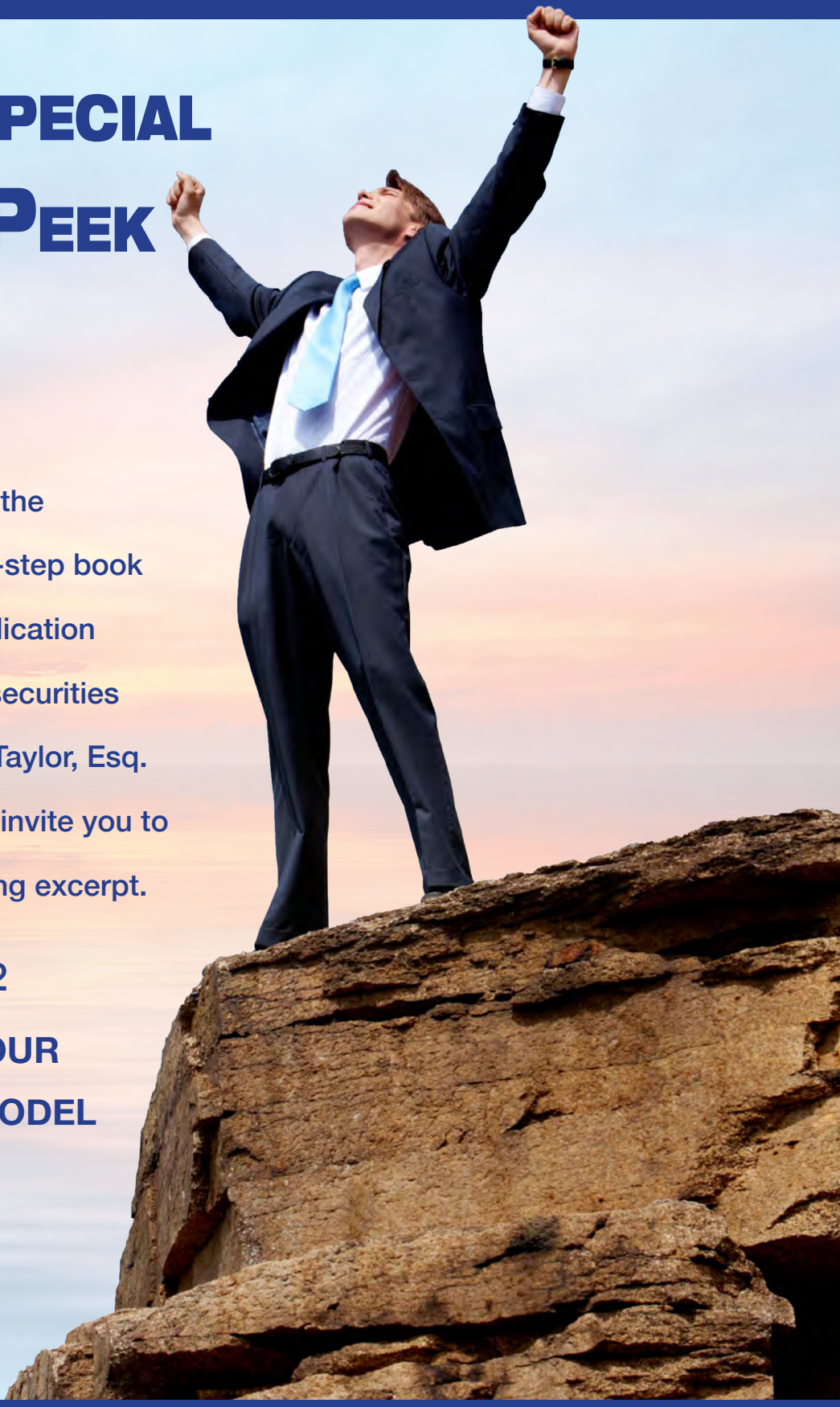
Your Special Sneak Peek



Thank you

for your interest in the upcoming step-by-step book on real estate syndication by corporate and securities attorney Kim Lisa Taylor, Esq.

We are happy to invite you to sample the following excerpt.

Chapter 2

Select Your Business Model

The following chapter is excerpted from a forthcoming manuscript by Kim Lisa Taylor, Esq., that will teach you how to set up and structure a company — and a securities offering — to legally raise money from private investors (i.e., syndicate).

Chapter 2

Select Your Business Model

Ordinary people, primarily the self-employed (or those who want to be), are using the business models discussed in this chapter to generate a return on investment for their investors and to make a living for themselves. The business model you will use is up to you. That's where your real estate training, coaches and experience come in. Your business model will become the subject of your website, company brochure and the investment summary that you will develop (with assistance of your attorney), so that investors understand you, your business model and the investment opportunity.

WHAT WILL YOU DO WITH THE MONEY?

The first thing you need to figure out is what you are going to do with the money raised from private investors and how much you will need. Developing an investment strategy that will yield a return on investment for yourself and the investors is the next step.

Real Estate

Here are some typical examples of how others use private money for real estate:

- Buying, fixing and flipping residential or commercial properties and splitting the profits with investors.
- Buying, leasing and holding residential properties to share cash flow during ownership, and splitting further profits (equity) on eventual resale.
- Buying and holding commercial income-producing rental properties such as multifamily property, strip malls, office, industrial, mini-storage, mobile home parks, student housing, parking lots, etc.; and sharing the cash flow with investors during ownership and splitting profits on eventual resale.
- Developing vacant land or redeveloping existing properties for sale or lease and sharing rental income and resale profits with investors.

- Land banking, which involves buying vacant land when prices are low and selling it when prices increase, or entitling it for development and then sharing profits with investors on eventual resale.

- Buying and holding (for current cash flow) existing promissory notes secured by real estate.

- Buying non-performing promissory notes secured by real estate at a discount and then modifying the notes to get them to perform, and holding them for cash flow or reselling them.

- Issuing promissory notes to investors and using the money to buy real estate or invest in companies owned by others.

- Issuing promissory notes to borrowers who use them to buy real estate (i.e., starting your own hard money lending fund).

Any other manner of things that will generate a return on investment.

(NOTE: If your business idea won't generate cash flow, either from operations or sale within a reasonable period of time, it's a non-profit organization, and this is not the right book for you.)

Here are some typical syndication applications:

SINGLE-FAMILY REAL ESTATE

- *Private lending fund*
- *Fix-and-flip fund*
- *Buy-and-hold fund*

COMMERCIAL REAL ESTATE

- *Multifamily/ mobile home parks*
- *Developing raw land*
- *Office/strip mall/ mini-storage*

BUSINESS STARTUP

- *Create a new product*
- *Offer a new service*

Once you know what you are buying, you can develop a business plan or investment summary that explains it to investors. If it's an existing property or business, you can base financial projections on historical operating information obtained from previous operations.

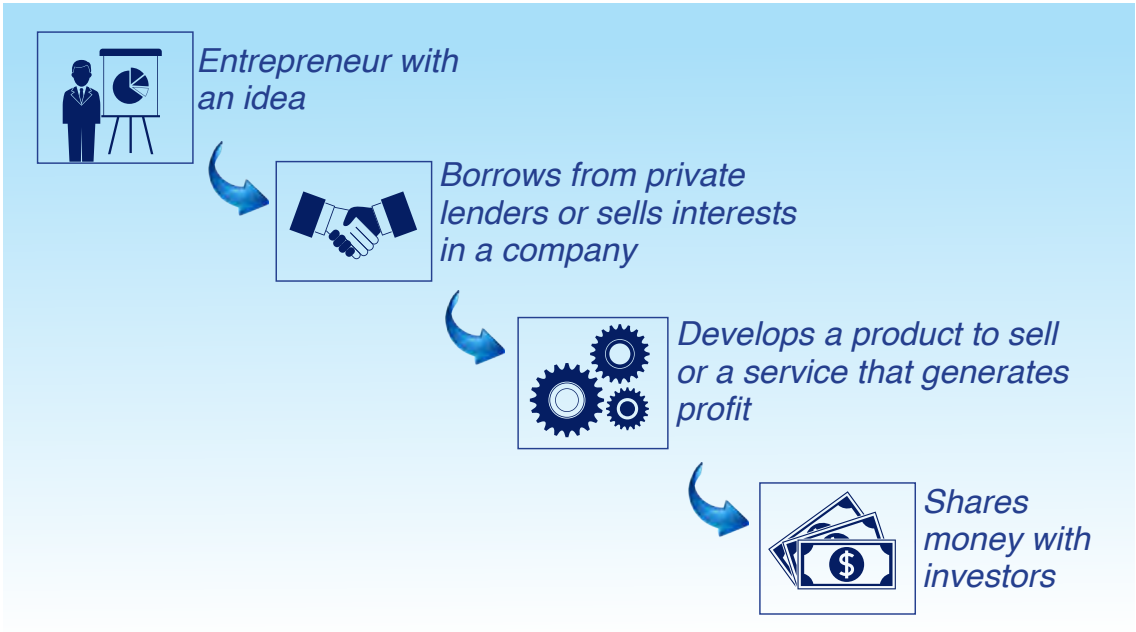
Small Business

While the primary focus of this book is on real estate syndication and crowdfunding, companies in other industries can apply most of the principles in this book to their companies if they need to raise capital to start up or expand. Some business applications for using private investor funds in non-real estate applications include:

- Launching a new product or business. The entrepreneur uses private investor funds to develop, manufacture, market and sell a product or business, and shares the profits with investors. (Have you ever watched the TV program "Shark Tank"?). If you are offering a brand-new concept, you may need some professional help to do market studies and help you make realistic projections.

- Purchasing or expanding an existing business to create greater cash flow or value and sharing the cash flow during operations or increased equity with investors on eventual resale.

- Joint venturing with or loaning money to other small businesses or individuals.



DETERMINE HOW MUCH YOU NEED AND WHEN YOU NEED IT

How much money will you raise? The key here is to figure out the exact amount of money you need to raise for your desired investment, or a minimum and maximum dollar range. Once you have raised money from investors, it may have to be deployed right away. Idle money doesn't earn returns. Too much idle money will dilute the returns on the money that is generating a return. That's not to say you shouldn't have some working capital and reserves, but the key here is to not have too much. Syndicators with too much money may be tempted to make poor investment decisions just to get the money working. If you find you have too much money and can't put it to work in a reasonable timeframe, the best solution might be to return the excess cash to investors — not as a return on their money, but as a return of capital. This could reduce the amount on which you are expected to generate a return and could perhaps lessen your burden.

CONSIDER YOUR OPTIONS

Private investor funds generally come from one or more of the sources provided below:

- *Borrowing from individual investors*
- *A joint venture with active partners*
- *Pooling funds from passive investors/syndication*

Strategy 1: Borrowing from Individual Investors

In this context, borrowing involves issuing promissory notes to individual private lenders with one investor per loan, usually collateralized against real or personal property of equal or greater value than the loan amount, although promissory notes may also be unsecured. If your strategy is to borrow money from private investors, you will need to form a legal entity (a limited liability company, limited partnership or corporation) to serve as the borrower on the note. If you are buying real estate, the borrowing entity will usually take title to the property. For a non-real estate application, the borrower may be the actual startup business that is raising the funds.

You might use borrowed funds in one of the several ways depicted below:

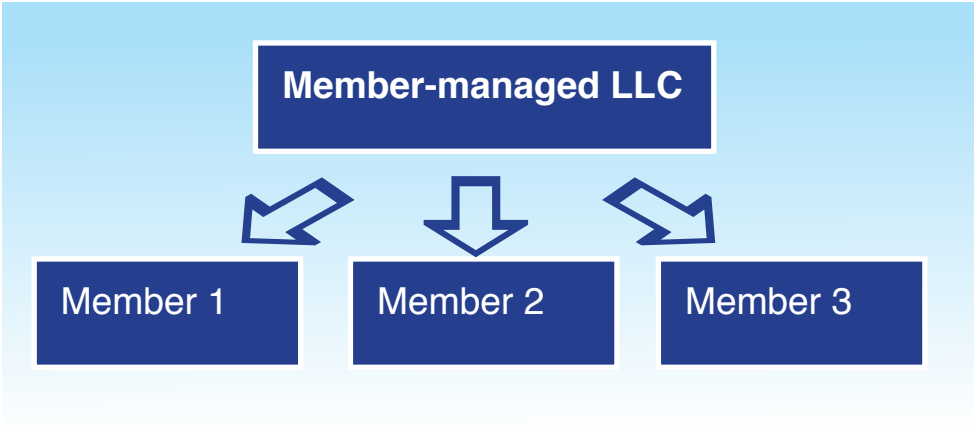
- *Single-family long-term hold*
- *Single-family fix-and-flips*
- *Buy notes*
- *Lend to others*
- *Develop product or service*

Strategy 2: Joint Ventures

This strategy includes partnering with active partners, which could range from individuals who team up with you to raise the money and start your company (your management entity), to sophisticated joint venture partners who will put up a big chunk of the money needed.

Joint venture partners at this level might include private equity funds, hedge funds, pension funds or family offices. This category also might include venture capitalists who take an active role in management of your company, in exchange for a preferred return and a cut of back-end profits.

Simple joint ventures may use a member-managed limited liability company, in which all members are considered to be “managing members.”



Strategy 3: Pooling Funds from Multiple Investors

This strategy involves pooling money from passive, private investors. You could do this by:

- Issuing fractional promissory notes to multiple investors;
- Issuing a series of promissory notes of equal priority to multiple investors; or
- Selling interests to one or more investors in a limited liability company, limited partnership, trust or corporation.

It is quite common to use a hybrid structure that incorporates more than one of these strategies. For any of these structures, you will need a securities attorney to help you:

- Determine the appropriate legal entity to use and help you form it.
- Figure out how you will share profits with investors.
- Draft appropriate legal documents so you can legally employ your strategy.

Legal Implications of Different Business Models

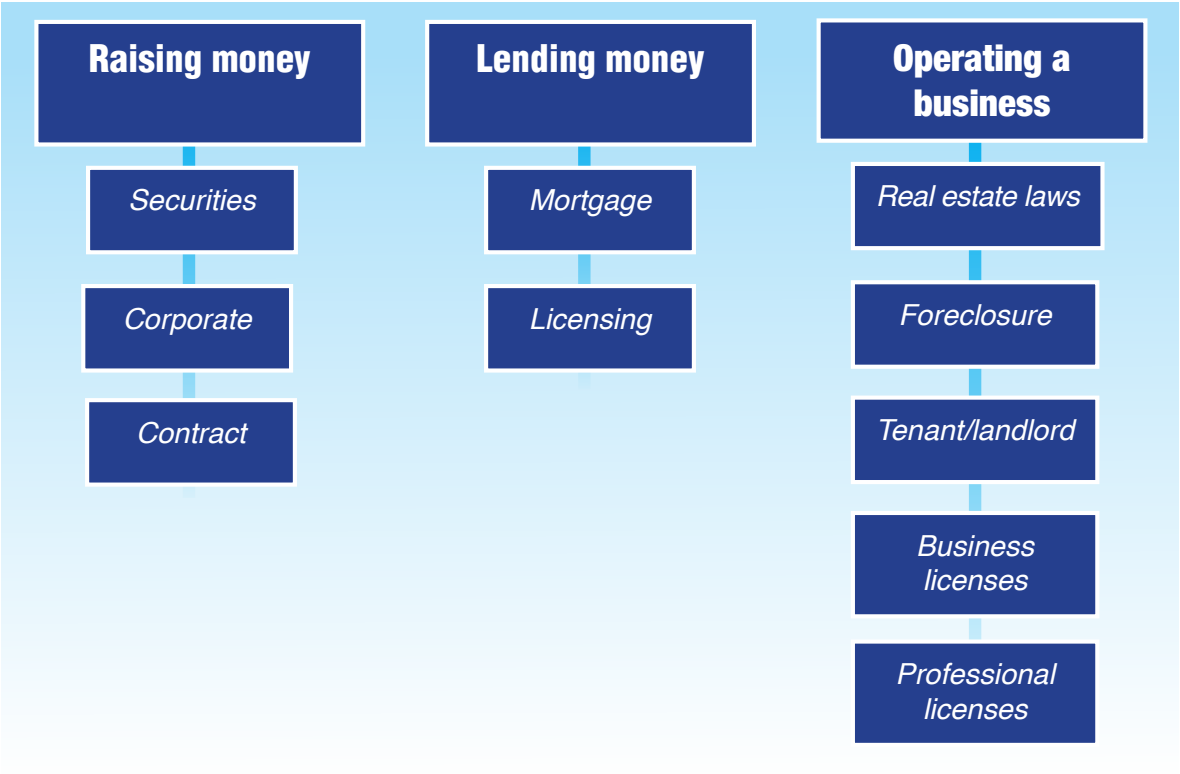
Based on the business model you select, different laws will apply, depending on how you raise the money and what you are doing with it. Below is an illustration of the laws you might need to consider in order to legally raise private money and operate your business.

TYPES OF SYNDICATES

As previously discussed, a syndicate is simply a group formed to pool resources for a common purpose.

In a real estate syndicate, the group is formed to pool members' resources (typically money from passive investors and services from the management team) to purchase real estate.

For a small business, the syndication may be formed to fund startup or expansion of a company, product or service.



There are three types of syndicates: specified offering, semi-specified offering and a blind pool. The differences are explained below.

- *Fully specified*
- *Semi-specified*
- *Blind pool*

Specified Offering

A specified offering often involves the purchase of an existing commercial property (or vacant land for development), or starting a business. As a syndicator, you will draft a property information package (i.e., an "investment summary") explaining details about the project, such as:

- Basic description of the property or business.

- Location and demographics.
- Opportunities to add value (by increasing occupancy and income and/or decreasing expenses).
- Planned use of the funds.
- Projected returns (based on historical financial records or from market studies) over a specified timeframe based on estimated income and expenses, and a projected sales price (also called the "pro forma").
- Proposed team members and their track records with similar investments.

In a specified real estate offering, you will typically obtain institutional financing for a portion of the project and raise the remaining amount from investors for the down payment and closing costs. For a development project, all of the money might be raised from private investors until the project is developed to a point where it is possible to obtain institutional financing. If you are starting a small business, you might obtain a small business loan for a portion of the financial needs or raise all of the money needed from private investors. The investors' earnings are based on performance of a specific asset, however, so if there is trouble with getting the property occupied or your financial projections don't come to fruition, the investors' returns will suffer.

Blind Pool

Blind pool syndications involve raising money from investors before any specific property or business has been identified for acquisition. The funds from private investors are typically pooled in a single legal entity, which invests in multiple assets. This structure allows diversification of the investors' risk because the company will own multiple assets so it can legally use earnings from one asset to offset losses in another.

If you decide to use a blind pool as the vehicle to raise funds, your reputation or track record with similar businesses or assets will provide the basis on which investors will make their decision. As a sponsor of a blind pool offering, you will prepare an investment summary or business plan that describes the type of assets in which your company will invest, the criteria the asset must meet to be considered for acquisition, and exit strategies that your company intends to employ to acquire, operate and ultimately dispose of the assets.

When raising money for a real estate blind pool fund, you should not provide projections such as "we will take $1 million and turn it into $3 million"), as doing

so would be pure speculation, but your company can provide information on how a typical deal might work, such as the following example for a single-family fix-and-flip fund:

> ***If the company buys a property for 70% of its after-repair value (ARV) minus the cost of repairs and sells it within 90 days, after deducting holding costs and costs of sale, the property should generate a profit of 15% or more. If we do that two or three times per year with the same investor funds, we could generate a return in excess of 30%. After-expense profits will be split 50/50 between the syndicator and investors, potentially giving the investors an annualized return of 15% of more.***

Notice there are a lot of assumptions in that paragraph:

- The property is purchased for 70% of its after-repair value minus the cost of repairs. These are the criteria the company will establish for the type of properties the company will acquire for the fund.

- The property will be sold within 90 days. If it isn't sold within 90 days, holding costs will eat into the profits.

- The company can repeat this same scenario two or three times per year with the same investor funds. This assumes the company has consistent deal flow and that there is another property meeting the same parameters that is available to purchase immediately after the previous one has sold, to which the company can apply funds from the sale of the previous property.

Thus, if even one of the aforementioned parameters slips, the 30% returns may not be realized, yielding less to investors than described. It is important when making projections or showing examples, that you state the assumptions on which those projections or examples are based. That way, if something happens and the returns are less than anticipated, you can explain why to your investors.

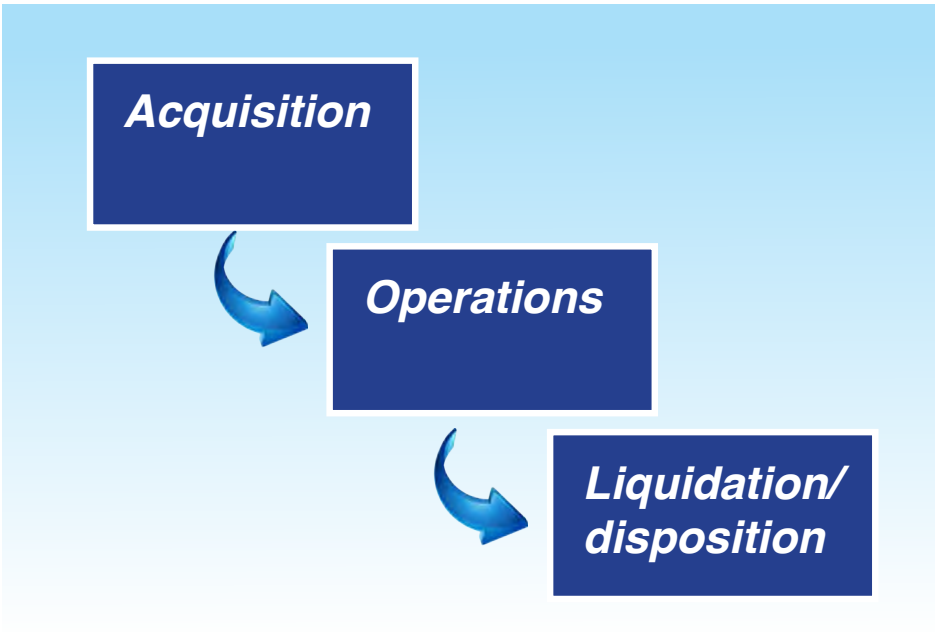
Blind pools can be used for any type of real estate asset class (such as multifamily, self-storage, office buildings, triple net properties, etc.) as well as to buy promissory notes, or to form a mortgage or hard money lending fund. In a non-real estate context, you might raise money so your company can become a venture capitalist that invests in or acquires small businesses meeting certain target parameters.

Semi-Specified Offering

This is a hybrid offering type that combines the elements of a specified offering and a blind pool. In a semi-specified offering, you can raise money for one or more properties you already have under contract, and then continue to raise money to acquire additional, similar assets. You would prepare a property package for the property under contract, and an investment summary describing the business model you will employ for future acquisitions.

PHASES OF A SYNDICATION

Each syndication has three phases:



Acquisition Phase

In the acquisition phase, your duties will include:

- Identify a suitable property, business or product.
- Perform financial and physical due diligence (if real estate) or market

research (if a business or product).

- With the assistance of an attorney, form a legal entity (LLC, LP or TIC) that will take title to the property on behalf of a group of investors.
- Obtain financing from institutional sources (if applicable).
- Hire a securities attorney to prepare offering materials (i.e., the legal documents necessary to raise private money from investors).
- Raise money from investors for the purchase (which may include either the whole purchase price or just the down payment plus closing costs).
- Close on the property, acquire the business, or develop the product.

Operations Phase

In the operations phase, your duties will include:

- Hire a professional property manager or manage the property yourself.
- Oversees improvements on the property such as rehabilitation or development.
- Operate the business, or develop and market the product.
- Pay the company expenses, including any institutional loan payments.
- Distribute periodic status and accounting reports to your company's investors.
- Share profits with investors.

Liquidation or Disposition Phase

In this phase, your duties will include:

- Market the property, business or product for sale.
- Ensure that all expenses of the company have been paid, including the principal amount of any loans from institutional lenders.
- Pay back the original capital contributions to investors.

- Pay out any preferred or other returns owed to investors.
- Pay your own fees or distributions that may have been deferred.
- Split any remaining profits with investors, or keep them as directed by your company's governing documents.

As you can see from the list above, a syndicator wears a lot of hats. Thus, it is important to decide how you will delegate some of these responsibilities, as it may be too much for a single person to handle on his or her own. Most successful issuers either have management-level partners or paid staff. Which model will work for you?

INVESTOR RIGHTS

The investors may also have some limited voting rights regarding major property decisions affecting the investment. However, a typical syndicator (or the management team) will make all major decisions regarding the property on behalf of investors. Most investors don't have the education, experience, or inclination to understand the complexities involved in acquisition and management of investment real estate or a startup business.

An experienced real estate syndicator will have spent considerable time and money learning a number of real estate acquisition and investment strategies, creative financing techniques and property management skills. It is these skills upon which the investors rely when they invest in a syndicate. For a small business startup, the investors will rely on the business owner's vision, knowledge and experience with its chosen opportunity. Part of the investor's due diligence before investing will include reviewing the background and experience of the syndicator to ensure he or she is comfortable relying on the syndicator to make investment decisions on the investor's behalf.

In the case of small business startups, some investors (such as venture capitalists or "angel investors") may take on a management role in addition to providing funds to help ensure the success of the business based on their own knowledge and experience.

NEXT: Paying Your Investors and Yourself

PAYING YOUR INVESTORS AND YOURSELF

Distributable Cash – Profit Sharing

After expenses (including any loan payments) are paid and reserves are set aside, any cash left over from operations, refinance or sale of an asset is considered "distributable cash" or "available cash." Sponsors typically earn between 20% and 50% of distributable cash generated from operations or sale of an asset, which may be paid as a direct split between the members and the syndicator or as a preferred return. Payments of distributable cash are called "distributions." The description of how funds are split amongst investors and the syndicator (or respective classes in a syndicate) is called the "waterfall."

Percentage Interests

A syndicator may sell a portion of the ownership interests in its company to investors.[1] For instance, you might choose to sell 60% of the interests in your company in exchange for all of the capital needed to meet the company's objectives. The money raised from investors is called their "capital contributions." As the syndicator, you (or your management team) would retain ownership of the remaining 40% of the interests. This is called "carried interest."[2]

Member Classes; Rights to Distributions and Voting

You may choose to separate cash-paying investors from management by creating separate classes of members.[3] One class might be cash-paying equity investors, while another may be your company and its management team or others who provide services to the company in exchange for their interests. The investor class could be further broken down into subclasses (e.g., Class A could be further divided into Class A-1, A-2, A-3), each with different returns or preference regarding payment of returns and return of capital. In this scenario, Class B interests, if reserved for the management class, usually take a subordinate position to Class A interests, who might receive a preferred return (before Class B gets paid) during company operations or a priority return of capital on sale of the asset. Another option is to simply split profits amongst the classes. In a real estate

1 Another way to raise capital is to offer promissory notes to investors, which will be covered in a later chapter.
2 Carried interest is the percentage of a private equity ... fund's profits that its general partners [or managers] receive as compensation. Traditionally, a general partner's carried interest is 20-to-25% of the fund's annual profit, after investors receive their return, www.Investopedia.com.
3 Business structures are discussed in another chapter. A limited liability company has members and one or more managers; a limited partnership has limited partners and one or more general partner

transaction, it is important to have a discussion with your securities attorney or tax counsel before making decisions about profit sharing, as doing it wrong could have negative tax implications for service-providing classes.

Your company will typically make distributions to cash-paying investors *pari passu*. A single investor's percentage interest is usually calculated by dividing the amount of that investor's capital contributions by the total capital contributions of all investors in the company or in its class. An investor's percentage interests, both in the company and in its class, will determine its voting rights and rights to distributions.

"Equity" is equal to the capital contributed by the investors. Note that this does not take into account the purchase price or value of the asset you are purchasing or developing. If multiple classes are used, the percentage interests may be calculated by class.

For example:

A sponsor sells 60% of the ownership interests in its company to investors in order to raise $1,000,0000. It offers individual interests for $1,000 each with a minimum required purchase of 100, or an investment of $100,000. An investor who invests $1,000,000 purchases 10% of the Class A ownership interests. So, while the investor owns 10% of the Class A interests, he or she only owns 6% of the total ownership interests in the company (0.10 x 0.60 = 0.06; 0.60 x 100 = 6%).

What does this mean with respect to this investor's distributions? This investor will get 10% of any distributions made to Class A members. If your company makes a distribution to all members, this investor will get 6% of those distributions.

What does this mean with respect to this investor's voting rights? If there is a vote in which only Class A participates, and voting is by percentage interests, this investor's vote will be worth 10% of the voting interests. If there is a vote in which all classes get to vote, this investor's vote will be worth 6% of the total vote.

Note, however, that the percentage of distributions may not match an investor's percentage interest if a different split is described in the company's governing documents.

For example, you could sell 99% of the interests in your company to investors, keeping 1% of the ownership (and voting rights) for the company while retaining the rights to receive 40% of the distributable cash.

Straight Splits with Equity Investors

A typical option for investors is an "equity partnership" position, where the distributable cash is split proportionately between the group of investors and the issuer, whose compensation can range from 25% to 50% of the distributable cash. In this case, the investor returns may be greater, but they will be dependent on the performance of the asset and your ability (as the syndicator) to maximize returns by increasing income and minimizing expenses.

Equity investors are usually paid distributions periodically during operations, or on refinance or disposition of the asset. A typical syndication with a cash-flowing asset may offer equity investors a straight split of distributable cash (e.g., a 50/50 or 75/25 split between the investors and the syndicator).

Preferred Returns for Equity Investors

Alternatively, many syndicators offer equity investors a preferred return (typically 6% to 10%) calculated against the amount of the equity investors' initial investment ("capital contributions"), plus a share of profits (usually somewhere between 50% and 75%). If your company is offering a preferred return, you may pay all of the distributable cash to investors until they achieve a specified return on their investment, before the management class takes any of the distributable cash for itself. Deficiencies in investors' preferred returns from prior years may carry forward (if cumulative) and can be made up from subsequent operations or on refinance or sale of the asset.

On offering a preferred return to investors, if there is any cash left, a you have several choices: 1) take an equivalent (or less) distribution for the management class; 2) split the remainder with investors according to their respective percentage interests in the company (e.g., Class A gets 60%; Class B gets 40%); 3) let the management class or investors keep the rest. These choices may come into play again if your company refinances or sells the asset.

Debt Investors

A different strategy is to offer a certain class of investors a fixed return on the amount of their investment, while your company and/or the equity investors keep the rest. For example, a large investor might take a position as a "debt investor."

There are two types of debt investors.

The traditional debt investor loans you money in exchange for a promissory note in which you promise to repay the principal and interest at specific times. Promissory notes usually include a remedy for default (if you fail to pay as agreed) giving the debt investor (aka lender) a legal remedy to recoup its principal. If the loan is secured (recorded in the chain of title against the real estate), the lender may be able to foreclose on the property. If you (or someone on your behalf) have signed a personal guarantee, the lender may be able to initiate legal proceedings to seize other assets you own.

Another type of debt investor invests in your company in exchange for ownership interests (with limited or no voting rights) in exchange for its right to receive a fixed, preferred return from operations before other investors or the management class are paid. On sale or refinance, the debt investor's capital contributions are paid back first. This class generally does not receive a share of profits, and its position can be bought out or "redeemed" (i.e., bought back), before equity investors by paying back its original capital contribution plus any preferred returns due, prorated for the period of time the company has used its funds.[4]

Creating a class of debt investors is an excellent way to use seller financing if an institutional lender won't allow subordinate debt on a property or to accommodate a large investor who wants different terms than other investors who invest less. A debt investor might also be someone who will guarantee a loan on behalf of the company and who wants to ensure he or she gets paid back first. Your company will simply create a separate class with rights different from and superior to its other equity investors. You can think of this like preferred and common stock in a public company.[5] Once the preferred class is paid off, the equity investors and the syndicators remain as the owners of the company.

In this scenario, the seller's returns may be lower than the equity investor's returns, but the debt investor position may be either preferred (meaning the investor gets paid before you do, but only if there is anything to distribute) or "secured"[6] by a promissory note (promising to make periodic interest and/or

---

4 See chapter on promissory notes.

5 A preferred stock is a class of ownership in a corporation that has a higher claim on its assets and earnings than common stock. Preferred shares generally have a dividend that must be paid out before dividends to common shareholders, and the shares usually do not carry voting rights. www.investopedia.com/terms/p/preferredstock.asp

6 Secured debt is debt backed or secured by collateral to reduce the risk associated with lending, such as a mortgage. If the borrower defaults on repayment, the bank seizes the house, sells it and uses the proceeds to pay back the debt. Assets backing debt or a debt instrument are considered security, which is why unsecured debt is considered a riskier investment. http://www.investopedia.com/terms/s/secureddebt.asp#ixzz4dNwxSCF3

principal payments) and a lien against the real estate.[7] The latter is a lower-risk position for the investor, but higher risk for your company, as the investor/lender with a promissory note may have rights to foreclose on the asset if the syndicator fails to pay. In the preferred scenario, any unpaid returns could accrue until the asset is refinanced or sold, without the issuer losing the asset to the investor(s).

Frequency of Payments to Investors

During ownership of real property, distributable cash is generally evaluated and distributed on a quarterly basis. For a small business, the proceeds may be distributed at different intervals or in a single event, such as sale of the company or product. The proceeds from any refinance or sale may first be used to return all or part of the investors' capital contributions, and any remaining distributable cash will generally be split between the members of the company and the syndicator.

The range of distributions offered to investors can vary greatly based on the type of investment (real estate versus startup business) and the level of risk to which an investor's money may be exposed. Generally, the higher the return offered, the greater the risk.

MORE WAYS YOU CAN EARN MONEY

Management Fees

Fees are typically considered an expense of the syndication, which means they are paid before determining distributable cash. Fees may be collected by the syndicator on a monthly, quarterly or annual basis.

As a real estate syndicator, you may earn the following types of fees:

- Acquisition fee — 1% to 3% of the purchase price.
- Asset management fee — 1% to 2% of gross collected revenue for cash-flowing assets.
- Refinance fee — 1% to 2% of the refinance loan amount.
- Disposition fee — 1% to 3% of the sale price.
- Loan guarantor fee — 1% to 2% of the loan amount, a flat fee, or a portion of the syndicator's fees and distributions. This fee may be paid to the

7 See chapter on promissory notes.

syndicator, an investor or someone in the syndicator's management team who signs loan documents on behalf of the syndicate.

- Interest on loans made to the company — 8% to 12% of the loan amount.

Real Estate Commissions

A syndicator who is also a licensed real estate broker or agent in the state where the subject property is located may also earn commissions or fees for providing licensed brokerage activities to the syndication, including:

- Commissions on purchase of the property.
- Resale commissions.
- Property management fees.

Expense Reimbursement

In addition to the fees and distributions you may earn as a syndicator, a sponsor is also typically reimbursed for payments made to third parties for organization of the company, due diligence/acquisition or operation of the property, syndication legal fees or other startup expenses.

SUITABLE INVESTMENTS

Suitable investments for syndication generally include any property type or company that will yield a sufficient profit to pay a return on investor's capital contributions. The returns may be generated by cash flow during operations of the asset and/or from the increased value of the asset (equity) on resale. In today's market, cash flow is the biggest draw for investors, followed by potential equity on resale.

Institutional loans are an important aspect of an investment. Institutional loans generally offer lower interest rates than what the company would have to pay investors. This is called "leverage."

Individual investors are generally looking for 7% to 10% returns from cash flow, plus an equity kicker at some future date, such as a "capital transaction" (i.e., refinance or sale) of an asset, or gain from sale.

CHAPTER 2 SUMMARY

To select an appropriate business model, you must first answer some basic questions:

- What will you do with the money you raise from private investors?
- How much do you need, and when is it needed?
- What are the possible sources of funding for your business (savings, institutional loans, small business loans, angel investors or individuals)?
- What legal relationship will you use to raise money?
- Will you borrow funds, syndicate, or enter into a joint venture?
- In what are you investing?
- What do you know about this type of asset?
- Do you have a track record?
- Can you get some training and/or team up with someone who has previous experience in this area?
- Are you buying properties one at a time, or forming a single company to buy multiple properties?
- Who will be on your management team? (Will they be others with knowledge about your business or access to money?)
- What returns will you offer investors? (Will they be fixed, a split of equity, or both?)
- Will you have different classes in investors? (If so, what are the rules for each class?)
- What is your proposed return on investment?
- When will the investors get their money back?

As the issuer, you should hire an attorney to provide advice regarding your business model, to review your investment summary before you show it to investors, and to draft the offering materials you will use to raise money from private investors.

In the following chapters we will discuss the different contractual agreements and legal entities you will use with investors, and the securities laws that apply to raising money from private investors.