Real estate tokenization and the potential benefits of reassessing the limited partner structure

Breaking New Ground
9 November 2020
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Tokenization is the process of translating an interest in an asset into a digital security. One of the best-use cases for tokenization may be real estate. Tokenization of a real estate asset is driven by the desire to improve the efficiency and liquidity of real estate markets that are traditionally illiquid and backed by paper-based processes. Through tokenization and smart contracts, the sponsor or general partner of an asset can set code-governed operating terms, trading rules, and more for ownership of an asset.

The process of tokenization also allows assets to be fractionalized: one may tokenize part of a property, a whole property, or a portfolio of assets. Tokenization also allows token holders to sell or borrow against their interest.

Benefits of tokenization

*Improved liquidity:* a marketplace for secondary trading unlocks liquidity that would not be traditionally available to traditional limited partner investors that are locked into an investment for as long as the sponsor holds the asset.
Alternative trading systems (“ATS’s”) are marketplaces for digital securities where tokenholders can resell their digital securities. The accessibility of online trading expands the investor market and results in faster and cheaper transaction processes.

**Market expansion:** commercial real estate investment traditionally has required relationships with sponsors, which limits market expansion. Through issuance of digital security tokens powered by a blockchain protocol, investors can connect with sponsors on a digital marketplace and invest in these sponsors’ projects by purchasing digital securities. Additionally, this marketplace has the potential to enable sponsors to access a global investor base without additional intermediaries that may otherwise be needed in cross-border transactions.

**Reduced transaction costs:** as dividend payouts, reporting, and compliance are automated through blockchain technology, the administrative costs associated with paper-based processes are reduced. Moreover, digital infrastructure allows for secure data transfer. Information related to the sale and ownership of a token is represented by “blocks” on the network and these blocks are recorded chronologically. The integrity of the transaction is preserved in that in order to change the history of a series of transactions, the block of transactions would have to be altered by solving complex mathematical problems and these alterations would be visible to the entire network.

**Players in the space**

Three main players facilitate the tokenization of a real estate asset. First, the sponsor, general partner, or manager issues an interest in the underlying real estate asset. Second, a digital transfer agent is required to issue and manage digital assets. The digital transfer agent also allows a token to change ownership between two investors. Third, a compliance partner is needed that can perform KYC, AML, and accreditation for a prospective investor. Other important players in the space, although not required to tokenize, include a broker dealer that can source investors for the capital raise, custody partners if third-party custody is required (digital transfer agents may be able to handle custody), and ATS’s which provide a venue for digital assets to be exchanged and traded.

**Drafting the documentation**

The drafting of legal documentation with respect to tokenization falls into two main categories. First are agreements between client entities and the various service providers - namely, know-your-client and onboarding services agreements, token services agreements, services agreements for regulatory and compliance advice, services agreements for promotion and distribution of tokens, and listing services agreements. Second are documents and agreements pertaining to token holders, such as private placement memoranda, subscription agreements, a smart contract for each token, and custody agreements.

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