Private Placement Memorandum

The Private Placement Memorandum (PPM) is primarily a disclosure document for Securities Act compliance purposes. It typically includes a summary of the fund's terms, investment strategy, the sponsor's view of the market opportunity, background information about the sponsor, and track record information. The track record should be reviewed carefully by counsel to ensure compliance with SEC guidance. For example, the SEC has determined that sponsors must include net performance return calculations (i.e., net of fees and carry) with equal prominence to any gross performance return information. There are also rules relating to ownership of track record information that may be relevant to newly formed teams. The "legal" sections of the PPM include disclosure on risk factors and conflicts of interest, as well as disclosure around tax, ERISA, and other regulatory implications of the fund. Finally, the PPM must contain any required offering legends that may apply, depending on the jurisdictions in which the fund interests will be marketed and sold.

Limited Partnership Agreement

The partnership agreement for the fund memorializes the relationship among the sponsor, as general partner, and the investors, as limited partners, and covers governance, economics, and exit and transfer provisions. Because most funds have a term of at least ten years, the document needs to provide clarity but also some degree of flexibility to allow for adjustment over time.

Subscription Agreement

The subscription agreement documents the investor's subscription for limited partner interests in the fund; it provides the contractual basis for the investor's capital commitment. The subscription agreement also includes numerous representations, warranties, and covenants related to investor suitability and other information needed for securities law and regulatory compliance.

Regulation of the Fund Offering Process and Operations

Although a real estate private equity fund is, by definition, designed to be exempt from registration under most US federal regulatory regimes, many regulatory requirements need to be addressed.

Securities Act of 1933

Most institutional real estate funds are offered by a private placement of interests under Rule 506(b) of Regulation D of Section 4(a)(2) of the Securities Act (Rule 506(c) permits general solicitation but requires the sponsor to take reasonable steps to verify the accredited investor status of the investors.) Compliance with Rule 506(b) provides a safe harbor for exemption from registering the offering with the SEC, but there is a requirement to file a Form D with the SEC after closing a sale of interests in the fund. To comply with Reg D, the offering generally must be made only to "accredited investors" as defined by the SEC and done without general solicitation. The sponsor cannot advertise the offering, and offers may be made only to prospective investors with whom the sponsor has a pre-existing substantive relationship. (No cold-calling!) Rule 506 offerings are also subject to bad actor disqualification provisions relating to prior acts by certain covered persons in the sponsor organization. Private placements are also subject to general antifraud provisions, meaning the sponsor will have liability for false or misleading statements.

Investment Company Act

Most funds are formed under an exemption to the Investment Company Act of 1940, which imposes significant registration and reporting requirements on "investment companies." Two popular exemptions are Section 3(c)(1), which provides an exemption for privately-placed funds with no more than 100 beneficial owners (look-through rules apply), and Section 3(c)(7), which provides an exemption for privately-placed funds in which all investors qualify as "qualified purchasers" as defined by the SEC. Note

Published in Probate & Property: Volume 37, Number 5 ©2023 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

there are certain exemptions to both the 100-person limit and the qualified purchaser requirement for certain "knowledgeable employees" of the sponsor.

An exemption under 3(c)(6) may be available to a fund that will acquire direct controlling interests in real estate.

Investment Advisers Act

A fund's sponsor or general partner may be required to register as an investment adviser under the Investment Advisers Act of 1940, which triggers reporting to the SEC. Registered investment advisers are also subject to additional requirements concerning the standard of care and performance-based compensation. Registration is generally required when regulatory assets under management exceed $100 million. Some sponsors can avoid registration by providing advice solely regarding real estate rather than securities, a conclusion requiring a very fact-specific analysis. Note that most states also have registration requirements for investment advisors that may apply in the absence of federal registration.

Anti-Money Laundering

Although not unique to raising capital via a private fund, it is worth noting that the fund sponsor must comply with Anti-Money Laundering regulations concerning the offering.

Freedom of Information Act (FOIA)

Public pension funds and public university foundations and endowments are some of the most common real estate private equity fund investors, and their investments are subject to FOIA and similar state disclosure laws. As a result, information about the fund's investments may be made publicly available. Those disclosures may be limited contractually to provide some protection to the sponsor.

Employee Retirement Income Security Act

Private pension funds are also common investors in real estate private equity funds, and those private pension funds are subject to the Employee Retirement Income Security Act of 1974 (ERISA). A fund sponsor will want to avoid the fund's assets being deemed "plan assets" under ERISA, which would trigger certain fiduciary standards of conduct and prohibited transactions. Most real estate funds find exemptions from ERISA by limiting their beneficial ownership to less than 25 percent ERISA plan investors or operating as a "venture capital operating company" or "real estate operating company."

Conclusion

Though the ready availability of discretionary capital makes the real estate fund appealing, it is typically more time-consuming and complicated to launch a real estate fund than to raise capital on a deal-by-deal basis.

Published in Probate & Property: Volume 37, Number 5 ©2023 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.