

Untangling the Ownership Web

Restructure Your Portfolio Through a Roll-up

[By Pamela V. Rothenberg]

Everyone is always looking for a sure thing, whether in our individual or business lives. As a result, many companies shelter their assets rather than take a risk. So, it should come as no surprise that most real estate developers and asset managers use separate single purpose entities (SPEs) for the ownership of real estate assets as the preferred operating structure.

Driving the use of SPEs is the universal objective of owners and managers to achieve the greatest possible limitations on their potential third-party liabilities, as well as the customary bankruptcy-remoteness requirements of asset-based equity and debt transactions in today's capital markets. It also makes imminent sense for owners who raise equity from different investors for each development or acquisition.

By segregating assets into separate entities, owners can protect the remainder of their portfolio from the reach of third-

But this structure is not without its challenges. If title to each portfolio asset is held by a separate SPE, the result is often a tangled and complicated web of ownership entities, leading to organizational headaches, significant reporting requirements, and considerable administrative costs—especially for owners or asset managers with a high volume of transactions.

Practical Solutions

Consider the case of an aggressive asset manager who, thanks to low interest rates and favorable market conditions in her region, is able to acquire and manage a portfolio of approximately 50 multifamily rental assets with an estimated value of \$750 million within a three-year period.

As is customary—and required by the institutions providing her equity and debt—for each company, the asset manager establishes a separate, single-purpose lim-

through the growth of her portfolio, the problem compounds.

Given the portfolio's size and complexity, the asset manager should consider restructuring it through a roll-up transaction. While a roll-up transaction can take a number of forms, it generally involves the consolidation of the ownership interests



Pamela V. Rothenberg is a member of the real estate development and real estate technology groups at Womble Carlyle Sandridge & Rice PLLC in Washington. She can be reached at prothenberg@wcsr.com.

A ROLL-UP TRANSACTION ENABLES THE ASSET MANAGER TO STREAMLINE HER PORTFOLIO'S OWNERSHIP STRUCTURE AND REDUCE ADMINISTRATIVE COSTS.

party creditors, which can generally only reach the equity in the particular entity with which they are transacting, and assure investors that their investments will not be at risk for liabilities associated with unrelated assets.

Furthermore, lenders and equity investors significantly reduce the likelihood that the asset serving as collateral for their investments will be dragged by developers into a bankruptcy proceeding filed by or against the principal owners of the asset-owning entity or their affiliates.

ited liability company, which is considered the owner. In this case, twenty or more investors own the membership interests of each limited liability company (LLC).

Clearly, the asset manager has amassed a significant and impressive portfolio within a relatively short period of time. By virtue of the 50 SPEs that own her portfolio's assets, the asset manager has created an intricate and fragmented ownership structure that, from a management perspective, is exceedingly cumbersome and costly. As the number of SPEs increases

of all the entities currently holding title to a portfolio into a single entity.

In this sample case, a consolidation would best be achieved through a roll-up of the membership interests held by investors in the various LLCs that own her portfolio properties (Ownership LLCs) into an umbrella limited liability company (Roll-Up LLC). When the roll-up is complete, every investor in the Ownership LLCs will own interests in the Roll-Up LLC.

Benefits that Payoff

A roll-up transaction would enable the asset manager to streamline her portfolio's ownership structure, significantly reduce administrative costs, and achieve her other short and long-term objectives. (See "Roll-Up Benefits," page 70.)

Before a roll-up can be implemented, several steps need to take place. Initially, each portfolio property would be appraised and a dollar value assigned to the membership interest owned by each member of each Ownership LLC. Based upon these appraised values and Ownership LLCs dollar amounts, an

exchange ratio would be established for the exchange of interests in the Roll-Up LLC upon contribution of the membership interests in the Ownership LLCs. Using the exchange ratio, the asset manager would then establish the percentage interest in the Roll-Up LLC to be received by each existing investor.

A new LLC would be organized to serve as the Roll-Up LLC, and the members in the Ownership LLCs (contributing owners) would contribute their membership interests to the Roll-Up LLC in exchange for membership interests in it. The Ownership LLCs that currently own the portfolio properties would remain in place. In effect, the Ownership LLCs would become wholly-owned subsidiary entities of the Roll-Up LLC.

Subsequent to transaction, the Roll-Up LLC could raise additional capital by issuing additional membership interests.

The consent of the contributing owners, as well as existing lenders for the portfolio, will likely be required for the roll-up transaction. To save transaction costs, these approvals should be obtained (even if only in concept) before proceeding with any of the required documentation. The consent of other third parties also may be required. Because the roll-up could be viewed as a change of control or indirect ownership, other contracts affecting the portfolio communities, which may contain restrictions on transfer and/or the Ownership LLCs, should be examined, and any required consents obtained.

Know the Law

The tax consequences of the roll-up structure also must be evaluated. The contribution by existing investors to the Roll-Up LLC of their respective membership interests in each Ownership LLC should generally be a tax-free transaction to both the investors and the Roll-Up LLC.

Each investor will obtain a tax basis in his membership interest in the Roll-Up LLC equal to the adjusted tax basis of the

membership interests in each Ownership LLC that he contributed to the Roll-Up LLC. Since after the roll-up each Ownership LLC will be a single-member limited liability company owned by the

will likely be exempt from the securities law registration requirements.

However, to properly claim this securities law exemption for the roll-up, certain notices must be filed with the Securities and Exchange Commission (SEC) and the comparable state securities commissions, depending upon the state securities laws of the residences of the existing investors.

Even if exempt from SEC and state law registration requirements, the roll-up transaction will nonetheless require the preparation of a private placement memorandum (PPM) for both current investors and any new investors in the Roll-Up LLC.

The PPM to current investors should explain, in detail, the consolidation/conversion process as well as the advantages, disadvantages, and risks involved.

The PPM to any new investors should explain, in detail, the financial, risk, and tax aspects of an investment in the Roll-Up LLC. Both PPMs should include a description of the portfolio communities owned by the Roll-Up LLC.

If all investors are accredited investors, the PPM need not be in a particular form nor meet specific regulatory requirements.

The applicability of the SEC's broker-dealer registration requirements also should be addressed before the roll-up transaction is implemented. The sellers of the securities to new investors will either need to be registered as broker-dealers or exempt from registration.

A roll-up transaction that consolidates ownership of a portfolio's communities into a single umbrella operating company can provide a number of benefits to an owner or asset manager.

In addition to simplifying a complicated ownership and management structure and reducing administrative costs, a roll-up can serve as the vehicle through which a portfolio may be best positioned for future growth, additional capital investments, and, ultimately, a portfolio-based sale. ■

ROLL-UP BENEFITS

Roll-up transactions can help asset managers:

- Streamline the portfolio's ownership structure.
- Reduce administrative costs significantly.
- Best position the portfolio for growth over the next cycle through the use of an improved asset ownership structure.
- Facilitate future investment by institutional equity partners and/or by individual accredited investors.
- Offer diversification of the existing investors' investments over the asset manager's entire portfolio.
- Maintain control over the portfolio in a manner that is consistent with past management practices.
- Employ a management structure that enables current investors to serve in an advisory director position with limited managerial discretion.
- Provide a mechanism for an investor's sale of his membership interest (i.e., increased investor liquidity).
- Establish an ownership structure that will facilitate the sale of the portfolio in the future.
- Set up an improved organizational/management structure that is as simple and flexible as possible.
- Maintain in place the present financing of the portfolio properties.
- Continue using a SPE bankruptcy-remote ownership structure that is required for new financing transactions.
- Offer an attractive investment entity for new investors.

Roll-Up LLC, individual Ownership LLCs will be treated as a disregarded entity (i.e., not separately taxed as an entity) for federal and state income tax purposes. As a consequence, only the Roll-Up LLC will have to file tax returns going forward.

Securities law requirements also must be considered. If all of the existing investors in the Ownership LLCs are accredited investors under applicable federal and state securities laws, the roll-up