How to Borrow Money to Fund Your Real Estate or Startup Business

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BORROWING FUNDS

How to Borrow Money to Fund Your Real Estate or Startup Business

In real estate, as with other investing ventures, it's not enough to simply have a good idea. It takes money to execute those ideas, and if funds aren't readily available to you, you'll need to find other sources from which to borrow.

Borrowing involves issuing promissory notes to private lenders. Each loan may have one or more investors per loan. The loans may be unsecured or they may collateralized against real or personal property of equal or greater value than the loan amount. Unsecured loans usually require personal guarantees.

This strategy works well for single-family properties that will be purchased with all-cash or to establish a "seed fund" (sometimes called a "general partner fund") that you can use to fund the pre-closing costs necessary to get commercial properties to the closing table, or to fund your startup business in non-real estate applications.

Certain institutional real estate lenders may prohibit subordinate debt. This prohibition against subordinate debt is typical of commercial loans backed by the U.S. government, such as Federal National Mortgage Association (FNMA), commonly known as Fannie Mae, or the Federal Home Loan Mortgage Corporation (FHLMC), commonly known as Freddie Mac. Additionally, some lenders who offer commercial mortgage-backed securities (CMBS) loans may also prohibit subordinate debt, although bridge lenders may not have such a prohibition. If you are buying commercial real estate with government-backed loans, then subordinate debt is likely going to be prohibited in your transaction, so you either can't use private lenders at all or you have to have a way to repay them before the property is closed.

In a seed fund, borrowed funds may be used to pay for legal fees, deposits, due diligence and lenders fees, or even to acquire properties at auction, while you organize your company and raise funds from equity investors who will stay in the deal long-term. Seed-fund investors can be given the option to convert their interests to a long-term equity investment in the company or their loans can be repaid from funds you raise from long-term investors.

Using Promissory Notes

If your strategy is to borrow money from private investors, you will likely form a legal entity such as a limited liability company, limited partnership or corporation, to serve as the borrower on the note. Borrowing in your own name can have undesirable legal implications. 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 must ensure that your investors understand who the borrower is and who will own the asset. If they are not the same entity, you will need to explain the relationship before the funds are collected. This is part of your securities obligation to provide all of the information investors need to make informed consent prior to making an investment decision.

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

- **Fix-and-flip single-family properties**
- **Buy notes**
- **Hold single-family properties long-term**
- **Lend to others**
- **Develop a product or service**
- **Grow an existing business**
- **Establish a seed fund**
- **Utilize a convertible note fund**

Who Will Loan You Money?

If you are issuing promissory notes, you are offering compensation for the use of an investor's money. The compensation you are offering is likely to be greater than the amount the investor is presently earning. If the money the investor is loaning to you is part of his or her retirement savings, you are giving that investor an opportunity to increase his or her retirement funds by the amount of interest you will pay in exchange for the use of their money for a pre-determined period of time. As a further inducement to making the loan, you might offer them loan origination fees or "points," which are usually a percentage of the loan amount. Points can be paid up-front or added to the principal loan amount and repaid when you repay the principal (on "maturity"). This can significantly increase the yield to the lender, especially if the loan will be short-term (less than a year) where the lender will never realize the full, annual interest you are offering. At 7% annual simple interest, private lenders can double their money in approximately 14 years.

The hardest part of choosing a private loan strategy for your business model will be figuring out who has money you might be able to borrow, and then mustering up the courage to ask them about investing with you through promissory notes. Although you are borrowing money in order to pursue your real estate or business startup goal, you are offering your investors an opportunity to participate in an investment they need to fulfill their own financial goals. Don't forget this important mindset when you are talking to prospective investors.

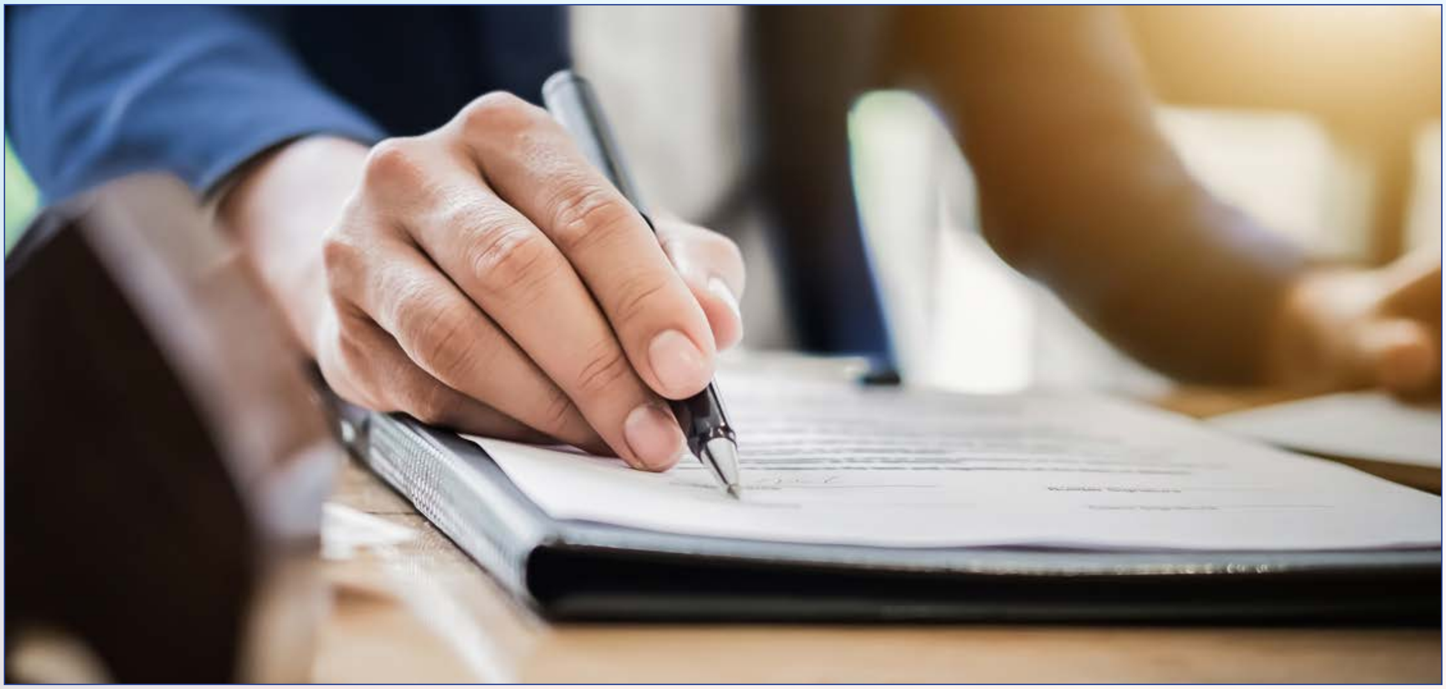
A good way to start the discussion with people you know who might loan you money is to ask about their current investments and long-term investment goals rather than starting off with a sales pitch about you and your investing goals. The most likely sources of private lenders are your family, friends, other business acquaintances, or people you meet who are interested in you and like your business model.

Hard Money Loans v. Private Loans

Hard money lenders are those who are generally in the business of loaning money. The source of funds may be their own money or money pooled from private investors in a securities offering.

While hard-money lenders are a potential source of funding you may want to consider, they may cost you dearly in interest and origination "points." Hard-money loan interest rates can range from 8% to 15% annually and points can range from 2% to 5% of the amount borrowed. Hard-money loans are best used for short-term obligations, such as a bridge loan you can use while you get other financing in place, or for a short-term project that you will sell right away. Hard-money lenders typically want their principal back within 1 to 3 years.

The alternative to obtaining a hard-money loan is to borrow money from private investors. Many real estate fix-and-flip investors rely solely on this method for funding their single-family investment properties, and many businesses have been started with a loan from one or



more benefactors. However, before you start a fix-and-flip business and start borrowing money from friends and family, you need to understand the securities laws that apply to your business. (Yes, securities laws apply to repeatedly borrowing money from individuals – even family and friends).

I emphasize this because there are many "serial borrowers," particularly in the single-family fix-and-flip business who are in denial and do not believe that securities laws apply to them. They can be routinely found at real estate investment association meetings (REIAs) held monthly in most major cities in the United States. In those settings, serial borrowers are rampant and securities legal compliance is largely ignored, exposing borrowers and their lenders to unnecessary peril. Such borrowers may be at extreme risk of regulatory enforcement action brought by securities regulators, or civil lawsuits from lenders alleging securities legal violations if any of their investments fail. There is no limited liability or indemnification for securities violations, leaving the personal assets of such borrowers vulnerable to seizure or attachment. In such event, a borrower might be tempted to redirect lender payments or proceeds from a sale to pay for their legal defense fees or regulatory fines. If you are a lender, you should ensure that the borrower is following securities laws so you don't take on that risk.

Promissory Notes are Securities

As previously discussed, promissory notes are defined as "securities" in The Securities Act of 1933 and in most state securities laws (aka "Blue Sky Laws"). It may be tempting to simply borrow money from someone you know to fix and flip a house — and it might be OK to do that one time — but when your business starts to depend on borrowing money from individuals as a repeat source of capital, or if the lenders are expecting you to invest their funds to generate their interest and principal payments, you are in the business of issuing securities, and you need to follow securities laws.

Typical Note Terms

Legally, when you borrow money, you enter into an adversarial relationship. In this type of relationship, you usually have to demonstrate your ability to meet the loan obligations before the lender will agree to loan you the money. Unlike investing in a business, a borrower doesn't have an obligation to keep the lender informed of the status of its project(s) — unless you are unable to make the agreed loan payments.

A promissory note is a contractual obligation between a borrower and a lender. It contains all of the terms of the loan, including identification of the parties (borrower and lender), the principal loan amount, the purpose of the loan, the duration of the loan, periodic payment schedule, start and end dates, the maturity date, the interest rate, points, transferability, the borrower's penalties or lender remedies on default, and identification of the collateral property the borrower offers to "secure" the loan.

Even though the note is really just a piece of paper signed by the borrower and pledging a promise to pay, unless it is non-transferable, it is a negotiable instrument that both state and federal securities laws define as a "security." It may be assigned or sold to another person (substitute lender) or the original borrower's obligations may be assumable (transferable) to a new borrower if the note terms allow it.

Interest may be paid periodically, such as monthly, quarterly, or annually, or interest may accrue without periodic payments until the principal loan amount is repaid. Interest can be calculated at a fixed rate (i.e., 7%) as in a fixed, "simple interest" rate note. Alternatively, interest may be "compounded," meaning the interest is periodically recalculated against the unpaid principal and added to the amount owed. Most real estate private loans use simple interest. Some notes offer the lender a share of profits derived from the use of the loan. These types of loans are called "shared appreciation loans" or "participation loans." The terms of the note will all be described in the promissory note.

Lender remedies for default on a note may include a "due on sale" or acceleration clause. If the due-on-sale clause is triggered, the borrower becomes obligated to repay all principal, interest, points or other fees due on occurrence of the triggering event, such as sale or transfer of ownership of the collateral asset. An acceleration clause will allow the lender to exercise this option if the borrower is in default. Default occurs when a borrower fails to perform according to the terms of the note, and it may be triggered by such things as missing successive payments, habitually paying late, failing to pay a principal "balloon payment" when due, or some other default event defined in the note, at which time the lender may exercise its remedies.

The loan may be secured by collateral for the borrower's performance of the note terms, or it may be unsecured. If the loan is unsecured, the only collateral is the note itself and the borrower's promise to pay. Collateral generally takes the form of a recorded trust deed or mortgage recorded in the chain of title for the property against which the loan was made, or it could be recorded against a different property in which the borrower has title and equity as substitute collateral. The type of recorded instrument depends on the state where the property is located. Some states use "trust deeds" and others use "mortgages."

For a secured note, the lender can foreclose on the collateral if the borrower fails to pay as agreed in the promissory note. Depending on the state in which the loan was made, the foreclosure may be "non-judicial," meaning that the lender merely follows a prescribed statutory process described in the state's real estate law or civil code and obtains title to the property after a period of time. Alternatively, in some states the foreclosure is "judicial," meaning that a court case must be filed and the parties must attend a formal hearing. In judicial foreclosure states, the foreclosure does not occur until a court order is issued transferring title to the lender. Once the lender has foreclosed and obtained title to the property, the lender may sell the property to a buyer at a foreclosure sale or auction. If the note is unsecured, there is no foreclosure remedy. In this case the lender's only remedy would be to sue the borrower and win a judgment, and then try to collect from the borrower.

Depending on its terms and the law of the state in which the loan was made, if a borrower personally guarantees a note, the lender may have the ability to recover from the borrower any deficiencies in the principal or other unpaid sums that may be recovered from sale of the property.

If a note is assignable by the lender, the lender's transferee or "successor in interest" may enforce its terms, collect deficiencies or otherwise renegotiate, foreclose or exercise the remedies defined in the note. However, since 2008, many foreclosure cases have required that a successor must have the original note signed by the borrower to enforce its rights.

Shared Appreciation Loans

Shared appreciation loans, also called "participation loans," are an often-overlooked but powerful tool that you might use to finance your business. They are often used by single-family fix-and-flippers to purchase or rehab real estate. They provide the benefits of a partnership, in which the borrower shares equity with the lender, but without having to answer to a partner or involve them in decisions on how the money gets spent. Participation loans can give the lender the benefit of a recorded interest in a property or assets of your company. The legal relationship between

the borrower and lender in a participation loan is not considered a partnership or joint venture. In some states, participation loans are also exempt from usury limits, which may limit the amount of interest a lender can legally charge a borrower for particular loan types.

The share profits are known as “contingent deferred interest,” which is usually determined after the borrower pays certain expenses associated with the transaction. Allowable expenses should be spelled out in the note and may include such items as closing costs, commissions, legal fees, improvement and holding costs (taxes, utilities, insurance) and certain fees. You will not generally charge your own labor costs as one of the allowable expenses, as that is how your company earns its share of the profits. Allowable expenses will be deducted before determining appreciation or profit to be split between the borrower and the lender.

In a shared-appreciation loan, you may owe nothing to the lender until the property sells, or you could offer to pay nominal fixed-interest payments (e.g., 5%) and then split the remainder with the lender upon sale. Periodic payments in a fix-and-flip loan don’t make a lot of sense, as that may induce the borrower to simply borrow more money with which to make the loan payments since the property won’t be generating any income during the period of ownership.

California has a specific body of law devoted to shared-appreciation loans. California statutes require specific language on a deed of trust stating that the property is subject to a shared-appreciation loan and citing the relevant regulation. This protects the lender and forces a title company, on sale of the property, to review the promissory note to ensure compliance with the note terms before paying off the lender and allowing the title to transfer to a new owner free of encumbrances.

A hybrid strategy some borrowers use for single-family fix-and-flips may be to offer a fixed-interest note recorded in first position and a shared-appreciation note recorded in second position against the collateral property in order to raise 100% of the money needed to fund a project. For instance, in a single-family fix-and-flip property, a borrower could have a hard-money loan in first position with a fixed-interest loan to fund the purchase price, and a shared-appreciation note loan in second position for the money needed to fund rehabilitation and holding costs. This strategy may be applicable in other business applications, as well.

Protecting Your Lenders

If you are borrowing private money, you have a duty to safeguard your lender’s investments. If your company is selling promissory notes, your company’s marketing materials should educate investors about unsecured versus secured notes. The following checklist contains important items that will safeguard your lender’s investment and keep everything legal:

» An attorney should prepare the promissory notes.

» For notes secured by real estate:

- A title company should provide and record the appropriate trust deed or mortgage document and you should ensure that evidence of recording is provided to the lender.
- The title company should additionally provide

a lender's title insurance policy naming the lender as the beneficiary to protect them from title defects related to the property, and the lender should receive a copy at closing.

- The title company or a separate escrow company should be hired to gather all the information your lender needs related to you and the collateral before they fund the loan.
- You should obtain appropriate fire and hazard insurance for the property and name the lender as an "also-insured" beneficiary on the policy.
- You should always create a loan that can be re-sold by your investor. This will alleviate pressure on you if a lender needs his or her money back while it is still tied up in your property or business, and you can't easily return the funds. To do this, you need to act from the beginning as if you are applying for a bank loan by filling out a loan application and letting the lender run a credit check on you. Provide backup documentation of your income and expenses just like you would have to do for a bank loan. The lender will need this if he or she ever wants to sell their note. A bank would do these types of things when it considers making a loan.

» When you pay off the note, be sure to get back the original promissory note, or have the lender sign a notarized document stating that it has been paid in full. If the note was secured by real estate, make sure the title company releases the lender's lien against the property so the new buyer obtains clear title.

» As the borrower, you should pay for any legal, escrow, or title costs as your cost of doing business. If you treat your lenders like a bank, they will appreciate your professionalism and you'll both rest easier; plus, you will likely create a loyal lender who is eager for your next deal and may become a potential source of referrals to other lenders.

» For unsecured notes (such as in a seed fund), you will usually need to provide a personal guarantee or other collateral in exchange for the loaned funds.

Once you have an understanding of what's involved in raising investor money, you are well on your way to moving from idea stage to action. Remember, while the concept may be simple, there are often complex aspects to money-raising when you are dealing with securities. So, it's always advisable to seek counsel from an experience securities attorney and other qualified professionals.

Ready to get started? Much challenge and excitement awaits; good luck!

About the Author

Kim Lisa Taylor is founding attorney of Syndication Attorneys, PLLC, a boutique corporate securities law firm that helps clients nationwide with their federal real estate securities offerings.


Kim Lisa Taylor, Esq.

She has been licensed in California since 2002 and in Florida since 2012. Her focus since 2008 has been securities transactional law. She and her team have drafted more than 300 securities offerings.

The firm employs additional of-counsel attorneys and other support staff.

The Syndication Attorneys, PLLC team assists entrepreneurs in structuring their investment opportunities to attract private investors, we draft the required legal documents, and we advise them on how to use securities laws to confidently raise the funds they need to achieve their business goals, either through their own network of family and friends or through crowdfunding on the Internet.

Our team includes content creators, editors and designers who create marketing materials to help ensure your offerings make a memorable first and lasting impression. And we have relationships with a host of other service providers – including crowdfunding platforms, fund administrators, self-directed IRA companies, web designers, marketing specialists and others.

We believe in educating our clients, frequently providing presentations and training for groups both large and small, experienced or just beginning, and even one-on-one VIP training.

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