Structuring Your Real Estate Investment

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Objectives

Negotiating and structuring a term sheet for a real estate development project

Negotiating and understanding operating agreements governing real estate developments

Determination of choice of entity and structure based on applicable real estate investment considerations

Elements and Components of a Term Sheet

- Description and identification of property and project.
- Corporate Structure (GPs; LPs)
- Equity Contributions
- Additional Capital Contributions and Dilution
- Governance/Major Decisions
- Distributions
- Put and Call Rights
- Debt Financing and Guarantees
- Allocation of Predevelopment Costs
- Development Plan and Budget
- Cost Overruns
- General Partner Fees (Acquisition, Development, Asset/Property Management, Construction Management, Guaranty)
- ROFRs/Exclusivity

Term Sheets: The "Project"

- The Parties will form a single purpose, bankruptcy-remote Delaware limited partnership (the "<u>Partnership</u>") to own, develop, finance, construct and operate that certain [DESCRIPTION OF PROJECT], located at [ADDRESS] [CITY] [STATE] (the "<u>Project</u>").

- The management, governance, ownership, and economic interests of the Company shall be set forth in a limited partnership agreement negotiated by the Parties and executed in accordance with this Term Sheet (the "<u>Partnership Agreement</u>").

Term Sheets: The Joint Venture

- *Financing*: The Partnership will finance the development, construction, and initial leasing and operation of the Project with capital from investors (which may include one or more of the Parties) and a construction lender. The construction loan will be in the amount of no less than $[____________________] (the "Construction Loan"), and the equity financing will be in the amount of no less than $[_________________________] (the "Equity Financing"), each on terms agreeable to the Parties.
- *Development Budget*: The sum of the Construction Loan and Equity Financing shall equal the total project costs as broken out in the development budget attached as Exhibit "A" hereto (the "Development Budget").
- *Guarantors*: [NAME OF GUARANTOR] and [NAME OF GUARANTOR] (each, a "Guarantor," and collectively, the "Guarantors") will personally guarantee the Construction Loan if personal guarantees are required by the construction lender.
- *Affiliate Agreements:* Affiliate Agreements at Loan Closing: (i) a property management agreement, (ii) a development agreement, and (iii) a general contractor agreement.

Term Sheets: Equity Ownership/Capitalization

- *Classes of Units*: Equity ownership in the Partnership shall be represented by two (2) classes of "Units."
- "Class A Units" and "Class B Units"

- *Capitalization of Units*: The Partnership's equity shall initially consist of 20 Class A Units and 1,000 Class B Units, to be allocated as follows:

  Sponsor or its affiliate entity: 20 Class A Units

  Limited Partners:1,000 Class B Units

Term Sheets: Capitalization Table

NAME	UNITS	PERCENT OWNERSHIP	INITIAL CAPITAL CONTRIBUTION
Class A Unitholder			
[Name of Sponsor] [Address]	20 Class A Units	___%	$0
Class B Unitholders:			
[Class B Unitholder] [Address]	__ Class B Units	___%	$________________
[Class B Unitholder] [Address]	__ Class B Units	___%	$________________
[Other Limited Partner Investors] [Address]	__ Class B Units	___%	$________________

Term Sheets: Management Rights

- *Appointment of GP/Manager*: Sponsor or its affiliate shall be appointed as "General Partner" of the Partnership.

- *Management Rights*: The General Partner, acting alone and without the joinder of any other Unitholder shall have the sole and exclusive management and control of the Partnership business and shall have the power and authority to take such action as it from time to time may deem necessary, appropriate or convenient in connection with the management and conduct of the business and affairs of the General Partner. The General Partner shall be responsible for overseeing the day-to-day management, maintenance and operations of the Project in accordance *with the Development Budget and Annual Business Plan* to assure the Project is being managed, developed and operated in a prudent, businesslike manner.

- *Limitations for "Major Decisions*": Notwithstanding the foregoing, the General Partner shall not take any of the following actions without first obtaining the written consent of Partner, which shall not be unreasonably withheld, conditioned, or delayed: [LIST OF NEGATIVE COVENANTS]

Term Sheets: Development Budget & Annual Business Plan

- *Budget*: anticipated costs and expenses of acquiring and developing the Property and constructing, leasing, operating and carrying the Project.
    - Prepared by GP and approved by LP prior to Loan Closing

- *Business Plan:* detailed annual operating and capital budget for the Project (detailed on a month to month basis), detailed assumptions, all anticipated income, operating expenses, reserves (if any), capital expenditures and other costs and expenses of the Partnership for the ensuing Annual Business Plan Year.
    - Prepared by GP and approved by LP after completion of construction (and then periodically, i.e., every 12 mos.)

Term Sheets: Management Rights (Cont)

"Major Decisions":

- Modifications to or incurring of any cost or expense not accounted in, the Development Budget or Annual Business Plan.
- Sale or other disposition of the Project or any part thereof or any interest therein, except for routine utility easements and sales of individual Units.
- Obtaining, increasing, modifying, consolidating, prepaying, or extending of any loan or borrowing of the Company.
- Decisions with respect to material litigation.
- Approval/modification of Project plans and specifications.
- Settling material insurance claims.
- Employee matters.
- Use of threshold reserve funds set forth in the Development Budget.
- Bankruptcy, dissolution, change of business.

Term Sheets: Removal of GP/Manager

- *<u>Bad/Disqualifying Acts</u>*: Limited Partner rights to remove Sponsor as General Partner for Bad and or Disqualifying Acts.
  - Bad Acts: fraud, willful misconduct, gross negligence, or theft
  - Disqualifying Acts: bankruptcy, insolvency, death or dissolution of Sponsor and or Guarantors
- *<u>Effect of Removal</u>*: Sponsor should retain following rights when removed:
  - Right to demand removal of the Guarantors from any applicable guarantees in relation to the Construction Loan or any other debt of the Partnership
  - Retention of economic interests in the Partnership in the event of removal

Term Sheets: Fees

- The Partnership shall pay the following fees as "guaranteed payments”
  - *Development Fee* to Developer in an amount equal to [__] percent ([__]%) of the Development Budget (excluding the development fee to be paid hereunder), payable in such a manner as is permitted under the Loan Documents executed in connection with the Construction Loan.
  - *General Contractor's Fee* to the General Contractor in a fixed amount equal to [___] percent ([__]%) of the estimated total construction costs, payable as set forth in the Construction Contract.
  - *Property and Asset Management Fee* (monthly) in an amount equal to [_______________] percent ([__]%) of the rental income of the Project, payable to the Property Manager under the Property Management Agreement.
  - *Guarantor Fee* (one-time) in the amount of [___]% of the Construction Loan, payable to the Guarantors on the date of the closing of the Construction Loan, subject to downward adjustment to cover similar fees owed to any lender or debt or securities broker.
  - *Equity Placement Fee* (one-time) in the amount of [___]% of the Equity Financing, payable to the finder(s) on the date of the closing of the Construction Loan

Term Sheets: Distributions

- *<u>Operating Distributions</u>*: net cash flow and proceeds of the Partnership after application to normal operating expenses, debt service obligations, guaranteed fees and subject to reasonable reserve. Issuance and timing usually subject to General Partner discretion (except for tax distributions, if applicable).

- *<u>Capital Transaction</u>*: net cash flow and proceeds of the Partnership from sale or refinancing.

- *<u>Distribution Waterfall</u>*:

1. <u>First</u>, 100% to the Unitholders, pro rata, in an amount equal to a preferred return totaling 8.00% per annum, determined on the basis of 365 or 366 days, as the case may be, of the average daily balance of each Unitholder's unreturned capital contribution commencing on the date of such and Unitholder's Capital Contribution.

2. <u>Second</u>, 100% to the Unitholders, until the Unitholders' unreturned capital contributions equal zero dollars.

3. <u>Third</u>, the remainder to all Unitholders, pro rata, in proportion to a residual interest as follows:

   A. Class A Unitholder (Sponsor): 30% [**<u>THE PROMOTE</u>**]

   B. Class B Unitholders: 70%

Real Estate Development Operating Agreements

- Formation (state law/name)
- Business of the company
- Capitalization/Capital Calls/Drag Along Rights/Tag Along Rights
- Allocations of profits, losses, and tax distributions
- Management (limitations of management)/Fees
- Fiduciary duties (or waiver thereof) and indemnification of members/managers
- Distributions
- Administrative - Accounting/Reports/Books and records
- Succession/Restrictions on transfers/Repurchase rights/Buy-Sell
- Reps and warranties
- Winding up
- Tax matters

Real Estate Development Operating Agreements

- Capital Calls
  - Determined by majority of unitholders
  - Made on pro rata basis
  - Defaulting members subject to dilution or loan obligation to non-defaulting member.

- Drag Along Rights
  - Majority Unitholder(s) right to demand minority unitholder(s) to sell units to third-party on same terms as majority (i.e., drag them along).

- Tag Along Rights
  - Minority Unitholder(s) right to join majority unitholder(s) in proposed sale of units to third-party on same terms as majority (i.e., tag along with them).

Real Estate Development Operating Agreements

- Call/Repurchase Rights
  - Rights of certain unitholder(s) to purchase other unitholder(s) capital at set price.
  - Used for death, disability, separation from service, change of control, and after certain milestones (occupancy/leasing threshold metrics).
  - Purchase price usually based on FMV (can be subject to valuation).
  - Discounts for minority interest, lack of marketability, and lack of control to be negotiated.
- Put Rights
  - Mirror image of a call right
  - Right to demand another unitholder purchase your units at a set price (i.e., buy you out).
  - Usually subject to lock-out period and only excisable after after certain milestones (occupancy/leasing threshold metrics).
- Buy-Sell/Shotgun
  - The Partnership's "prenup"
  - Withdrawing partner offers to sell units to other members at a fixed price OR buy their units for an equivalent pro rata amount based on the offered sales price by the withdrawing member.

Equity and Debt Financing

- Allocating debt and debt service ratios
- C-Corp v. S-Corp v. Pass-Through
- Equity financing terms
  - Capital calls
  - Distribution waterfalls
  - Sweat equity, i.e., a “carry” or “promote” to the manager/GP
  - GP Co-Invest; GP Fees
  - Liquidation Preferences and Preferred Returns
- Federal and state securities law implications
  - Investment contracts under SEC v. W.J. Howey Co.
  - Securities Act of 1933; Securities Exchange Act of 1934 and Blue-Sky Laws
  - Registration exemptions require disclosure of investment risks and federal and state notices of securities issuances, i.e., private placement memorandums and Form D filings

Common Types of Real Estate Ownership Entities and Structures

Limited Liability Companies

Limited Partnerships

General Partnerships

Corporations

Trusts

Sole Proprietorship

Other: REITs; Delaware Statutory Trust; TICs

Limited Liability Companies

- Legal entity that provides limited immunity from personal liability to its members, managers, employees, or agents from debts, obligations, or liabilities of the limited liability company. KRS 275.150
- Operating Agreement
- Managers (i.e., GP) and Members (i.e., LP)
- Preferred entity structure in Kentucky

Pros:

- Flexibility (Managers/GPs and Members/LPs); waiver of traditionally imposed statutory obligations
- Pass through taxation
- Asset protection from 3rd parties (i.e., limited personal liability)
- No restrictions on number or type of investors

Cons:

- Lack of liquidity and restrictions on transfers of membership interests
- Most CRE subscription agreements are irrevocable until there has been a capital event
- Removal of managers by passive investor members

Limited Partnerships

- An association of two or more persons formed under the laws of any state and consisting of one or more general partners and one or more limited partners
- Partnership Agreement
- General Partner(s) and Limited Partner(s)
- The preferred structure until the Kentucky LLC statute passed in the ’80s

Pros:

- Familiarity
- Tax Treatment

Cons:

- Relatively inflexible – a number of “non-waivable provisions” apply to every LP (KRS 362.1-103)
- Fiduciary duties cannot be entirely waived (KRS 362.250)
- GP’s personal liability is effectively unlimited

General Partnerships

- An association of two or more persons to carry on as co-owners of a business for profit

Pros:

- Shared management and control
- No required state filings

Cons:

- Each general partner subject to joint and several personal liability
- Member-managed LLC alternative

Trusts

- A fiduciary arrangement between a grantor, trustee, and trust beneficiary whereby the trustee manages an asset contributed by grantor for the benefit of the beneficiary

Pros:

- Estate planning device
- Tax shield (revocable v. irrevocable)
- Variety of different types of trusts
- Privacy
- Limitations on heirs' ability to control the asset
- Creditor protection

Cons:

- Loss of ownership and control
- Inflexible (i.e., irrevocable trust)

Corporations

- A separate and distinct entity from its owners
- Directors, officers, shareholders
- Bylaws

Pros:

- Corporate veil
- Tax strategy
- Real-estate adjacent operating companies benefit

Cons:

- Real estate, the “bundle of sticks”, also comes with a bundle of liabilities; corporation cannot segregate real estate from its other assets
- Tax treatment
- Burdensome compliance with corporation statutes
- Delegation and compensation for managerial duties

Factors and Considerations When Selecting Entity and Structure

- Number of anticipated Investors
- Degree of investor involvement
- Degree of investor risk exposure
- Jurisdiction of investors (i.e., foreign investors)
- Investment strategy
- Tax treatment
- Equity and debt financing

Tax Treatment

- Pass-through treatment
  - LLC
  - LP
  - GP
  - S-Corp election by corporation
- Non-pass through
  - Corporation
  - C-Corp election
- C-Corp v. S-Corp

Allocation of Profit and Losses

- Profit and Losses typically allocated in accordance with the partner's "distributive share" (IRC § 704)
- Loss allocation is a major tax benefit of owning real estate
- Profits are generally realized upon a capital event (although this varies depending on your strategy)
- Distributive share is determined by the partnership agreement
- Deficit capital accounts – typically real estate JV Operating Agreements will contain a provision stating that members are not required to restore negative capital accounts
- Subject to capital calls and dilution

1031 Exchanges

- IRC Section 1031 allows taxpayers to defer capital gains taxes from the sale of real estate when the taxpayer exchanges the "relinquished property" for qualified "replacement property."
  - The properties are held for productive use in a trade or business or for investment
  - The properties are considered like-kind
  - Holding and closing deadlines/periods are met
  - The taxpayer receiving the replacement property is the same as the taxpayer who exchanged the relinquished property
- Identity requirement and choice of entity:
  - Partners can not take title to replacement property in their individual capacity of relinquished property sold by partnership
  - Individual can not take title to replacement property in an entity if relinquished property sold by individual (except for a single member LLC (PLR 9850001) and revocable trusts (Rev. Proc. 2002-69))

Unique Financing Can Affect Entity Structure (Examples)

- Agency debt – typically requires restrictive language in operating agreement/partnership agreement ensuring compliance with respective programs, and oftentimes requires special manager/member
- New Markets Tax Credits – Community Development Entities created for purposes of capturing tax credit
- Drop and Swap 1031 exchanges – distributing LLC interests in exchange for TIC interest in property
- Low-Income Housing Tax Credits – 99.99% of units issued to tax credit investor members to pass dollar-for-dollar credit through to tax credit investor
- Public Incentives (Generally) – lower the cost of a project and sometimes allow the GP to take larger share in the equity pool
- Mezzanine Debt – subordinated debt that is paid out before LP capital but after primary debt

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