

Current Challenges Facing an Investor in a Real Estate Fund or Venture

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In the current sobering and stressful US real estate market, many equity investors need to determine their rights and obligations and identify legal, contractual and structural means to resolving pressing issues affecting their real estate-related investments. Their concerns range from control over decision-making, responding appropriately to capital calls and the limited access to reasonable debt financing. They also are concerned about their exposure to liability and litigation risk, their rights and exposure with respect to a possible venture bankruptcy filing, and the limited usefulness of contractual exit provisions and procedures for removal of the general partner/managing member.

An equity investor's concerns, as well as the legal, contractual and structural issues that arise from those concerns, will vary significantly depending on the nature of the investment: (i) a complex fund or fund-of-funds with multiple capital commitments callable at the manager's discretion; (ii) a single property or portfolio of related properties with the operator or developer as the manager; (iii) stabilized properties or redevelopment/construction projects; or (iv) properties that were aggressively financed or have their mortgage debt held by a CMBS pool. The investor's ability to address its concerns will also depend on that investor's status in the structure, i.e., a non-managing member of a limited liability company or a limited partner in a limited partnership, or a managing or co-managing member or general partner of the venture.

This article will identify certain business issues which help define the current environment, discuss contractual, structural and legal factors, and touch upon possible solutions. Both multi-investor funds and joint ventures will be considered. Generally, the issues facing non-US equity investors are very similar to those

facing US-based investors, but aspects unique or of greater concern to non-US investors will be noted.

Acquiring and Analyzing the Information Necessary for a Comprehensive Assessment

Acquiring all potentially relevant information as rapidly as possible is essential, but not always possible. The scope of useful information often goes beyond that contractually required to be provided under the fund or venture documents, although the information rights provisions of those documents are a useful starting point. In the current volatile market environment, real-time "flash" data as to current property and asset performance and market valuations can be more useful than historical financial or property data from even a few months earlier.

The general partner/managing member's assessment of current performance and valuation of the fund or venture investments will be useful, but should be rigorously reviewed, challenged and analyzed against third-party marketplace data. Finding a consensus may require multiple sponsor-investor conferences or meetings. Investors in single properties or a portfolio of related properties with the same sponsor should have an easier time obtaining accurate information from the sponsor than investors in multi-investor funds. Those investors should be aware that fund sponsors may, on advice of counsel and other advisors, limit multi-investor conference calls to a prepared presentation and limited questions-and-answers. Individual follow-up and in-person meetings may be necessary if an investor wants a comprehensive, in-depth and nuanced understanding of the venture's issues. Sophisticated and experienced sponsors recognize that the current environment requires that they devote additional time to investor information. However, some may be resource-



constrained, and others may conflate superficial “investor relations” with responding to detailed investor due diligence.

In particular with respect to multi-investor funds, the sponsor’s current valuation of assets should be reviewed, and the investor should have a working knowledge of FAS 157 as applied to the fund’s assets. Foreign investors should be cognizant of the differences between FAS 157 and IFRS standards, and should review financial statement and valuation reporting not only against contractual reporting requirements but against their own reporting needs and current evolving industry practices.

Investors should not limit their inquiries and evaluations to the investment. An analysis or informed estimate as to the solvency, “staying power,” capital strength, current motivations and other commitments of both the sponsor and other investors in the fund/venture and of its lenders will be required. This may be particularly difficult for non-US investors who lack adequate presence in the United States. Such investors may want to make independent inquiries of third parties for information relevant to their investment(s). In doing so, investors need to be conscious of the legal constraints imposed on them by any non-disclosure covenants they may have entered into. Expanding the scope of permissible disclosure to third parties may be possible, particularly if the general partner/managing member is soliciting investor approval of any action.

Achieving the necessary depth of knowledge may require that the investor (i) have a direct (formal or “off the record”) line of communication to the

general partner/managing member or, in the case of a multi-investor fund, to one or more individual asset managers within the sponsor’s organization and/or (ii) retain third-party consultants to evaluate sponsor-provided data and assessments. In the case of multi-investor funds with advisory boards in place, the investor should consider attempting to allocate some of the inquiry and assessment burden to that group, even if that duty is not expressly stated in the

documents as being within their normal scope. Additional indemnification of investor representatives and waiver of claims by the investor may be a necessary corollary to this approach.

Evaluating Financial Exposure of the Investor; Future Capital Calls

An equity investor’s exposure to financial loss arising from an investment, whether it is loss of funds

already funded, funding commitments, or exposure to additional liabilities, will likely be its initial concern. To the extent the investor has its own reporting requirements under IFRS or otherwise, the valuation issue (read: investor doubts as to sponsor’s valuation) becomes an immediate concern. In the case of a non U.S. investor, the impact on that investment of currency fluctuations may also become an issue.

An investor may have (i) unfunded capital commitments which can be called by the general partner, or (ii) pledged its future unfunded capital commitments as security for a line of credit for the fund which may be drawn upon by the fund’s general partner. Analysis of fund documents and awareness of the impact of current developments are critical. For example, turnover of key personnel or existing loan

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defaults may trigger a “key-man” or other provision at least temporarily suspending capital commitments.

A new capital call for an already troubled investment in the current environment will often trigger a “zero-based budget” approach by the investor’s management. That in turn requires the investor to evaluate reputational, financial and legal risks should it fail to fund a capital call.

It is more likely than not that in good times investor default provisions in a fund or venture agreement were often only lightly negotiated by investors. These provisions typically include all or some of the following: (i) the right of the non-defaulting investors/general partner to make a priority loan to fund the delinquent contribution; (ii) the right of the non-defaulting investors/general partner to make a capital contribution to fund the delinquent contribution, and to dilute the ownership interest of the delinquent investor, often applying an inflated multiplier to the replacement capital; (iii) the grant of a security interest in the defaulting investor’s interest in the fund/venture, and the right to apply the investor’s distributions to cure the default; (iv) the right to buy out the defaulting investor at a discount to historical cost or current value; (v) the right to reduce or eliminate the defaulting investor’s management, control or voting rights; and/or (vi) the right to sue the investor and a credit-worthy investor affiliate for the delinquent contribution and any damages.

The considerations in determining whether and to what extent to pursue default remedies may vary depending upon the nature of the investment. In an entity where there may only be two or three investors, the general partner/managing member may have more limited assets and therefore may not be free to

pursue remedies against a defaulting member. It may, itself, be unable to meet its capital call requirements and it might be trying to save a portfolio of other investments with very limited resources.

In a multi-investor fund, on the other hand, fund managers may well pursue default remedies, if for no other reason than failing to do so may raise issues of fiduciary duties to the fund and fundamental fairness to those investors who meet their capital calls. If, however, an investor has used a shell company and determines to “walk away” from its investment, all the remedies except a lawsuit will be of limited value, and even the lawsuit remedy will be subject to the

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usual risks, delays and uncertainties of litigation. A non-US investor may create additional jurisdictional and enforcement hurdles for a fund or venture sponsor seeking to enforce remedies. With today’s dearth of debt financing, fall in real estate asset values and illiquidity (read: no acquisition

financing; no buyers), default remedies have lost much of their *in terrorem* effect.

At the same time, an investor attempting to determine whether to fund a new capital call in the current market cannot ignore the reality that even many institutional investors are under severe stress. Defaults by significant co-investors are no longer hypothetical questions, but real possibilities to be taken into consideration. Therefore, prospective investor default scenarios should be analyzed by the investor seeking to salvage or work out an existing investment. Non-US investors, normally adverse to litigation, may have to get comfortable with credible threats of litigation as an acceptable tactic for forcing reluctant co-investors to meet their capital commitments.

Some fund managers have considered deferring capital calls in exchange for extending the fund’s



commitment period. Others have recently offered to reduce future capital commitments in order to alleviate stress on investors and to recognize the decline in availability of acceptable acquisition or redevelopment possibilities. For many investors, particularly those with long investment horizons, a fund sponsor proposing to reduce an opportunistic fund's capital commitment "firepower" in the current low valuation environment seems contrary to the fund's basic investment strategy, however beneficial it might be to some troubled investors, and may give rise to questions of whether this is consistent with the fund general partner's duty to operate the fund in accordance with its stated purpose. Careful structuring of amendments to fund documents by allowing individual investors to "opt out" of reductions or even increase their investments to replace proposed capital commitment reductions can help deflect concerns that implementing such amendments violates duties of the general partner.

Asserting Influence and Control in a Crisis

Once the investor has conducted some information-gathering and assessment, it next needs to determine what, if any, action it can or should take, either in response to a specific request from the general partner/managing member, or unilaterally. The equity investor should keep in mind both the benefits and costs of action versus inaction. There is also the need to maintain incentives of other stakeholders, particularly management and other investors, whose cooperation and continued efforts may be prerequisites to the future success or the efficient liquidation of the investment.

If the investor determines that the venture's general partner/managing member has either failed to propose an acceptable solution to issues facing the venture, or is incapable or unwilling to take appropriate action, the investor must then determine how it can best cause a specific action to be implemented. The starting point is the extent to which the documentation gives investors a vote or consent right over specified "major decisions." Those provisions, however, are typically negotiated and drafted with a view to limiting a general partner/

managing member's right to take certain future unilateral actions. They are unlikely, standing alone, to provide investors with a path to achieving control of the venture. Even fund/venture agreements provisions regarding termination of the general partner/managing member may be inapplicable in many troubled investments, absent a colorable claim of malfeasance or gross negligence. The broad impact of current market issues may help shield managers against such claims.

Beyond the interpretation of contractual provisions, legal issues to be considered if an investor chooses to participate in solutions or restructuring include: (i) whether the investor's legal or fiduciary duties to its owners and other constituents mandate its taking or attempting to take any particular action, (ii) the extent to which the investor in taking an action is exposed to the additional risk of potential litigation or liability to other investors in the fund/venture or to other parties and (iii) the availability of insurance, indemnification and/or effective waivers from other stakeholders. If the investor trying to assert control, or exert influence, is also a lender (directly or through an affiliate) to the venture, then the effort may raise conflict of interest and lender liability issues as well. Existing loan or venture disclosures and waivers will need to be reviewed and possibly supplemented.

Investors should be alert to the possibilities that their mere presence and interest in the venture's current issues may give them an adequate "place at the table" in any negotiations, whether with the general partner/managing member, lenders or other parties, regardless of their contract rights. Realistically, any investor participation may well lead rapidly to a discussion of possible additional investor capital contributions or loans. An investor's willingness (and capability) to fund needed capital in the current financing environment should give that investor substantial leverage to renegotiate other elements of the venture or fund that no longer make economic or structural sense. As one current political advisor (with past private equity fund experience!) recently noted: "You never want a serious crisis to go to waste. And what I mean by that is an opportunity to do things you think you could not do before."

Planning and Implementing Effective Solutions

The current problems faced by real estate ventures and funds range from effecting changes at the property or asset management levels to improving operating cash flow, refinancing debt or coping with loan covenants, to implementing exit strategies in a hostile selling environment. Often these problems are inter-related, and previously minor weaknesses in real estate or human assets may result in survival-threatening situations in the current weak economic environment.

Once the problems are identified, appropriate solutions can be evaluated and planned. Implementing one or more solutions will require reviewing existing documentation, considering how best to maintain or improve incentives for various parties (management, other investors, lenders) and alignment of interests, and analyzing tax consequences of such solutions. In many instances, existing contract structures will not by themselves allow reasonable solutions. Some examples are discussed below. Investors should also be alert to the possibility that solving problems may require multiple steps, or even a stand-alone, short-term resolution followed by a separate longer-term restructuring. While “kicking the can down the road” should never be the initial approach to problems, it may be necessary in some situations.

Obtaining New Financing/Restructuring Existing Financing. A need for additional equity or mezzanine debt financing, whether to fund deficits or refinance existing debt, is perhaps the most critical and difficult problem facing real estate ventures and funds today. Obtaining such financing will often require changes or concessions that are not covered by existing agreements and a restructuring of the “capital stack” and may involve an infusion of new capital by existing investors. Financing, whether from existing or outside investors, and whether at the property or venture level, may only be available at lower valuations, which are highly dilutive to existing investors, and may require additional capital or mezzanine debt. Financing may also require current control parties to cede or share control over the property or venture with other parties and/or to provide credit enhancement.

If existing debt is restructured, either with or without obtaining new financing, the parties

must carefully analyze the US federal income tax considerations of any such restructuring. Rules that impact debt restructuring are extremely complex and may result in the parties having to recognize significant income arising from forgiveness of indebtedness.

Dilutive financing from affiliated parties will raise conflict of interest concerns. In multi-investor funds those concerns can usually be diminished, but not eliminated, by making a rights offering to all investors, a “market check,” and, if needed, obtaining a third-party valuation report. With regard to funds, dilutive financing via co-investment or “side-car” entities may be more easily structured to avoid investor blocking rights, particularly if a fund is past its initial offering period. In ventures with a very limited number of investors, the parties will have to negotiate through these issues. What is very difficult in such ventures, however, is that those parties most adversely affected by new financing may hold the managers responsible for current problems, they may have contractual approval or veto rights, and they may be of the view that the terms being offered to other parties in the capital structure are far too generous and no more likely to save the investment.

A dilutive financing requires a comprehensive re-evaluation of the existing capital structure and the distribution waterfall. Changes in the subordinate levels of a waterfall may motivate the necessary consents. In the end, in some instances dissenting parties may have to be bought out of their positions or compensated differently to facilitate a new financing. Investors should also be prepared to justify, not only to their supervisory boards, but to their equity constituency, the new terms provided current stakeholders of any restructured venture or fund, and demonstrate that interests of managers and investors are aligned.

Effecting Management Changes. Necessary changes sought may include removal of the general partner/managing member, introduction of a co-manager, changes in the sponsor’s individual personnel overseeing the venture/fund, or even a merger with another fund or venture. While “without cause” general partner termination and



fund termination provisions exercisable by investor consent may well become common terms in new funds organized in 2009 or later, they are extremely rare in existing funds, and in ventures usually exist only in the context of total exit provisions such as (i) investor right to force a sale or liquidation, (ii) buy/sell provisions or (iii) put/call provisions.

Achieving a consensual exit of an underperforming manager may require a partial or complete monetization of the manager's deferred compensation, and may take the form of a buyout of that manager's interest. Pricing discussions will be heavily influenced by factors such as current valuation of the manager's carried interest, the respective parties' expectations as to the probability and magnitude of future gains, the extent to which claw backs of previously distributed carried interest distributions may be possible or likely, the perceived residual value of the manager's knowledge base and role in restructuring or disposing of existing investments, the effect on loan covenants and major leases/contracts, reactions of other parties (such as other investors, lenders, local partners and major tenants), and possibly adverse US tax consequences to the manager. Requests for waivers of both known and unknown claims in the context of manager exits are common but require careful evaluation by investors and their counsel.

Investors should bear in mind the need to retain flexibility to properly incentivize a new manager or co-manager with both current management fees and performance-based compensation, and maintain

realistic expectations for new manager performance, given the current market environment. Knowledge of recent trends in new fund management compensation levels and expectations may be helpful.

Achieving an Exit from the Investment. If exiting the venture or fund is the investor's desired solution, and assets are to be sold, investors in real estate ventures and funds may also need to deal with the consequences of achieving an acceptable exit in a challenging sale environment. Consequences may include a need to provide seller financing and

accept or dispose of in-kind distributions received from ventures or funds. The tax consequences of such solutions and potential phantom income, as well as the accounting of such transactions under IFRS or GAAP, need to be evaluated. If the joint venture partner has or can find the required capital, the investor needs to analyze both existing contractual exit provisions and the possibility of negotiating new exit terms. An alternative

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for investors who wish to exit troubled funds, cannot meet future capital calls, or require current liquidity, may be to find a buyer at an acceptable price among the emerging class of specialized secondary market buyers, or among other co-investors in the particular fund or venture. Various structured or synthetic secondary transactions may be possible. A purchase of the investment by an investor or other affiliate raises the conflict of interest issues described earlier regarding affiliate financing, which may be mitigated by similar techniques to those described above.

The Bankruptcy Option. In certain circumstances, a bankruptcy of a venture or of a fund's significant asset-holding entities may be a necessary solution. Considerations in such a scenario include the impact on holders of debt and equity in the asset's capital structure, the transactional costs and time of such a solution, the scope of any general partner/managing member's "carve-out" guaranties and indemnities, risks (highlighted recently in slightly different circumstances by the General Growth Properties bankruptcy proceeding) that ostensibly "bankruptcy-remote" entities may be dragged into a bankruptcy proceeding, and the ever-present tax consequences of any cancellation of debt or recapture of depreciation.

Other Considerations

Investor reactions to specific venture and fund issues may also be influenced by the nature of the investor. Non-US investors may approach certain concerns

differently than US taxable or tax-exempt investors, either because of differing tax consequences, changes in currency exchange rates, varying reporting and regulatory requirements, and differing sensitivities to potential conflict of interest and litigation risks. Institutional professionally-managed equity investors may have differing concerns than high net worth families and individual investors.

Fund and venture investors in the current real estate environment must be informed, engaged and assertive. To the extent they are long-term investors with adequate time horizons, resources and patience, they may in fact harvest substantial long-term value from the current market environment. As regards new investments, it remains to be seen to what extent future real estate multi-investor fund and joint venture terms and structures will change materially from those in place prior to the recent crisis. ★



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