

A GUIDE TO RAISING CAPITAL FOR REAL ESTATE TRANSACTIONS

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The pool of individuals and businesses that own or are interested in acquiring real estate investments has never been deeper. With a plethora of asset types ranging from single-family homes to downtown skyscrapers – with multi-family apartments, senior-living communities, commercial medical facilities, retail centers, manufacturing buildings and industrial warehouses (to name a few) sandwiched in-between – opportunity abounds for those willing to take the plunge. And while the terms and availability of debt financing for real estate acquisition and development have seldom been better in recent memory, access to this vast cache of opportunity rests, in large part, on the ability of the buyer to bring capital to the closing table.

Given the capital-intensive nature of real estate investing, there are few in the marketplace with both easy access to potential real estate assets and the cash (or desire) to independently acquire, construct, develop, own and/or operate those assets. As a result, it is often necessary for those with access to attractive real estate investments to raise all or a portion of the required capital for those investments from third parties ranging from friends and family to institutional investors.

Whether you are a seasoned real estate professional or considering your first real estate investment, raising capital for a real estate investment can bring with it significant economic and other potential benefits. It can also be daunting and rife with concepts with which you are unfamiliar or uncomfortable.

The goal of this series will be to de-mystify the concepts involved in raising equity or mezzanine capital for real estate transactions to make them more understandable and approachable for individuals and businesses interested in participating in the real estate investment space. This initial guide provides a high-level summary of certain topics central to sourcing, structuring and accepting investments in real estate projects.



REAL ESTATE INVESTMENT STRUCTURES

SIMPLICITY IS STANDARD

Real estate investments take a multitude of structural forms driven by the desire of the “sponsor” of the investment (typically, the individual or business bringing the investment opportunity to market) and its prospective investors to capture a wide variety of benefits available to real estate owners and investors or to avoid any number potential drawbacks.



“Partnership,” “fund,” “joint venture” and “1031” are widely used terms that, directly or indirectly, reference just a handful of available investment structures. Add in the alphabet soup of “JVs,” “LPs,” “REITs,” “OZs,” “DSTs” and “TICs” and it is no wonder that many can be confused or intimidated when attempting to structure a real estate investment.

Despite the seemingly endless structuring options, many (if not most) real estate investments take a relatively simple form – referred to colloquially as a “GP/LP” structure – whereby the investment sponsor (GP) actively manages and controls the investment and investors (LPs) take a passive role in reliance upon the experience and knowledge of the investment sponsor. Many investment structures, including joint ventures, single- and multiple-asset investment funds, and certain of the tax-based structures referenced later, are simply variations on or otherwise incorporate this “GP/LP” structure.

Ultimately, while structuring a real estate investment may appear at the outset to be an overwhelmingly complicated undertaking, that is simply not the case in the majority of instances.

MORE ON STRUCTURING

EXPLORING COMPLEXITY

Where additional structural complexity is necessary, the benefits of the complexity tend to outweigh the burdens. For example, structures may be employed to leverage available tax credit programs or tax increment financing; allow for 1031 “like-kind” exchanges; qualify for “Opportunity Zone” benefits; take advantage of benefits available to real estate investment trusts (REITs); or a combination of these options. In each case, necessary structural complexity may result in a significant boon to investment returns and provide access to different or additional investment partners with more targeted or nuanced investment strategies.

In the end, the large number of structuring options should be viewed not as a barrier to entry into the real estate investment space but as a tool that, if understood and employed effectively, can help drive significant economic benefits to investment sponsors and their investors.

An experienced and knowledgeable legal and advisory team can be invaluable as you consider structuring options for your proposed real estate investment.



SETTING INVESTMENT TERMS

WHAT IS MARKET?

Regardless of structure, an investment sponsor will only be successful in raising capital if its investment offering is attractive and marketable to prospective investors. The marketability of a real estate investment offering will depend on two things:

- The inherent characteristics of the particular investment (type of asset, past and projected financial performance of the particular investment, etc.)
- The terms of the investment offered to investors.

Investment sponsors have virtually unlimited flexibility in determining what to offer their prospective investors, and the sheer number of options can make it difficult to know where to start. Ultimately, however, **investment terms can be simplified into two primary buckets – management rights and economic rights** – and what is acceptable to sponsors and investors within these “buckets” is typically driven, in large part, by the market for investments similar to the one proposed.

MANAGEMENT RIGHTS VS. ECONOMIC RIGHTS



MANAGEMENT RIGHTS

Generally speaking, these relate to the relative rights of the investment sponsor and its investors to manage, govern and make decisions regarding the underlying real estate investment. Perhaps unsurprisingly, investors may be willing to give more management leeway to investment sponsors with a long track record of successful real estate investments than to new entrants into the real estate investment space. New sponsors may find it necessary, for example, to offer investors significant rights with respect to material decisions related to the underlying project, such as asset sales or refinancing of debt secured by the project, or rights that more easily allow for changes in managerial control if the sponsor is unable to satisfactorily perform.



ECONOMIC RIGHTS

These are provisions that dictate an investor's return on its investment and govern the relative rights of the investment sponsor and its investors to payments or distributions from the operation, refinancing or sale of the underlying investment. These rights encompass concepts such as distribution waterfalls, preferred returns and carried or "promoted" interests. They will also determine any fees, such as asset management fees, development fees or acquisition/disposition fees, payable to the sponsor or its affiliates in connection with the investment. More than most other considerations, understanding "market" economics is an important prerequisite to successfully raising capital for a real estate investment. It goes without saying that investors will not be interested in a deal that is not market.

THE LEGAL LANDSCAPE



In exchange for their investments, equity investors will typically receive an interest (typically LLC units, partnership interests, or stock) in the entity that will, directly or indirectly, acquire, develop, own and/or operate the underlying real estate asset (whereas debt investors may receive a promissory note or similar instrument). These investment interests (whether equity or debt) are “securities,” and the offer and sale of securities is highly regulated under a complex mixture of federal and state statutes.

All offers and sales of securities must be either registered with the Securities and Exchange Commission (SEC) and applicable state regulators or must otherwise be exempt from registration. Due to the time and cost required to register a securities offering with the SEC and/or state regulators, very few investment sponsors register their investment offerings. Instead, the vast majority of real estate investment offerings are conducted under available registration exemptions (terms like “Reg. D” and “crowdfunding” are commonly used as shorthand references to certain of these exemptions).

While the SEC has made recent attempts to significantly expand the availability and utility of its registration exemptions in hopes of fostering private access to investment capital, the existing statutory scheme remains complex and potentially confusing to those without significant experience.

For example, securities laws impose significant limitations and/or obligations with respect to:

- Information that must be disclosed to prospective investors (including, in certain cases, audited financial information)
- The number and/or type of investor that may be solicited for investment (including restrictions on the inclusion of certain investors who are not “accredited” and do not meet certain income, net worth and/or sophistication thresholds);
- The dollar amount of capital that may be raised (including limits on individual investments by non- “accredited” investors in certain situations);
- The manner in which investment sponsors communicate with prospective investors (including limitations on public advertising or solicitation of investments).

These are only a handful of the important facts and circumstances that must be considered in connection with a proposed investment offering under the current regulatory regime. As the country moves forward under a new administration, it is important to note that, due to appointment of new SEC commissioners, changes in regulatory priorities or other considerations, rules can (and frequently do) change and recent efforts to reduce regulatory burdens on raising capital can be undone. In all cases, we urge you to engage an experienced securities attorney with a detailed understanding of the applicable federal and state registration exemptions to ensure your offering is legally compliant.



MORE ON SECURITIES LAWS

INVESTMENT ADVISER AND INVESTMENT COMPANY CONSIDERATIONS

An additional layer of securities regulation that is often underappreciated (or perhaps misunderstood) by real estate investment sponsors relates to the potential characterization of the adviser as an “investment adviser” or the investment entity as an “investment company.” If an investment provides for fee ownership of the underlying real estate (either directly or indirectly through one or more wholly owned or controlled entities), neither the investment sponsor nor the underlying investment will generally be subject to regulation as an investment adviser or an investment company.

Variations on this typical investment structure, however, including joint ventures or other co-ownership arrangements, may in certain instances result in minority or passive ownership of an underlying real estate investment. In these instances, investment adviser and investment company issues may come into play and bring with them onerous registration and compliance requirements.

Understanding the regulatory framework governing securities offerings is imperative for anyone intending to sponsor one or more real estate investments, as failure to comply with applicable rules and regulations can seriously undermine the viability of the investment(s) and can lead to personal liability for the investment sponsor.

LIABILITY CONCERNS

WHY SHOULD I CARE?

The primary legal remedy available to investors with respect to a real estate investment is a claim for rescission of their investments, which, if successful requires the sponsor to return the investors' investments, plus attorneys' fees, costs and interest. In addition to investors' rescission claims, securities regulators may also institute monetary penalties or institute orders suspending or barring the investment sponsor from participating in existing or future investment offerings.

In addition, real estate investment sponsors are often susceptible to non-securities claims related to conflicts of interest. These claims typically arise either from the use of affiliated service providers (such as developers, general contractors, property managers, etc.) or, in the case of a sponsor with multiple concurrent investments, the allocation by the sponsor of a particular real estate investment to a particular investment vehicle. Failure to disclose conflicts of interest, or to provide for a mechanism for resolution of such conflicts, is a common source of legal problems for real estate investment sponsors.

Legal issues of this nature tend to arise at a time when investment expectations are not being met, due to poor performance of the underlying investment, failure of the investment sponsor to deliver projected returns, or otherwise. As a result, these claims can exacerbate existing issues or undermine completely the viability of a real estate investment, which can create additional legal issues for the investment sponsor, including defaults under existing debt financing, guaranties or agreements with third-party service providers. Depending on the facts and circumstances, the investment sponsor could be personally liable in connection with certain legal claims.

By understanding and ensuring compliance with securities laws and other applicable regulations from the outset, an investment sponsor can eliminate or significantly mitigate potential legal liability in connection with raising capital for real estate investments.

ADDITIONAL CONSIDERATIONS

While the foregoing summary touches on a number of the primary considerations and concerns related to raising capital for real estate transactions – it is certainly not all-encompassing. If you have questions regarding anything discussed in this article or any future article in this series, or if there are issues or concepts not outlined above about which you would like additional information (or you believe deserves a dedicated article), please reach out to [Evan Sheets](#) or another member of the Winthrop & Weinstine real estate finance and development team.



ABOUT WINTHROP & WEINSTINE

Headquartered in Minneapolis, Winthrop & Weinstine is a leading real estate law firm with clients in Minnesota, the Midwest and beyond. Financial institutions, developers and investors seek our attorneys' expertise with issues related to financing real estate projects, large and small.

Getting projects built takes dedication, time – and money. Our attorneys work with clients to source and combine financing for real estate projects and help them navigate the sometimes rocky path of real estate finance. We see roadblocks and detours as opportunities in disguise, and develop creative, practical alternatives to obstacles that arise.

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