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A New Vehicle for Overseas Investment

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Real Estate Opportunity Funds:
A New Vehicle for Overseas Investment

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As investors seek to diversify their direct equity real estate portfolios, real estate opportunity funds have become an attractive vehicle for investments in domestic and overseas real estate markets. Investors may find that certain property types are difficult to add to a direct equity portfolio or an investor may lack the development and management skills to enter into a real estate market, especially in a foreign jurisdiction. These challenges and risks are minimized by investing in a fund which is created by a sponsor who has special expertise and a demonstrated track record with the investment strategies that it proposes to execute in a specific market.

An investment in a real estate opportunity fund is essentially the purchase of a limited partnership interest in a limited partnership or the purchase of a membership interest in a limited liability company. In most transactions, a limited partnership is formed (versus a limited liability company) and the sponsor of the fund takes the role of general partner and manager of the limited partnership. An investor subscribes to the fund as a limited partner and commits a certain amount of capital. Over a specified period of time, the investment period or commitment period, the general partner will call an investor's capital and the capital is then used to purchase real estate projects or real estate operating companies which are then owned, repositioned, sold or held by the limited partnership, depending of course on the investment strategy. The sponsor/general partner is compensated for its role in the form of a management fee and by sharing in the cash flows with the investors from the operation and sale of the fund investments.

As legal counsel for an investor in real estate opportunity funds, it is of the utmost importance to review the private placement memorandum and the limited partnership agreement for the fund. While there are numerous issues to consider and negotiate, this paper focuses on five topics that are ever present in a foreign real estate fund transaction. These topics should be reviewed, investigated and understood in advising an investor client who is interested in a real estate opportunity fund that is created for the purpose of investing in real estate in overseas markets.

I. Distribution Section

One of the most important provisions of a limited partnership agreement for a real estate opportunity fund, domestic or foreign, is the distribution section. This provision will call out the expected preferred return of the investor/limited partner, set forth the manner in which a limited partner will receive its preferred return and return of its initial capital investment and detail the sponsor's compensation in the fund which is commonly referred to as its carried interest. The cash flow distribution (or waterfall) for a foreign real estate opportunity fund usually provides for payment of the preferred return on the capital contributed by the limited partners as the first hurdle; that is, the investor will receive its expected return first from the net cash proceeds of the fund. The investor will generally receive a return of its capital as the second hurdle of the waterfall and the next two hurdles usually include a percentage split between the sponsor and the investor in which the sponsor will receive its carried interest. Distributions in foreign funds tend to be made on a cumulative basis and not on an investment-by-investment basis. This approach is advantageous to the investor because it gives priority to the investor's receipt of its preferred return and initial capital investment before cash flows will be allocated to the sponsor/general partner.

In a distribution section, an express restriction against in-kind distributions is a reasonable and prudent request when negotiating the limited partnership agreement for a foreign fund. Because an investor seeks to receive cash from investment in a foreign fund, the receipt of a fee interest in property that is located in a foreign country or a percentage interest in a foreign real estate operating company would almost always contravene the investor's portfolio objectives.

II. Side Letters

In most real estate opportunity funds, a side letter is negotiated between the general partner and each limited partner. The side letter is an important document for the investor because it often contains rights and benefits that are above and beyond those provided in the limited partnership agreement. When an investor has certain legal or regulatory requirements with which it must comply and that are personal to the investor, the side letter is the appropriate tool to use to supplement the limited partnership agreement. A side letter may also be used to provide a larger investor with certain financial incentives that are not offered to the other limited partners. Because the general partner is essentially making side agreements with other limited partners, an investor will want the opportunity to review the side letters provided to other limited partners and request the same rights or benefits. The provision commonly known as the "most favored nations" provision would accomplish this by requiring that the general partner provide copies of all side letters to an investor and agree to provide the investor with the same rights and benefits offered to the other investors under certain circumstances.

III. Tax Concerns

Because a limited partnership agreement, domestic or foreign, will contain numerous tax provisions, counsel for the investor should have expertise in tax law or work with a tax attorney. If not already included in the limited partnership agreement, certain tax provisions should be requested in a side letter to shield the investor from negative tax consequences that may arise, particularly in foreign funds. For example, certain provisions of the Internal Revenue Code or tax treaties may change the status of a limited partner so that the limited partner may be considered a taxpayer in an overseas jurisdiction by virtue of its investment in the fund. To address this serious concern, the limited partner might ask the general partner for a representation that the fund will not make any investment that would cause the limited partner to have a "permanent establishment" in any country other than the United States. To have a permanent establishment in another country would expose the investor's worldwide income to taxation in that country. Most general partners of foreign real estate opportunity funds are sensitive to this issue and agree to provide such a representation. This issue is particularly important when the fund is making direct investments in foreign real estate versus investments in foreign real estate operating companies.

IV. Key Man Provision

The expertise of a sponsor is often tied to a team of real estate professionals who have a significant amount of experience in real estate management and development. Because the expertise of one or more individuals may be critical to a fund's success, especially in a foreign country, a limited partnership agreement should contain a key man or key person provision which provides that if one or more of the lead individuals leaves the sponsor's team, then the general partner will cease making new investments and no longer have the right to call capital from the limited partners. This provision has the result of shutting down the fund's pipeline for new investments until such time as the key person is replaced.

V. Foreign Currency Risk

Because exchange rates may fluctuate when exchanging United States dollars for foreign currency, the fund, and ultimately the limited partners, may be exposed to some level of currency risk, depending on the foreign jurisdiction. Hedging is the most common strategy used by investors in overseas markets to reduce exposure to foreign currency risk. When reviewing the limited partnership agreement, an investor will inquire whether the general partner has the authority to hedge and to what extent the general partner will engage in hedging to reduce foreign currency risk.