REAL ESTATE JOINT VENTURES INVOLVING PRIVATE EQUITY FUNDS: REGULATORY, STRUCTURING, AND PRACTICAL CONSIDERATIONS

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INTRODUCTION

The real estate joint venture (JV) is an investment vehicle that marries investment or development competence on one hand with capital on the other to invest in a real estate platform. The investment or development competence is supplied by a "sponsor" (the individual or entity that creates, operates, and executes on the business plan for the JV) while the capital is generally supplied by a mix of debt and equity, referred to collectively as the "capital stack."[1] This article focuses primarily on the capital investment (or "LP")[2] arm of the JV, and, more particularly, a specific source of equity: the private equity fund (PE Fund).

In large-scale, commercial real estate investing, there are multiple avenues to fund the equity portion of the capital stack for a project. Most commonly, equity is: (i) self-funded by the project sponsor; (ii) syndicated among "friends-and-family" investors, high-net-worth individuals, or family offices; or (iii) raised by partnering with an institutional partner or fund (collectively, "capital investors"). Very often, these types of investors attribute large portions of their investment portfolio to "alternative investments" (i.e., not traditional publicly-traded stocks, bonds, and cash and cash equivalents)—most notably private equity and real estate.

Real estate is an attractive investment for capital investors because of a variety of important attributes, notably tax efficiency, cash flow, intrinsic value of an underlying hard asset, and a large market of buyers and sellers. Still, real estate investing presents certain risks: (i) real estate investing is a highly capital-intensive business, in comparison to most other types of investments; (ii) real estate investing is highly specialized across asset classes (e.g., retail, office, industrial, hospitality, multifamily, etc.); and (iii) real estate investing is impacted significantly by geographic considerations. The combination of being an attractive investment asset class and being a capital-intensive, specialized business creates a perfect environment for the real estate JV: LP investors are willing to form JVs with sponsors who share disproportionately in the profits due to their ability to execute on a particular investment strategy and their specific knowledge and expertise.

The JV structure is, in its base case, straightforward.[3] The structural considerations become more complex, however, once investors are identified. Different laws and regulations apply, and different accommodations will need to be made, with respect to the JV depending on the nature of the investors. Are they domestic or foreign? What type of entity is investing and with what proclivities? If a US entity, is it tax-exempt or not? If foreign, what is its country of origin and classification status (e.g., sovereign wealth fund, qualified foreign pension fund, bank holding company, insurance company)? More complicated yet, in addition to these other considerations, *what if the LP is a PE Fund*?

This article addresses how JV investing in real estate with a PE Fund (as opposed to other, more traditional, LPs/sources of capital) leads to unique business, formational, transactional, and regulatory implications. To that end, the article provides a general overview of PE Funds, including how they are structured and funded, and explains why the structure and funding of PE Funds matters for JV investing. It also addresses a variety of hot topics impacting JV investing with a private equity fund with an emphasis on the current regulatory environment that must be navigated to ensure compliance with federal and state laws and regulations. Finally, it addresses certain structuring considerations in connection with JV agreements, including those related to management, capital calls and timing considerations, permitted transfers, and exit strategies.

GENERAL DISCUSSION OF PE FUNDS AND INVESTMENTS

What is a PE Fund?

A PE fund is an investment vehicle formed to enable large investors to select a professional investment

manager to invest in primarily "private" investments.[4] While PE Funds can be used for a variety of investment strategies (such as leveraged buyouts, venture capital, M&A, real estate, and others), this article focuses on private equity investing in real estate, through JVs.

How is a PE Fund constructed?

A PE Fund is organized as either a limited liability company (LLC) or limited partnership. The entity is typically formed in Delaware,[5] and an election is made to be taxed as a partnership so taxes on profits are only paid at the partner level, rather than at a corporate level and then again on distributions to partners. As discussed below, however, prudent counselors should keep additional structuring options in mind to address the needs of certain investors to be taxed at a corporation level (e.g., foreign investors and non-profits).

A PE Fund is established by a sponsor and is nearly always set up as a special purpose vehicle (SPV or SPE) subsidiary of the sponsor's main company. The sponsor will also generally provide for itself to have the primary authority to act on behalf of the PE Fund entity, whether as the manager, managing member, or general partner, depending on how the PE Fund is organized (the sponsor is referred to generally herein as the GP).[6] Especially in the context of a limited partnership—in which the GP is truly a general partner—the use of an SPE is important for shielding liability.

Separately, the sponsor will engage an affiliated investment advisory entity through a management agreement or investment advisory agreement (the Investment Manager). The Investment Manager will: (i) run the day-to-day operations of the PE Fund; (ii) employ the team involved in the fund investment services and operations; (iii) evaluate, make, and oversee investments and dispositions; and (iv) complete reporting and administrative functions of the PE Fund. In consideration for these services, the Investment Manager will be reimbursed for its expenses and will be paid an investment management fee (most often one to two percent of assets under management, depending on the track record of the sponsor, size of the PE Fund, and other economic factors). The Investment Manager in a PE Fund is subject to certain regulatory securities requirements, which are described in detail below.

The GP will then seek LP investors to invest in the fund on a "blind pool" basis (i.e., where the fund manager has broad discretion to identify, underwrite, and execute on transactions, potentially subject to certain parameters/mandates set forth in the fund documents). The fund itself does not have direct operations, but rather is an investment holding company that makes investments in portfolio companies or, pertinent to this article, JVs.

It is also important to note that PE funds are structured as closed-end funds, meaning that there is a window of time in which the sponsor raises capital for the fund (typically 12 to 18 months) after which the fund cannot accept new capital. This is one of the distinguishing characteristics that separate PE Funds from hedge funds (which, unlike PE Funds, often allow for capital to flow in and out of the fund on an ongoing basis). Once funds are raised (or during the fund-raising process, depending on the cycle), the "investment period" will begin. The investment period is a finite period of time for the Investment Manager to deploy the capital, typically two to three years from the last capital closing.

Another notable feature of PE Funds is that not all of the capital committed by investors is deposited at the outset of the fund. Rather, investors contractually agree to capital commitments, which are called over time by the Investment Manager when new investment opportunities are selected.

Once the PE Funds have deployed the capital into actual investments, there is a hold period in which investments are held, then liquidated. Most often, the fund has an overall time horizon of 10 years from first closing, and, potentially, an extension right of up to three years. The extension may be at the discretion of the GP or, in some instances, might require approval of an investment committee comprised of the GP and certain key LP investors.

What are the sources of funds for a PE Fund?

Where do PE Funds source their investment dollars? This is where things get interesting and complicated from both a business and legal perspective. PE Funds, by design, are large sources of capital. It is simply too expensive from an organizational and compliance perspective to have PE Funds that do not have some level of scale. This fact alone will generally eliminate smaller, unsophisticated investors from the pool of investors. Additionally, there are also regulatory reasons (discussed below) for why PE Funds tend to only accept funds from certain types of investors, namely: family offices (domestic and foreign), institutional investors such as pension funds, endowments, insurance companies, funds of funds, and sometimes high-net-worth individuals.[7] Thus, the private equity industry has established itself as an attractive alternative-investment option for institutional investors and the lucrative compensation structure for PE Funds has attracted a large portion of the most sophisticated and talented investment managers in the PE and real estate industry.

Why does the source of funds matter? It matters a great deal because the origin and composition of the PE Fund's investors (notably, pension funds, foreign investors, and non-profit investors) have a dramatic impact on the way in which the PE Fund is structured, whether it is to comply with exemptions from complex and cumbersome regulatory requirements or to accomplish preferred tax treatment. For instance, foreign investors and non-profit investors have a particular need to use "blocker entities" set up as corporations (rather than partnerships), in order for tax to be paid at the corporate level before distribution.[8] Accordingly, it is not uncommon in PE Funds to utilize a feeder fund and/or parallel fund structure in addition to the main fund. The feeder fund is established to allow certain investors to invest through a blocker structure before funds are "fed" down to the main fund, while other investors invest directly in the main fund. Alternatively, parallel funds will invest in the same investments and be on the same economic and governance terms, but will invest alongside the main fund, in proportion to their applicable capital commitments.[9]

Why do the structure and funding of a PE Fund matter for JV investing with a PE Fund?

On the spectrum of complexity for obtaining outside equity capital, real estate JV investing with a PE Fund is one of the most complex arrangements. First, in order to attract PE Fund investment into a real estate JV, the project itself must be large, and the sponsor of the JV, in most cases, must have an impressive track record of success and sophistication. PE Funds must deploy large amounts of capital, so they often seek to do so with JV sponsors that are capable of executing on either very large projects or a pipeline of projects (potentially through a programmatic JV).

Second, as a result of being an excellent single-point source for a large equity check (rather than syndicated equity deals), and being managed by highly professional Investment Managers, PE Funds are generally known to drive demanding business and legal terms. Their JV agreement (JVA) forms (typically an LLC Agreement or limited partnership agreement) are onerous documents that provide for tight controls on the activities of the JV sponsor, detailed, affirmative obligations of the JV sponsor (as opposed to a general standard of operation that a sponsor might dictate in a syndicated deal), and powerful economic and management-based remedies for material defaults by the sponsor.

Third, in a real estate JV with a PE Fund, the JV sponsor may also need to accommodate certain structuring needs of the PE Fund. For example, rather than a simple organizational structure where the JV sponsor is the Managing Member or Manager of the LLC with only one other member, the other members may include both the main fund and a parallel fund, or it might include additional related fund entities (e.g., a co-investment entity comprised of some of, but not all of, the investors in the main fund). The PE Fund investor in a real estate JV may also require other structural changes from a traditional JV to help with tax structuring. One such structure commonly

employed when there are foreign investors is the use of a so-called "baby-REIT." In this structure, a single-property JV may be established as a real estate investment trust (REIT). Upon exit, the REIT entity itself is sold, rather than selling the property, in order to mitigate tax issues for foreign investors under the Foreign Investment in Real Property Tax Act (FIRPTA) (discussed below).

Fourth, while regulatory compliance at the PE Fund level is the obligation of the Investment Manager of the PE Fund and not the sponsor of the real estate JV, the real estate JV sponsor needs to be aware of the implications of a regulatory foot fault by the PE Fund. For example, a failure of the PE Fund to avoid exemption from ERISA (when accepting investments from pension funds), as discussed in greater detail below, can result in the underlying investments (i.e., the real estate JV) being considered plan assets of the pension fund, thus pushing down burdensome fiduciary obligations, reporting requirements and limitations on related party transactions. This can be mitigated through representations, warranties, and covenants on behalf of the PE Fund investor in the JVA (if the sponsor has the negotiating strength to get such terms), but a failure of the PE Fund to prevent the issue may not be resolved through typical contract remedies in favor of the JV sponsor.

Finally, the finite nature of a PE Fund's lifecycle may impact whether it is a good partner for a particular type of real estate JV (as noted above, the total life of the PE Fund is about 10 years from first closing, sometimes with a limited extension right). This needs to be taken into account by both the PE Fund considering a JV investment and the sponsor of the JV to determine if the PE Fund's time constraints align with the time horizon of the proposed investment by the JV. In some instances, the business plan for a JV investment may have a relatively long lifecycle (consider a development deal or a major value add transformation project). This can be navigated, but the JV sponsor should not assume that a PE Fund investor will be willing or able to hold its investment for the long term.

What type of investment platform is it?

There are multiple forms a real estate JV may take based upon the nature of the platform. Is the JV for a one-off investment transaction, or for multiple investments (i.e., programmatic)? Is the investment an acquisition of an existing stabilized asset, an existing asset that must be redeveloped/repositioned, or is it a ground-up development project? Does the JV involve a single PE Fund or multiple funds? All of these factors will impact whether a PE Fund is the right investment partner for a JV sponsor and determine how the JV organizational documents and business deal will be structured.

In the simplest case, the JV would include a one-off investment in a single property that is already stabilized and cash flowing. In that case, the deal is pretty simple, the sponsor/GP puts up a small amount of cash equity (or none, in rare circumstances) and the PE Fund investor puts up the remaining equity. For ease of example, say the equity split is 90/10, where the LP invests 90 percent of the capital and the GP invests 10 percent. The GP will likely be compensated through fee income, which fees may include an acquisition fee, financing fee, asset management fee, leasing and property management fees, or a combination thereof, plus a "promote" or "carried interest" intended to compensate the GP for its "sweat equity" and expertise. The goal of this article is not to provide an exhaustive summary of the variety of economic models; there are entire articles dedicated to JV economics and distribution waterfalls. That said, a very typical distribution waterfall for this type of transaction (on liquidation or other liquidity event), would be as follows[10]:

- Return of capital: Distributions are first paid to the LP and GP until their invested capital is returned.
- Preferred return on Capital: Accrued preferred return (eight to 10 percent is common in real estate JVs) is paid to the investors on their respective capital contributions.
- Promote catch-up: All or a major portion of the next tranche of distributions are paid to sponsor

until it receives a percentage (often 20 percent) of the total returns.

- Adjusted allocations: If there are remaining funds to be distributed after the promote catch-up tranche, then the remaining funds are distributed according to a new allocation that does not match the capital contributed (e.g., 80 percent to LP, 20 percent to the GP).

In a programmatic JV (i.e., a JV that is created to invest in multiple investments over time), there are a number of other complexities that will need to be addressed. As a preliminary matter, however, it is important to understand why programmatic JVs are valuable. For real estate sponsors, having a reliable and available source of capital is an enormous benefit. It allows for a more systematic and deliberate approach to deal sourcing, or, in a development context, it allows the sponsor to pursue multiple projects that take many months or even years to gestate, without the major unknown of where it will source the equity to execute on the deal. For the LP, there is great value in the consistency of having a sophisticated sponsor who is capable of executing on a number of transactions, rather than needing to spread the sponsor relationships too broadly or investing in a haphazard manner. This value is accentuated if executing in a particularly specialized asset class or a competitive geographic area.

One complexity that should be emphasized is that, from a structuring perspective, programmatic JVs have the challenge of measuring performance and allocating distributions over a number of deals and longer time horizon. Consider this: what if one project creates enormous profit (thus earning the GP a significant promote) and the next several investments suffer and lose money? Considerable time during the negotiation of JVAs for programmatic JVs is spent on determining appropriate allocation of carried interest, clawbacks, and/or backloading the promote (European style), assuming a holding company approach is used for the JVA.

Another complexity is that a programmatic JV can be structured as a framework for doing deals together. As part of the overall relationship, there will likely exist some level of exclusivity, ranging from complete exclusivity for a period of time (e.g., the sponsor can only present and do deals with the LP) to some lesser type of exclusivity where the LP has a right of first offer on future deals, perhaps within certain parameters. Programmatic JVs, in this respect and others, can be thought of as a marriage of sorts, so a significant amount of negotiation goes into the parameters of the longer-term relationship between the parties, especially what happens if the relationship ultimately ends in a divorce.

Development JVs occupy a separate universe altogether. Development deals naturally take several years to pay off, and they have additional risks associated with permitting, construction, supply chain issues, and lack of cash flow until the project is completed and leased. As a result, development JVs are inherently riskier investments than simply purchasing a project with existing cash flow. In fact, there are many LP investors who categorically will not invest in development transactions. That said, if an investor does not need cash flow, has a higher tolerance for risk, and places a high value on capital appreciation, development JVs can be very lucrative and outpace the performance of stabilized real estate, especially if partnering with the right sponsor. The sponsor in a development JV contributes much more value to the enterprise than a sponsor who simply finds, underwrites, acquires, and manages an existing asset. A development sponsor must understand acquisitions (and sometimes assemblage), how to navigate local governments and the entitlement process, as well as construction and leasing. Accordingly, the compensation to the sponsor—whether through a development fee or carried interest—can often be more significant.

Other important considerations

As noted above, an issue of particular importance when considering whether a PE Fund should invest in a development JV is how long the PE Fund has left in its fund life and how long the parties anticipate it will be until an exit from the asset will occur. When evaluating the timeline, it is helpful to think about the worst-case scenarios playing out, taking into

account potential for delays in permitting, construction, lease-up, stabilization, and exit.

Another material negotiating point in a development JV is the economic impact of future capital calls, especially for project cost overruns. What happens if there is a major change in the budget and the GP cannot fund its proportionate share of the capital? Some key considerations in that instance are whether the failure by the GP to fund is a default by the GP, and whether the additional capital contributed by the LP is considered a member loan or additional equity. If it is equity, the parties will negotiate whether the dilution effect is punitive and whether such additional capital will have preferred status and rate of return in the distribution waterfall.

Further, what happens if that budget issue was caused by the ineptitude or failed performance by the GP (or its affiliate that serves as the development manager)? It is very challenging to remove a GP in the event of a major default. That difficulty is compounded when removing a GP who is in the middle of providing development services and who is likely a guarantor on the construction loan. Accordingly, there may be multiple "doomsday" type remedies for the LP in the case of a major default by the GP in a development deal, including loss of some or all of the promote and removal from management. When negotiating these provisions, the GP will need to consider the impact of losing these rights and the fact that the GP will likely be the loan guarantor under the construction loan. Being removed from management and the development manager role while still being a guarantor is a dangerous proposition for the GP since it may become liable for matters it can no longer control and has no seat at the bargaining table with the lender.

HOT TOPICS TO CONSIDER RELATED TO INVESTOR CONSIDERATIONS/COMPLIANCE

There are several considerations—both regulatory and non-regulatory—to take into account when considering the investments by outside investors in a fund or JV structure. We outline several of them below, noting that a deeper dive into each is required.

SEC registration

A question that must be answered in each instance for real estate funds (and sometimes in JVs) is whether the investments are securities and, if so, whether the fund manager needs to take certain steps for the fund and the fund manager to comply with securities laws and regulations. In the US, there are two primary regulations upon which managers must focus: the Investment Advisers Act of 1940, as amended (the Advisers Act) (which relates to fund managers) and the Investment Company Act of 1940, as amended (the Investment Company Act) (which relates to the fund itself).

The Advisers Act defines an "investment adviser"[11] as any person who, for compensation, engages in the business of advising others regarding the value of, or investing in, "securities." Investment advisers of a certain size (generally over $100 million in AUM) are required to register with the SEC unless they qualify for an exemption.

The main question for fund managers is whether their investment advisory activities pertain to securities. While real estate itself is not a security, the definition of security[12] in the Advisers Act is broad. Real estate fund managers focus primarily on whether the target asset or instrument is an "investment contract," which is included in the definition of securities. This becomes a facts-and-circumstances analysis in each instance based on the *Howey* test,[13] which was created by the US Supreme Court to determine whether a particular transaction is an "investment contract." Under *SEC v. Howey Co.*, an "investment contract" is defined as being a contract, transaction, or scheme whereby a person:

- Invests money;
- In a common enterprise;
- Is led to expect profits;
- Solely from the efforts of the promoter or a third party.

With this broad definition, many real estate fund interests could be securities, though investing directly in fee simple real estate (or wholly-owned entities that own real estate) suggests that the real estate fund is not a security. Consequently, pre-2010, many fund managers relied on exemptions to the Advisers Act to avoid registration as an investment adviser. The implementation of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act resulted in changes to the Advisers Act, however, and brought greater scrutiny and reporting obligations upon real estate investment advisers. As such, a greater number of real estate fund managers have registered with the SEC as registered investment advisors.

The second main regulatory framework, the Investment Company Act, defines "investment companies"[14] as being an issuer that holds itself out as investing in or holding securities, or where the amount of securities that it holds exceeds 40 percent of its total assets. Funds that own real estate, again, arguably do not own securities, though funds that own interests in other entities (such as partnership interests) may be construed as owning securities, and thus require registration.

Exemptions for registration also exist for real estate funds under the Investment Company Act, with the main exemptions being under section 3(c)(1) [funds offering interests privately to accredited investors (less than 100 shareholders)] and section 3(c)(7) (funds offering interests privately to qualified purchasers). Some funds are also able to qualify for exemption under section 3(c)(5)(C), which provides an exemption for funds that are primarily real estate funds if they hold a threshold amount of "Qualifying Interests" assets (55 percent are real estate assets), up to 25 percent of other real-estate-related assets and up to 20 percent of any other assets.

There are also similar state laws that may be applicable to the fund advisor and fund in a particular instance.

Conflicts of interest

Increased registration and scrutiny from the SEC, together with growing sophistication and awareness of institutional investors, has heightened focus on areas of potential conflicts of interest for real estate fund managers. There are several areas of focus for risk here, all of which can be mitigated by full disclosure up front to potential investors in an ongoing context. These include:

Affiliate Fees: Real estate fund managers are often a part of vertically integrated companies, with different business lines that seek to support the investments of the fund. For instance, a fund manager may also have an affiliate property manager or other service provider. Key concerns include whether the arrangements with affiliates are market, and whether the affiliates retained are qualified to perform the services rendered. Each should be confirmed with detail by the fund managers.

Management Fee Income: Real estate managers should disclose when and how management fees would be structured and paid and any deviations in fees paid—whether through other structures like co-investments, separate accounts or the like—should be disclosed up front.

Expenses and Expense Allocations and Reimbursements: Real estate fund managers often want to allocate overhead and certain internal expenses to the fund, under the theory that the use of personnel or the expenses are for the benefit of the fund, and would otherwise be charges from third parties if incurred. Likewise, fund managers may want to allocate third-party expenses to the fund in certain instances. In all such instances, such fees should be disclosed clearly, and incurred subject to a consistent written policy that sets forth the reasonableness of such incurrences.

Economic Adjustments: Real estate funds often have separate distribution waterfalls for cash flow and capital proceeds on the theory that if the investments are cash-flowing greater than the preferred return, then the fund manager should be paid a promote share from such cash flow. In certain instances,

there are true-ups and holdbacks related to a promote being advanced before final resolution of the economics, all of which should be disclosed.

In each instance, policies and approaches should be documented and set forth initially in the fund process. Specific transactional contexts, such as continuation funds, principal transactions, and portfolio sales where proceeds may be allocated across different assets, all give rise to additional conflicts of interest that have received heightened scrutiny from the SEC, investors, and industry bodies.[15]

OFAC/Anti-money laundering compliance

Typical anti-money laundering and compliance provisions will apply to each investor and investment. Sponsors, fund managers, and funds will need to confirm compliance with all applicable Anti-Money Laundering (AML) Laws and Economic Sanctions Laws. The AML laws include the requirements of the Bank Secrecy Act, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot Act) of 2001 (Patriot Act), the Money Laundering Control Act of 1986, and the Anti-Money Laundering Act of 2020 (AMLA 2020).

The Economic Sanctions Laws include the requirements of the US Department of the Treasury Office of Foreign Asset Controls' (OFAC) Foreign Assets Control Regulations, including Executive Order No. 13224,[16] OFAC's Specially Designated National and Blocked Persons Lists, and any enabling legislation or other executive orders or regulations in respect thereof (collectively the "Orders").

A part of this evaluation is whether investors, their interest holders (usually those controlling or over a certain threshold ownership amount), and beneficial owners are listed on any of the sanctions lists, blocked persons lists, or any other list of terrorists, terrorist organizations, or narcotics traffickers maintained pursuant to any of the OFAC rules and regulations, or maintained by any other government or agency thereof,[17] and include covenants of compliance in the future for investors. The evaluation also covers whether the source of funds used to make the investment are derived from specified unlawful activities as defined by the Money Laundering Control Act, and whether the investor has complied with applicable AML obligations under the Bank Secrecy Act, Patriot Act, or AMLA of 2001.

ERISA

Certain US private employee benefit plans (e.g., corporate pensions) are subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA). ERISA and the Department of Labor's regulations issued thereunder govern how such an employee benefit plan's assets can be invested and transacted with other parties. When such a US private plan (or an entity that is deemed to hold "plan assets") invests in a fund, both the fund and fund manager should determine whether ERISA applies and, if it does apply, comply with its requirements in operating the fund.

Absent an exemption or an exclusion,[18] when a US employee benefit plan subject to ERISA invests in the equity of another entity, the plan's assets[19] include both the equity interest in the entity and an undivided interest in each of the underlying assets of the entity. Real estate funds often rely on one of three exemptions: (i) venture capital operating company (VCOC); (ii) real estate operating company (REOC); or (iii) insignificant equity participation by benefit plan investors (commonly known as the "25 percent test"). Both the VCOC and REOC exemptions require the fund manager to invest in a specific manner as of the initial long-term investment and then meet certain compliance measures annually thereafter. For example, in the context of a REOC, the fund manager's first long-term investment would need to be an investment in assets valued which are at least 50 percent (valued at cost) in real estate which is managed and developed, and with respect to which the fund has the right to substantially participate directly in the management or development activities. This is a factually driven analysis.[20] Compliance with the 25 percent test does not bear on the fund manager's investment activities; instead, it looks to the composition of the investors in the fund. The 25 percent test requires that less than 25 percent

of the value of any class of equity in the fund be held by "benefit plan investors,"[21] disregarding any person (other than a benefit plan investor) who has discretionary authority or control with respect to the assets of the fund or any person who provides investment advice for a fee with respect to fund assets and their respective affiliates.

If the fund does not satisfy the requirements for an exemption, the fund will be considered to be "plan assets" and the sponsor and fund manager will likely be fiduciaries of such plan assets. Specifically, ERISA provides that a person is an ERISA fiduciary if that person: (i) exercises discretionary authority or control over the management or disposition of a plan asset; or (ii) provides investment advice with respect to a plan asset for a fee (direct or indirect). Should the sponsor or fund manager find itself as an ERISA fiduciary, it would affect how the fund would need to be operated, in particular regarding the standard of care owed to investors and how transactions are completed. ERISA provides that a "fiduciary shall discharge his duties with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims" and act solely in the interest of plan participants and beneficiaries.[22] In contrast, most sponsors and fund managers that are not deemed to manage plan assets are subject to a gross negligence standard.

Further, ERISA provides that ERISA fiduciaries must avoid prohibited transactions, which include transactions between an ERISA plan and a party in interest or an ERISA fiduciary.[23] Prohibited transactions include sale, exchange, or leasing of real property, and the definition of "party in interest" is very broad (e.g., including all service providers to the plan). All such transactions are prohibited unless there is an applicable prohibited transaction exemption. As with the plan asset analysis, each prohibited transaction analysis is fact-driven and individual. Many transactions typical to a real estate fund, such as a fund manager transacting with affiliates, may not have applicable exemptions and would therefore be prohibited. The ramifications of entering into a prohibited transaction are significant and could include a variety of remedies in addition to exposure for breaches of fiduciary duty, including civil penalties, excise taxes, make-whole provisions, and unwinding of transactions.

Tax/structure considerations

Tax considerations are a primary driver of investment structure. Most fund vehicles and JV entities are themselves partnerships for tax purposes, resulting in a "flow through" of tax items to investors. Consequently, depending on their tax profile, investors will typically demand structures that promote tax efficiency and mitigate certain adverse tax consequences that could otherwise result from an investment. This may include covenants and obligations on the part of the fund and sponsor or fund manager that ensure tax compliance and minimization of tax upon exit events. The fund or JV may also need to make "tax distributions" to investors who will owe tax irrespective of whether the economic waterfall provisions of the operating agreements would otherwise mandate distributions.

US tax-exempt investors, such as qualified pension, profit-sharing, and stock bonus plans, certain educational institutions and their affiliated support organizations, and certain other tax-exempt entities, are subject to US federal income taxation on their unrelated business taxable income (UBTI) in excess of $1,000 during any tax year. Subject to certain exceptions, UBTI is defined as the gross income derived by such a tax-exempt entity from an unrelated trade or business (including a trade or business conducted by a partnership of which the tax-exempt entity is a partner), less the deductions directly connected with that trade or business. Accordingly, if the investments of a fund or JV generate UBTI, then the UBTI would be passed through from the fund to the investors, and those tax-exempt investors would have to pay tax on that UBTI. Many investors are not organized in such a way to easily pay these taxes, and a small amount of UBTI can create a large issue for a tax-exempt investor. It should be noted that where a JV holds its assets through a REIT, UBTI will generally not be a concern.

While passive categories of income such as interest and dividends are generally not treated as UBTI, an "override" rule exists which treats as UBTI any income or gain that is "debt financed." Since real estate is a highly leveraged asset class, the debt-financed UBTI rules are of particular concern to UBTI-allergic investors.

UBTI can also arise from other circumstances, such as property being "dealer property" under the regulations.

Structural solutions do exist in addressing UBTI in certain circumstances. These include (for US pension funds and certain endowments) structuring the transaction to comply with the Fractions Rule,[24] owning the assets through a blocker entity or a REIT, or structuring the fund or JV and its investments in such a way so that the UBTI-generating investments are excluded from the tax-exempt entity's ownership. It should be noted that the benefit of these structures is that the blocker (or REIT) would then file tax returns and serve to "block" any allocation of UBTI to the tax-exempt stakeholder. However, the blocker (but not the REIT, as described below) would be subject to US tax on its net income at regular corporate tax rates. All of the above structures require managers, sponsors, and investors to establish what is needed for a particular investor and protocols for reporting and filing UBTI-related forms (including the 990-T, if required).

While a REIT is not itself subject to an entity level tax (thereby creating the opportunity for blocking UBTI without tax leakage), REIT compliance is, itself, expensive, and not every investment strategy is "REIT-able." Where a REIT structure is available and the parties understand the costs, REITs can provide the greatest flexibility for funds, including for foreign investors as described further below. REITs, however, come with their own requirements, including: (i) ownership tests that begin in the REIT's second taxable year;[25] achieving two yearly gross income tests;[26] and one quarterly total asset value test;[27] and (ii) not undertaking certain "prohibited transactions" (essentially, dealer sales) that would attract a punitive 100 percent tax. Structuring for a REIT includes addressing these issues in the definitive documents, as well as ensuring that a compliance system is set up to ensure regular monitoring of the ongoing REIT requirements. The cost of REIT failure is being taxed as a regular C corporation, subject to an entity-level US tax. It should also be noted that a REIT may itself be a member of a fund or JV, which often requires the fund/JV to agree to operate in a manner that produces qualifying REIT income (since, as described above, the fund is typically a pass-through entity).

Foreign investor concerns

Non-US based investors have additional concerns regarding tax. Specifically, foreign persons are subject to US federal income tax on a net basis to the extent they earn income that is treated as "effectively connected" to a US trade or business (ECI), which includes trade or business activities conducted by one or more partnerships or flow-through entities (such as a fund/JV) in which the foreign investor is a member/partner. Real estate related gains are also deemed to be ECI under FIRPTA.[28]

Under FIRPTA, generally, persons (as the term is defined under the FIRPTA legislation) purchasing US real property interests (transferees) from foreign persons, certain purchasers' agents, and settlement officers are required to withhold 15 percent of the amount realized on the disposition. In most cases, the buyer is the withholding person, and if the tax is not withheld from the seller's proceeds, the buyer is responsible for that tax.

Many consider FIRPTA to be unfair, creating an unlevel playing field between US and foreign investors as a result. Thus, much structuring is done in transactions involving foreign investors to minimize the impact of FIRPTA, including structuring the investment to use leverage, REITs, blockers, or leveraged blockers.

Additionally, for certain investors that are non-US corporations, a branch profits tax will apply to income that is treated as ECI. Branch profits taxes are intended to level the playing field for a non-US investor by having it pay the equivalent of the US tax

it would have paid had it been selling through a US branch instead of a foreign entity. In some cases, ECI plus branch profits taxes can cause the effective tax rate paid by a non-US investor to exceed 50 percent.

As a result of these concerns, foreign investors often require special structures be put in place and covenants made to preserve the tax efficiency of their investments.

Identifying the domicile of the investor, and what laws and treaties might apply to it, is a critical first step in each investment.

The world of foreign investors is not a monolith. Different rules and different options may apply depending upon the type of investor. For instance, sovereign wealth funds and qualified foreign pension funds have different rules that apply to them as compared to private foreign investors. While several of the tax efficiency techniques to address each of their concerns is similar, the identification of the type of entity and the applicable provisions is of primary importance when initially structuring a fund, JV, or an investment for each.

For governmental entities, section 892 of the Internal Revenue Code (Code) provides that income to foreign governments is exempt from tax, unless it is derived from commercial purposes within the United States.[29] This includes income for sovereign wealth funds from a "controlled commercial entity."[30] Sovereign wealth funds will often require investments where they hold less than 50 percent of the interests and structure the management and decision-making of the asset so as not to result in "effective control" of the entity. Once the sovereign investor holds less than 50 percent and isn't in control, then any blocker or REIT structure works; however, under FIRPTA, the investor will still try and avoid asset-level sales (and subsequent REIT distributions) and will instead insist on exits being structured as sales of REIT shares.

Another type of special foreign investor is the qualified foreign pension fund (QFP). 2015 legislation created QFPs, which are generally exempted from the application of the FIRPTA rules. A QFP must satisfy a number of requirements. Once qualified, these investors will insist on REIT structures, but unlike section 892 investors, they will not require REIT share sales. They will, however, remain subject to withholding on ordinary dividends from a REIT unless treaty rates are available.

Other foreign investors may or may not be eligible for the benefits of any treaty. These investors will focus on the nature of the income being earned, the tax classification of the fund's entities (including whether they are fiscally transparent in a manner that allows for treaty benefits to be claimed), as well as other factors that determine ECI and treaty eligibility. Typical structures that mitigate ECI and FIRPTA include "leveraged blocker" entities. These entities are corporations that have related party debt from the fund investors, thereby creating some interest deductions without impacting economics. These structures require careful planning, transfer pricing analyses, and also an analysis of certain interest limitation rules under the Code. Various exceptions and qualifications from withholding may be available in these structures. The leveraged blocker structure, as well as REITs and tax haven feeder funds, all involve complexity, and the applicability and value in each instance must be considered on a case-by-case basis.

With each structure comes reporting and maintenance requirements for fund managers. Each should be examined closely when considering foreign investors.

The Committee on Foreign Investment in the United States (CFIUS) is an interagency committee authorized to review certain transactions involving foreign investment in the United States and certain real estate transactions by foreign persons, in order to determine the effect of such transactions on the national security of the United States.[31]

Historically, CFIUS was not an active agency (although authorized to exercise broad powers if it chose to pursue them). CFIUS filings were voluntary, though CFIUS could pursue enforcement if it chose to do so. But with the passage of The Foreign

Investment Risk Review Modernization Act of 2018 (FIRRMA) and the promulgation of its regulations, increased attention has been brought to foreign investments in real estate, including increased regulatory activity.

Specifically, in February 2020, CFIUS implemented three changes that have a significant impact on foreign investments in real estate.

First, in addition to the voluntary ability to file with CFIUS, parties are now required to notify CFIUS if there will be foreign investment in US businesses that: (i) produce, design, test, manufacture, fabricate, or develop one or more critical technologies; (ii) own, operate, manufacture, supply, or service critical infrastructure; or (iii) maintain or collect identifiable sensitive personal data of US citizens (e.g., hotel guests' bank information, hotel app users' geolocation information, hotel spa customers' health information). These US businesses are referred to as "TID US Businesses." Subject to certain exceptions for fund investments, there is a mandatory filing requirement if the foreign investor: (i) acquires a 25 percent or greater interest in a TID US business; and (ii) is ultimately owned 49 percent of greater by a foreign government.

Second, CFIUS now has express "real estate jurisdiction." Before, CFIUS jurisdiction was over US businesses, which raised questions as to whether investment in real estate by a foreign investor in and of itself would give rise to CFIUS jurisdiction.

Third, CFIUS has increased its enforcement capabilities. Congress has allocated significant funding increases to CFIUS for these purposes. The result has been a significant increase in actions pursued by CFIUS. While all CFIUS actions are not public, the general consensus is that CFIUS is far more active today in blocking, adjusting, or forcing divestment in transactions than ever before.

JV STRUCTURING CONSIDERATIONS

The following section covers a few structuring considerations related to JV agreements, with particular attention to some provisions that may be affected when the LP is a PE Fund. These are but a few of the areas in the JV agreement that may be affected by having a PE Fund participate as an LP. As with the hot topics covered above, we note that in each instance a deeper dive into each and its particulars is required.

Management structure

As discussed earlier, the majority of real estate JVs are structured as Delaware LLCs, and Delaware LLC law provides a lot of flexibility in how to structure the management of the LLC. The LLC could be structured to be managed by a board of managers, a managing member (which would typically be the sponsor/GP), co-managing members, or even an outside manager.

If the LLC is structured with the sponsor/GP acting as the managing member, the sponsor/GP handles the day-to-day management of the JV, with certain key decisions subject to approval of the LP(s). By giving the managing member control over routine decision making, this type of a structure can enable quick decision making and can help avoid deadlocks. An LP, however, may be given the right to remove the sponsor/GP in certain instances following material default or failure to achieve certain results.

Alternatively, the JV could be managed by a board of managers, which is typically comprised of individuals closely affiliated with the GP and LPs. Under this structure, the board generally would not make all of the day-to-day decisions, but would instead grant authority for most day-to-day decisions to one or more officers of the LLC, albeit reserving major decision-making authority for the board. The board usually includes representatives from multiple members, or possibly from each of the members, and the number of board positions that a member may appoint is often proportionate to that member's interest in the LLC. Often, board members may be removed and replaced by the JV member that appointed them to the board.

The LLC agreement will set forth the parameters for the operations of the board, such as how often the

board will meet, voting requirements, the definition of a quorum, who can call meetings of the board, when meetings of the board can be called, board meeting notice requirements, and how the board can conduct business outside of regular meetings.

Although a JV could be structured with co-managing members, you would not expect to see this type of structure if the JV is comprised of a single GP and a single PE Fund LP. In a co-managing member structure, multiple members co-manage the LLC, which involves active involvement in the management of the entity. Management of a JV could be structured with a third-party hired manager which is not one of the members, although that would also be unlikely for the type of real estate JVs discussed in this article.

Capital calls and subscription finance facilities

A capital call is the right to compel investors to contribute additional capital to the JV. Almost all real estate JV agreements include provisions for future capital calls in the event that the JV finds itself in the position of needing additional capital to complete construction or otherwise to pay operating expenses, although there are often limitations on when capital calls can be made. Capital calls can either be "anticipated," based on a pre-determined schedule, or "unanticipated," based on unanticipated or changed circumstances. For example, capital calls could be triggered based on the project going over budget due to price escalations or unforeseen expenses because of a drop in occupancy rates and associated rental income, or due to increased costs of financing.

JV agreements will likely include penalties in the event that a party fails or refuses to make a required capital contribution. If another party does make the capital contribution, the contributing party may receive a preferential return on the additional capital or may be permitted to treat the funding as a loan to the JV with priority over distributions and other payments to the investors. In addition, the non-contributing/defaulting member may have its interest in the JV punitively diluted. Further penalties for failure to contribute additional capital could include loss of promote, claw-backs of fees that were previously paid to a party, or claims related to breach of contract.

When entering into the JV agreement, an LP needs to be prepared for potential future capital calls and needs to ensure that it will have quick access to cash in order to timely provide additional capital if required to avoid the potential consequences discussed above. One such solution is a capital call facility, also known as a subscription finance facility. This type of facility is a revolving line of credit that may be available to a PE Fund to bridge the timing gap between the deadline required for contributing additional capital into the JV and the receipt of additional capital into the PE Fund to pay for such capital call.

While subscription finance facilities can be structured in multiple ways, lenders may require that the facility be secured by collateral, including the investors' outstanding capital commitments, bank accounts, and rights of the fund to require and enforce the investors' capital commitment requirements. The lender may exclude some of the investors and their capital commitment requirements from its calculations of the value of the collateral. Factors that lenders consider in determining whether to exclude an investor may include the investor's net worth, credit rating, and other typical bank underwriting criteria. The facility may also include the right to exclude investors after the facility closes for subsequent events such as bankruptcy, disputes with the fund over the investor's requirement to contribute, or a material deterioration in the financial status of the investor.

Permitted transfers

Most JV agreements include some limitations on the ability of the members to transfer their interests in the entity. In addition to restrictions on the parties regarding which transfers may occur, JV agreements may also restrict when those transfers may occur and may require the parties to wait some period of time before transfers can be made. That said, albeit

with limitations, there are usually some transfers permitted from the start of the JV, such as affiliate transfers or transfers for estate planning purposes.

When drafting the JV agreement, it is important to understand that the sponsor/GP and LP often have different concerns and considerations when it comes to permitted and prohibited transfers. Many LPs desire increased flexibility on transfers at upper levels. In addition, they often desire limitations on the sponsor/GP's ability to transfer its interest. At the least, the sponsor/GP will often desire the ability to be able to make transfers to affiliates or (depending on the entity structure, likely at upper tiers) for estate planning purposes. The sponsor/GP may also desire that the LP be required to remain obligated for additional capital contributions even if the LP makes a transfer to an affiliated entity.

Some JV agreements will contain additional pre-approved transfers, which may be subject to satisfaction of certain conditions before the transfer can occur. These conditions may include express requirements for compliance with laws, including compliance with the OFAC and anti-money laundering regulations discussed above, prohibitions on transfers to competitors of other members, and threshold financial requirements of the transferee.

Further, if the LP is a PE Fund, it may desire to include permitted transfers that tie to the Investment Manager, such as permitting transfers to the Investment Manager, advisees of the Investment Manager, wholly-owned subsidiaries of the Investment Manager, or entities controlled by or under common control with the Investment Manager.

Exit mechanisms

Although some might argue that pre-negotiated exit strategies make it too simple for a party to make an early exit from a deal, it is common for a real estate JV agreement to include a mechanism for the parties to part ways before the planned disposition of the asset. There are multiple types of exit provisions that are commonly used in JV agreements. Before deciding on which one to use in a particular JV agreement, consideration should be given to determine the correct exit mechanism for the particular deal.

As previously mentioned, it is typical for a PE Fund to have a duration of 10 years from the first closing, with some possible short-term extensions. This shorter life cycle needs to be considered when a PE Fund invests as an LP in a real estate JV. It is important for the sponsor/GP to consider whether the anticipated remaining life of the PE Fund aligns with the anticipated project life cycle. Even if the timing does align and is not an issue for the JV, the parties should account for what happens if one party wants or needs to exit the deal early.

Although it is less likely for an early exit strategy to be used than not, a pre-agreed upon exit strategy enables the parties to part ways if irreconcilable differences, deadlocks, or changes in capital strategies, among other conditions leading to an early exit, arise. Properly and thoughtfully addressing these issues on the front end can make the overall relationship between the parties much easier in the long run.

There are numerous factors to consider when determining what type of exit mechanism works best for a particular deal. These factors include the legal structure of the parties, tax matters, time constraints on the funds being invested, overall liquidity of the parties, anticipated ability to find replacement equity for the project, and the parties' long-term plan for continued participation in the project, to name a few. Some of the common exit mechanisms include: (i) buy/sell provisions; (ii) put/call provisions; and (iii) tag-along and drag-along rights. Some considerations related to these are addressed below.

Although no two buy/sell provisions are exactly the same, buy/sell provisions typically involve either the sponsor/GP or an LP sending a notice to the other party triggering a set period of time during which the other party either must sell its interest in the JV to the triggering party or must buy the triggering party's interest in the JV. The JV agreement will include a mechanism for determining the price that must be paid under the buy/sell transaction, and the

triggering party's calculation of the purchase/sales price is generally required to be included in the notice triggering the buy/sell transaction.

Buy/sell provisions typically incentivize the calculation of a fair price pursuant to the methodology set forth in the JV agreement. The party triggering the buy/sell transaction does not know when it sends the triggering notice whether such triggering party will be the buyer or the seller. Because of that, parties are generally incentivized to be fair in calculating any grey areas in their calculation of the purchase/sales price. This principal loses some effectiveness, however, if one of the parties is more likely to be the buyer in a potential buy/sell transaction. If such party is aware of that disparity, such party may be less incentivized to put forth a fair calculation of the purchase/sales price.

Intuition may tell you that the larger and more capitalized a party, the more likely for that party to elect to buy as opposed to sell. This, however, may not prove to be true when dealing with a PE Fund, even if it is a relatively large fund. The limited duration of the PE fund could hinder its ability to elect to buy under a buy/sell arrangement. Consideration should be given to the anticipated timing of the JV in conjunction with the remaining life of the PE Fund to determine whether this mechanism makes sense for the parties.

Buy/sell provisions can be drafted as standalone provisions that could be exercised at any time or after certain time periods or certain thresholds. Buy/sell provisions are also sometimes included as remedies following the default by a party to the JV agreement.

Another common exit mechanism is a put/call provision. Put/call provisions generally give a party the right to require another party to purchase its interest (referred to as a "put"), and can also include the right of a party to require another party to sell its interest (referred to as a "call"). A JV agreement may contain both put and call rights or only one or the other. Purchase/sales price calculations under put/call provisions may require appraisals for determination of the fair market value, and this process can take some time.

Similar to buy/sell provisions, these provisions may be drafted as standalone provisions triggered by timing or achieving certain thresholds or as remedies following default.

In considering whether to include put/call provisions in the JV agreement, the parties should consider whether the sponsor/GP will have an advantage based on more in-depth day-to-day knowledge of the asset and whether there are concerns about either party being able to unreasonably manipulate the process based on the timing of its exercise of the put/call.

JV agreements may also include tag-along rights and drag-along rights. Tag-along rights allow a minority interest holder to "tag along" with the majority interest holder in the sale of interests in the JV. Tag-along rights do not require the minority interest holder to participate in the sale, but instead give the minority interest holder the ability to do so.

To the contrary, drag-along rights give one party the right to force the other to join in the sale of the interests of the JV on the terms negotiated by the party doing the dragging. Drag-along rights are generally designed to protect majority interest holders. Drag-along rights provide the ability of one party to negotiate the sale of the entire JV, as opposed to just that party's interests in the JV.

Because tag-along and drag-along rights are generally structured such that the party being dragged along or the party tagging along gets equal treatment to the other party, these rights work more smoothly when the economic interests in the JV of the sponsor/GP and LP are closely aligned and there are not a lot of disproportionate distributions built into the JV agreement. If the economic interests and distribution structures vary greatly between the parties, care needs to be taken in drafting these provisions to account for those differences.

Notwithstanding the inclusion of a pre-negotiated exit mechanism in the JV agreement, the parties

may still end up in a scenario where they cannot be exercised. For example, lenders almost always include restrictions on transfers of ownership interests. The financing documents for the project may prohibit the exercise of the pre-negotiated exits, or may impose a requirement to obtain lender consent prior to exercising the rights. However, the parties may be able to negotiate pre-approval for some smaller set of permitted transfers that would not require lender consent.

Crystallization

If the JV agreement is structured with an LP with a long-term hold strategy, however, it is becoming more common for the sponsor/GP to be able to "crystalize" its promote before the occurrence of a capital event. A crystallization event can result in the promote being calculated and paid in advance of a capital event. Crystallization is often triggered upon the occurrence of an event that adds value to the project even though it is not a capital event that triggers cash for distribution. Examples of events that might trigger crystallization of the promote could include completion of the development or the property achieving stabilization. Crystallization is becoming more common in deals with open-ended or longer-term LP funds, or in longer-term structures where the sponsor/GP does not have the ability to trigger a capital event.

Absent the occurrence of the capital event, there are still ways to pay the sponsor/GP the crystallized promote. For example, each of the other JV parties could contribute additional cash to pay the crystallized promote. As another option, the sponsor/GP could have the ability to treat the crystallized promote as an additional capital contribution, which, in effect, could have a diluting effect on the other participants in the JV. In addition, the crystallized promote could be paid out of distributions that would otherwise go to pay the other participants in the JV.

CONCLUSION

Real estate JVs are an attractive investment vehicle for many PE Funds. As this article has explained, however, partnering with a PE Fund to establish a real estate JV is one of the most complex ways to fulfill the equity portion of the capital stack. Effective counselors in this area must be knowledgeable about the consequences the structure and funding of the PE Fund can have for the real estate JV. While not exhaustive, this article has endeavored to touch on some of the most important of these consequences, including the fact that PE Funds must deploy large amounts of capital and exit investments in a finite period of time, require careful tax planning, and are subject to a spider's web of federal and state laws, regulations, and reporting requirements. Careful planning, a robust understanding of the potential organizational structures, and an acute awareness of the laws and regulations in place are essential to effectively helping clients navigate a successful real estate JV. To that end, this article has also offered practical guidance and drafting tips that the authors hope will expand any real estate practitioner's toolbox.

Notes

1 At a base level, the real estate "capital stack" is comprised of equity and debt. There may be numerous tiers in each category and there are various legal rights and priorities associated with each. This article focuses solely on the equity portion of the capital stack.

2 The investors in a real estate JV are colloquially referred to as LPs, and the sponsor is colloquially referred to as the GP. It is worth noting that although GP and LP emanate from limited partnership vernacular, they are often used even when the investment vehicle is an LLC (which is most common), notwithstanding the fact that the legal terms for such parties in an LLC context are Manager (in a manager-managed entity) or Managing Member (in a member-managed entity), as it relates to the sponsor party, and Member, as it relates to the capital investor.

3 As a practical matter, JVs are generally organized as LLCs or limited partnerships, most often formed in Delaware, with a managing member or general partner that is an affiliate of the fund manager and one or more other members or limited partners that are investors.

4 There is often confusion about whether the "private" in PE refers to whether the fund itself is a non-public investment or whether the fund places money in non-public transactions. Historically, the answer was generally "both,"

but over the past several years a number of the most famous and successful PE Fund managers (not the individual funds themselves) have actually started trading on the public markets (e.g., Blackstone, KKR, Apollo, among others). While there are countless PE Fund strategies, it's generally better to think of the "private" part of PE as the type of investment made by the fund itself (although even that isn't always the case, since some PE funds invest in publicly traded securities).

5 Selection of Delaware as the jurisdiction of formation and the governing law with respect to PE Funds is nearly universal, for a variety of reasons. Delaware is well known for having: (i) ultimate contractual flexibility for establishing governance of LLCs and limited partnerships under LLC agreements and limited partnership agreements; (ii) easy to navigate statutory and administrative legal regimes for business entities; (iii) the most sophisticated body of case law and specialized courts for addressing business disputes in a (relatively) expeditious manner; and (iv) familiarity and acceptability to investors.

6 See supra note 2.

7 For example, in order to allow high-net-worth individuals to invest, the sponsor will want to ensure that each such investor satisfies the definition of "accredited investor" under Regulation D (17 CFR § 230.501) (which is relevant for securities law registration exemptions) and is considered a "qualified client" under Rule 205-3 of the Advisers Act (as defined below) (which is relevant to permit the sponsor to have a carried interest, or performance-based ownership percentage in the PE Fund). See infra note 11 and accompanying text for a more thorough discussion.

8 See discussion of tax considerations below.

9 Parallel funds are often organized in off-shore, tax-advantaged jurisdictions, such as the Cayman Islands.

10 There are countless variations on the basic distribution waterfall model described above. As just one example, sometimes there are tiered hurdles, at each of which there is a greater percentage of the remaining distribution allocated to the GP in consideration for achieving better results for the LPs.

11 15 U.S.C. § 80b–2(a)(11): "'Investment adviser' means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956 [12 U.S.C. § 1841 et seq.] which is not an investment company, except that the term "investment adviser" includes any bank or bank holding company to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company, but if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser; (B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor; (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; (E) any person whose advice, analyses or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 3(a)(12) of the Securities Exchange Act of 1934 [15 U.S.C. § 78c(a)(12)], as exempted securities for the purposes of that Act [15 U.S.C. § 78a et seq.]; (F) any nationally recognized statistical rating organization, as that term is defined in section 3(a)(62) of the Securities Exchange Act of 1934 [15 U.S.C. § 78c(a)(62)], unless such organization engages in issuing recommendations as to purchasing, selling, or holding securities or in managing assets, consisting in whole or in part of securities, on behalf of others; [1] (G) any family office, as defined by rule, regulation, or order of the Commission, in accordance with the purposes of this subchapter; or (H) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order."

12 15 U.S.C. Section 80b-2(a)(18):"'Security' means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guaranty of, or warrant or right to subscribe to or purchase any of the foregoing."

13 SEC v. Howey Co., 328 U.S. 293 (1946). The Supreme Court defined an investment contract under the Securities Act of 1933 to be "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise." In this case, an investment contract is distinguished from owning fee interests in land or real property coupled with management services; rather, "[t]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test be satisfied, it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without

intrinsic value." (citing SEC v. Joiner Corp., 320 U.S. 344 (1943)).

14 15. U.S.C. § 80a-3(a)(1).

An "investment company" means any issuer which

(A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

(B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

15 Institutional Limited Partners Association (ILPA), GP Led Secondary Fund Restructurings, Apr. 2019, available at https://ilpa.org/gp-led-restructurings/ (accessed December 23, 2021).

16 66 Fed. Reg. 49079 (Sept. 23, 2001).

17 These lists include: (i) the three lists maintained by the United States Department of Commerce (Denied Persons, Entity, and Unverified, which lists, together with others, can be found at https://www.export.gov/article?id=Consolidated-Screening-List); (ii) the list maintained by the United States Department of Treasury (Specially Designated Nationals and Blocked Persons, which lists can be found at https://www.treasury.gov/ofac/downloads/sdnlist.txt); and (iii) the list maintained by the United States Department of State (Terrorist Organizations and Debarred Parties; the Terrorists Organizations list can be found at https://www.state.gov/j/ct/rls/other/des/123085.htm; the Debarred Parties list can be found at:https://www.pmddtc.state.gov/?id=ddtc_kb_article_page&sys_id=c22d1833dbb8d300d0a370131f9619f0).

18 In addition to the exemptions described above, an entity whose interests are a publicly-offered security or a security issued by an investment company registered under the Investment Company Act of 1940 will not be deemed to hold plan assets as a result of an employee benefit plan's equity investment.

19 See 29 CFR § 2510.3-101, as modified by § 3(42) of ERISA.

20 By way of example, 29 CFR § 2510.3-101(j) sets forth the following examples:

(7) A plan, P, invests (pursuant to a private offering) in a limited partnership, W, that is engaged primarily in investing and reinvesting assets in equity positions in real property. The properties acquired by W are subject to long-term leases under which substantially all management and maintenance activities with respect to the property are the responsibility of the lessee. W is not engaged in the management or development of real estate merely because it assumes the risks of ownership of income-producing real property, and W is not a real estate operating company. If there is significant equity participation in W by benefit plan investors, P will be considered to have acquired an undivided interest in each of the underlying assets of W.

(8) Assume the same facts as in paragraph (j)(7) except that W owns several shopping centers in which individual stores are leased for relatively short periods to various merchants (rather than owning properties subject to long-term leases under which substantially all management and maintenance activities are the responsibility of the lessee). W retains independent contractors to manage the shopping center properties. These independent contractors negotiate individual leases, maintain the common areas and conduct maintenance activities with respect to the properties. W has the responsibility to supervise and the authority to terminate the independent contractors. During its most recent valuation period more than 50 percent of W's assets, valued at cost, are invested in such properties. W is a real estate operating company. The fact that W does not have its own employees who engage in day-to-day management and development activities is only one factor in determining whether it is actively managing or developing real estate. Thus, P's assets include its interest in W, but do not include any of the underlying assets of W.

21 "Benefit plan investors" include: (i) any employee benefit plan (as defined in section 3(3) of ERISA); (ii) any plan described in section 4975 of the Internal Revenue Code of 1986, as amended; or (iii) any entity whose underlying assets include plan assets by reason of a plan's investment in the entity.

22 See Section 404(a) of ERISA.

23 See Section 406 of ERISA.

24 See I.R.C. § 514(c)(9)(E).

25 REITs must have more than 100 shareholders and five or fewer individuals (which may include certain entities in certain instances) may not own more than 50 percent of the shares over the last half of the REIT's taxable year. (See 26 U.S.C. § 856(a)(5) and (h)).

26 The two tests are a 75 percent annual gross income test (see 26 U.S.C. § 856(c)(3)) where rents from real estate related income (such as rents from real property and interest on loans secured by mortgages) need to make up at least 75 percent of the annual gross income of the REIT, and a 95 percent annual gross income test (see 26 U.S.C. § 856(c)(2)) where rents from real estate related income, plus dividends, interest, and other qualifying income, need to make up at last 95 percent of the annual gross income of the REIT.

27 The quarterly asset test means that at the close of each quarter of the taxable year at least 75 percent of the value of the REIT's total assets is represented by real estate, cash, and cash equivalents, and certain other tests limiting the amount of holdings of the remainder are achieved (see 26 U.S.C § 856(c)(4)).

28 Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, Title XI, Subtitle C, 94 Stat. 2599, 2682 (1980).

29 26 U.S.C. § 892 (2022).

30 The term "controlled commercial entity" means any entity engaged in commercial activities (whether within or outside the United States) if the government: (i) holds (direct-

ly or indirectly) any interest in such entity which (by value or voting interest) is 50 percent or more of the total of such interests in such entity; or (ii) holds (directly or indirectly) any other interest in such entity which provides the foreign government with effective control of such entity.

31 CFIUS operates pursuant to section 721 of the Defense Production Act of 1950, as amended (section 721), and as implemented by Executive Order 11858, as amended, and the regulations at chapter VIII of title 31 of the Code of Federal Regulations. FIRRMA expanded and updated the authority of the President and CFIUS to review and to take action to address any national security concerns arising from certain non-controlling investments and real estate transactions involving foreign persons.