

HOW TO RAISE CAPITAL FOR REAL ESTATE *LEGALLY*

*The Only Guide You Need to Raise Private Money
Legally for Real Estate Funds and Syndications —
With New Content!*

By Kim Lisa Taylor, Corporate Securities Attorney

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 - b. Crowdfunding and Investor Management Platforms
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 - d. Federal Securities Exemptions
 - e. Federal v. State Securities Exemptions
 - f. Investor Marketing Materials Checklist
 - g. Legal Entities Side by Side
4. Library of Referenced Materials in the Book (saved as PDFs that you can easily review or save to your own desktop)
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WHAT OTHERS SAY

About Syndication Attorneys, PLLC's Legal Services

Dyami Myers-Taylor

Kim is great! She's done an outstanding job every time I've worked with her over the years. Having done 300+ syndication offerings she is more knowledgeable than other securities attorneys I've interviewed and hired, straight to the point, and has practical ongoing first-hand experience seeing what's working and not working with different operators raising capital and the various entity and capital structures. Whether you're new to the industry or an experienced syndicator or operator and want deep securities and deal structuring expertise you're in good hands.

Jake Durtschi

I have used Syndication Attorneys for a couple of deals now. They have consistently provided really good advice. They are very specialized in what they do. They are no nonsense. They just get it done and get it done right. The work they specifically provided for me is syndication work on multifamily construction and multifamily acquisition. They have done a great job for me.

Dakota Harwell

This business is BIG TIME. If you need legal docs for a syndication, go ahead and hire Syndication Attorneys today! I'm being serious, they created HIGH QUALITY legal docs and gave me EVERYTHING I needed to move forward. Plus, they move FAST and the team is a pleasure to work with. I highly recommend!

Matthew Ma

Kim and the Syndication Attorneys team is amazing. They provide a breath of fresh air and knowledge in the syndication world. You can tell their passion and expertise for real estate investments, legal fund structures, and ability to clearly communicate with us the sponsors. They work hard to ensure every detail is met, well thought out, and help educate you on creating a successful business and fund. We're so glad to have them as a part of our investment legal team and look forward to many years of success together.

Chris Pomerleau

I utilize and trust Kim and her entire team at Syndication Attorneys for all of my SEC-compliant investments! Very reasonably priced, very easy to get a hold of, extremely knowledgeable, and a thought leader in the field. Thanks Kim and the entire team!

John Crouch

I have worked with Kim and her team on a few deals. The work product is always top notch, and I always walk away from our interactions with more knowledge than I started. Kim adds tremendous value to the legal side of our business and beyond.

Hans Rommerswinkel

My business partner Burt and I had a free consultation call with Kim Lisa Taylor, Esq. today. It was an extremely valuable call. We learned a great deal about things we should be doing immediately and what things we could wait on for a short time. Kim's knowledge is tremendous and she has a gift for simplifying concepts to help you easily understand them. We have decided to move forward with a pre-syndication retainer package to get even more value from Kim and her team. Kim is an incredible asset to anyone looking to create syndications the right way."

Bobby Sharma

Kim Lisa Taylor, Michael Fugler, and the whole team at Syndication Attorneys has been a pleasure to work with. Not only did they help me with my PPM but also getting a lot of value from the master mind group that Kim organizes for her clients.

Thomas Lorenson

Kim Lisa Taylor and her entire team at Syndication Attorneys are simply phenomenal. As a new Asset Manager of both a Home Renovation

Fund, and a 40-unit multifamily complex their team has been instrumental in our success! Both responsive, and deeply knowledgeable, I could not ask for better legal counsel. I highly recommend Kim's services to anyone interested in succeeding as an Asset Manager no matter their experience level.

MPJ

Fantastic experience. I spoke with attorney Mola for a 30-minute discovery call because I am interviewing SEC attorneys to assist with our multifamily investments. I did not have great experiences prior to finding Mola and her firm. One attorney required I reserve time on her website and pay a \$550 fee to have this initial discussion. Another attorney offered a free initial "consultation," but it was limited to 15 minutes, and it was more of a sales call than a consultation - an unfortunate waste of my time. Mola is an attorney and gave me helpful information and explanations easily worth thousands of dollars in attorney advice and counsel. I am an attorney in another field of law and would readily recommend Mola Bosland and the Syndication Attorneys team.

CP

Kim is the go-to for Asset Managers and those raising private money! She has a great way to get the information to you efficiently and in an understandable manner.

David Guarino

The folks at Syndication Attorneys did an excellent and very timely job for us with a recent raise. We had tried using another source for our filings, but it was quite messy and inconvenient. Nothing comes close to working with Kim and her team!

David Braylark

Syndication Attorneys has played a pivotal role in helping our business structure our syndication deals. They have a very knowledgeable staff and we look forward to working with them more in the future.

About the Book

Adam Balsinger

Super informative - a must read if you're raising private money. I'm in the midst of raising money for a real estate syndication and found this book to be incredible. Great content. An absolute must read if you're raising private funds.

Derikg

Immediately jumped to the top of my recommended reading list. I've spent the last 5 months and about 350 hours of research in order to get close to the information in this book. Raising private money is an effective capital funding strategy, but requires a strong base of knowledge regarding what is and is not allowed under, for example, 506(b). Kim does a fantastic job of

detailing this information in a manner that is organized, clear, and reflective of her experience in this business.

This immediately became a #1 recommended reading for investors I know looking to raise private money or participate in a private equity raise as an investor.

All the information you need is in this book!

Excellent book, it clarified a lot of doubts about how to raise money from investors. Everyone in this business should read this book for sure. I have read other syndication books but definitely this is the best.

Emilio

This book is the real deal. Written in plain English and easy to understand. And while it lays out the consequences of not following securities laws it also gives great tips on how to successfully raise private money. For the price this book is a great value for anyone looking to put together a syndication or even for those just looking to participate in one.

Ellem

Stunned how enlightening it is! Worth 100,000 times its price!! Easy to read and understand. Learned a lot. OMG, you don't know what you don't know until you read it here, I'm baffled such things as sending a blast email to people could get you in trouble. This book's worth 100,000 times its money.

J Beal

If you are going to raise private money, buy this book! Kim is a professional that understands the business and can help you navigate the SEC rules. If you are raising money buy this book!

About Our Podcast, Raise Private Money Legally

If you wish to follow our podcast, go to:

<https://followthepodcast.com/raiseprivatemoney>.

Dave Renaud

Kim is always a great source of reliable real estate and legal information. Her webinars have top notch guests and pertinent information.

Alina Trigub

Kim provides outstanding value through her webinars. Always great content and interesting speakers. Highly recommend!

Thomas Caruthers

What a terrific teleseminar! Kim and the guys from the Citadel Group painted a very clear picture on what it takes to succeed in real estate syndication.

There are a lot of moving parts to this and they addressed most of them, including addressing issues I hadn't thought of. Great job. I now have the information I need to make a plan.

About Our Website, www.SyndicationAttorneys.com

Jackson Peyton

Dear Syndication Attorneys,

Thank you for your excellent website. I've learned much from the articles posted there about marketing and about staying compliant with SEC regulations. Kim Taylor's videos are also excellent resources. Your generosity in sharing these materials is very much appreciated.

Sincerely, Jackson P.

Bill W

Anyone contemplating or already raising capital would greatly benefit by checking out the SyndicationAttorneys.com website. It is amazing and provides an incredible amount of resources. I've watched their podcasts, read the recently released book and spoken to both Kim Lisa and Charlene. I highly recommend them!

Ian Harrison

Syndication Attorneys website is a fantastic source of concise and well structured information that has obviously be written by people with genuine experience. The follow up call was equally useful. We look forward to doing business with the team.

About Kim as a Speaker for Your Events

Irene Azkue

I attended one of Kim Taylor's presentations and she was fantastic! Truly knowledgeable and engaging. I learned a lot and look forward to working with her when syndicating my deals.

Steve Knowles

At a real estate seminar recently, I heard Attorney Kim Lisa Taylor give several excellent, comprehensive presentations regarding the legal side of real estate syndication. It's a serious complicated business but Ms. Taylor made it easy to understand and easy to hear. She even made it fun at times. If you ever have an opportunity to hear Kim Lisa Taylor speak on the legalities of real estate syndication, be sure to attend. You'll be glad you did...now...and later.

Who Should Read This Book?

1. Real estate investors who want to buy real estate using private investor funds.
2. Real estate professionals (brokers, agents, mortgage brokers) who want to expand their current practice and start buying properties alongside their clients.
3. Passive investors who want to invest in real estate — but first want to understand how a group real estate investment works.
4. Financial advisers whose clients want alternatives to traditional investment opportunities and want to understand group real estate investment structures and syndicates.

**SECTION 1 —
INTRODUCTION TO
SYNDICATES AND FUNDS**

Chapter 1 – What is a Real Estate Syndicate or Fund?

Real estate syndication is a means for a group of “passive investors,” organized by an “asset manager” whose goal is to pool money with which to acquire, operate and dispose of real estate for profit. The ultimate goal is to generate “equity” that can be split among the participants (investors and management), each of whom become members of a “syndicate” or “blind pool fund” (fund) entity formed for this specific purpose.

You may see the terms syndicator, fund manager and asset manager used synonymously throughout this book. All of these terms refer to the core group of active investors who are organizing and running a syndicate or fund on behalf of investors. This is the “asset manager” entity that oversees property managers and reports to investors. The asset manager is solely responsible for the overall performance of syndicate or fund properties. This is a separate and distinct entity and function from a property manager who deals with day-to-day operations of the property.

The term “issuer” or “company” refers to the entity selling the interests to investors, regardless of whether it is a syndicate or a fund.

Funds versus Syndicates

The only distinction between a syndicate and a fund is that syndicates acquire pre-identified properties, while blind pool funds (funds) raise capital based on an “investment summary” (business plan for the fund) so that capital can be raised in advance of finding properties (hence the name “blind

pool”). While creating a fund may sound like a panacea for capital raisers, don’t get too excited as it’s the hardest way to raise money and requires a significant “track record” with previous syndicates before you will have any chance of success. Our statistics show that syndicates are 85% likely to close on a property. It is my belief that funds are only successful closer to less than 50% of the time.

What is a Track Record?

Your track record may take the form of a spreadsheet identifying similar property that members of your asset management entity have owned (if by themselves) or controlled (if their previous properties had investors) and how they have performed, or it could be displayed in a series of photos with relevant details about each property and its investment performance.

What if you don’t have that type of experience? You should seek members for your asset management entity who do. You can leverage off others’ experience – just make sure your marketing materials represent that the experience belongs to certain members of your asset management team (not you, personally), as that would be misleading.

Generally, you must have demonstrated success owning or controlling at least 5-6 similar properties with investors in a series of specified offerings before investors you meet through advertising will consider investing with you, or before you should consider creating a fund.

What is Equity?

Equity in a property is equal to the capital contributions contributed by investors when you first acquire a property. The issuer (your syndicate or fund) will sell off a portion of the ownership to passive investors and retain a portion for the asset management team. Later, on sale of a property, equity is the cash left over after paying all property expenses, including outstanding loan balances, closing costs, and other liabilities (taxes, contractors, utilities bills, etc.), that can be shared among the participants.

Note that equity doesn't take into account the purchase price of the value of the asset you are purchasing or developing, as part of the purchase price is usually contributed by a lender, which is a liability on the balance sheet for the property; not an asset. All-cash deals rarely work for commercial properties, as lenders generally demand a lesser return than passive investors. The portion of the purchase price contributed by a lender creates the "leverage" that a syndicate or fund needs to be able to pay higher returns to investors, and to have enough left over to pay the asset manager for its non-capital contributions.

What, Exactly, are Securities?

When the entity allows investments by passive investors who are relying on the asset manager to generate profit, the entity is selling "securities." What exactly, are securities?

Section 2(a)(1) of The Securities Act of 1933 defines the term "security" as follows:

“The term ‘security’ means any **note**, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, **investment contract**, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.” [Emphasis added]

Most state definitions of securities closely mirror the federal definition.

In 1946, the U.S. Supreme Court further defined the term “investment contract” when it determined that “an offering of units of a citrus grove development, coupled with a contract for cultivating, marketing and remitting the net proceeds to the investor, was an offering of an ‘investment contract’,” [U.S. v. Howey, 328 U.S. 293 (1946)].

In the Howey case, the Supreme Court held that: “The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.” Based on Howey and subsequent case law, the current standard for determining whether an investment constitutes an “investment contract” has been reduced to a four-

prong test (called the “Howey 4-Prong Test”) including the following elements:

- An investment of money
- In a common enterprise
- With the expectation of profit and
- Based solely on the efforts of the promoter or a third party.

Here is the plain English translation: “If you take control of an investor’s money, and the investor is relying on you to generate a profit for them, you have created a security.” And even simpler: “If you have passive investors, you are selling securities.”

How does this translate to interests in a limited liability company?

When forming a limited liability company, you generally have two choices: Will it be managed by the members or managed by a manager? In some states, you are required to make this election when filing the formation documents with their secretary of state or other business formation agency.

A member-managed limited liability company, in which all members participate in management of the company, is not treated as an investment contract, as it does not meet the fourth prong of the Howey Test, primarily because all members are presumed to be “managing members” and each is relying on their own efforts to generate a profit.

Conversely, forming a manager-managed limited liability company, where there are one or more managers and passive investor-members, always creates a security because the passive investors will be dependent on

the manager(s) to generate a profit on their behalf, thus meeting the fourth prong of the Howey Test.

What is a Securities Offering?

Real estate syndication and funds are regulated by the federal Securities and Exchange Commission (SEC) or state securities agencies (sometimes both), as both usually involves the sale of “securities” in the form of either promissory notes or “investment contracts.”

When you are selling passive interests in your company, you are selling investment contracts. When you are repeatedly borrowing money from private investors (family, friends and acquaintances), you are selling securities in the form of promissory notes.

A securities offering must be registered (approved by the regulatory agencies) unless exempt, which generally requires following a strict set of rules and filing of exemption notices with applicable securities agencies. The process of offering securities to investors is called a “securities offering” or “private placement offering.”

The documents the asset manager will share with prospective investors to tell them about the investment opportunity are called “securities offering documents” or “offering materials.”

Many people who are raising money from private investors fail to recognize: a) that they are offering or selling securities; or b) that they must follow securities laws to legally do so. And some have convinced themselves, usually because they don’t fully understand the rules, that securities laws don’t apply to them; we call them “in denial.”

There are four kinds of people who don't follow securities laws when raising money from private investors; 1) those who don't know; 2) those who don't care; 3) those who are in denial, and 4) those who are in jail. If you don't want to be among them, please continue reading this book.

What Isn't a Securities Offering?

This book is not about finding institutional lenders, such as banks, credit unions or even hard money lenders (people who are in the business of loaning money) to loan you money. However, these sources of funding should always be explored first, as they may be the cheapest source of financing, with the lowest interest rates and longest terms. Getting cheap money from these sources for part of the funds needed will allow you to raise less from private investors, and to leverage their returns. For a great reference guide to obtaining institutional financing for commercial real estate, read the book "Borrow Smart, Learn the 'Not So Secret' Weapons of Commercial Real Estate Investors" by my good friend and trusted advisor, Eric Stewart of Atlantic Investment Capital. You can buy it here:

<https://www.amazon.com/dp/B09QZ11F72>.

Chapter 2 – What Can You Buy With a Syndicate or Fund?

Suitable Real Estate Asset Classes

A syndicator or fund manager (asset manager) will find a suitable property (or property type), form a real estate investment company, usually a limited liability company (“LLC”), to acquire it, and then find a lender (for commercial properties), and coordinate a group of investors who will contribute cash to the company for all acquisition and improvement costs not funded by the bank loan plus the asset manager’s acquisition fee. In exchange for their capital contributions, investors will receive a membership or ownership interest in the company and a return on their investment. The asset management team earns fees and a share of profits in exchange for their sweat equity.

The Life Cycle of a Syndicate

An illustration showing the life cycle of a typical real estate syndicate that acquires and owns a single commercial property is provided below:

Life Cycle of a Typical Real Estate Syndicate



The life cycle of a typical multi-property fund is provided in Chapter 18.

Types of real estate assets commonly targeted for acquisition by syndicators and fund managers include pretty much any type of real estate. A list of asset classes that are suitable for group investments is provided below:

Asset Classes Suitable for Group Investments

- Multi-Family Property
- Single-Family Property
- Self-Storage
- Retail Shopping Centers
- Office Buildings
- Industrial Warehouses or Parking Lots
- Farm Land
- Vacant Land
- Mobile Home or RV Parks
- Marinas
- Existing “Value-Add” Properties or New Development



How Much Capital Do You Need From Investors?

How do you know how much capital to raise? For a specified offering (syndicate), you will need to itemize the funds you need to close on a property. This is called the “uses of funds.” Then you need to estimate the amount of the loan you will get from a lender. Subtract the loan amount from the total uses of funds and you will have the amount you need to raise from investors. The loan amount, amount raised from investors plus any seller credits is the “sources of funds.” See Chapter 13 for a more detailed explanation of sources and uses of funds.

For a fund, your sources and uses of funds table will be much less detailed, but you might itemize expenses for such things as legal and marketing expenses. You won’t be able to determine property-related costs or management fees until you get properties under contract.

Raising all of the money from private investors to acquire commercial real estate rarely works as a commercial lender will typically require less in interest payments than private investors want as a return on investment. By “leveraging” the investment with a bank loan, the asset manager boosts the yield on the cash contributed by investors. This boost generally yields a sufficient “cash on cash return” to pay investors a return on their investment in the mid to high teens, while paying the asset manager 20-50% share of profits.

How Do You Know if a Property Works for Syndication or a Fund?

The asset manager must identify one or more real estate assets that will generate a sufficient cash on cash return to pay investors (and the asset manager) a portion of “distributable cash” or “available cash.” Distributable cash is cash left over after paying property expenses, debt service (loan payments), asset management fees, and withholding reserves.

Distributable cash can be generated from making improvements and increasing rents for value-add properties (cash flow), or by developing new buildings that can be sold or rented. Distributable cash can also be generated by refinancing the property with a higher loan amount after value has been added or development has been completed, or by realizing the “equity” generated by selling the property after improvement or development and achieving a stabilized period of occupancy. A refinance or sale is called a “capital transaction.”

Distributable cash, when generated, is typically disbursed to all members of the syndicate by following a “distribution waterfall”, which explains the step-by-step process for paying members whenever cash that has been generated from cash flow or a capital transaction is distributed. Distributable cash cannot be guaranteed and may only be distributed when the property generates it – anything else is a return of capital.

Not all properties are suitable for syndication. They have to generate a sufficient cash on cash return to be able to pay investors an “annualized return” in the mid-to-high teens, and to pay the asset manager a sufficient share of distributable cash to make it worthwhile to take on the risk and do all the work necessary to operate the syndicate of fund.

If the cash on cash return isn’t sufficient to generate a cash flow return for investors within a couple of years of their investment; and an annualized return in at least the mid-teens after the projected sale, with the asset manager keeping 20-30% of the profits, the property is over-priced for a syndication model. Such property may be fine if someone wants to buy it on their own, but if there isn’t enough cash to split between the asset manager and investors, and still achieve your target cash returns, your choices are to offer a price that works, and if it can’t be had, then walk away.

Key Takeaways

All of this and more is detailed in the following chapters.

Chapter 3 – Why Syndicate or Create a Fund?

Real estate entrepreneurs syndicate and create funds because it's a means for them to achieve their goals of buying bigger and more properties, and perhaps a means to exit a less-than-fulfilling job. At the same time, asset managers can help their investing family, friends and acquaintances achieve their own financial investing goals. But how, specifically, do asset managers earn money? First, let's talk about the participants.

What Do Participants Contribute to a Syndicate or Fund?

What Do Investors Contribute?

Investors make “capital contributions” that are used to pay for the down-payment, closing costs, operating capital, capital improvements, legal fees, certain management fees and reserves.

What Does an Asset Manager Contribute?

The asset manager makes “non-capital contributions” of knowledge, time and effort, and actively oversees property management of real estate “assets” (properties) on behalf of a syndicate or fund. Specifically, the asset manager will analyze properties, make offers, get them under contract, organize the offering documents that will be presented to investors, conduct due diligence prior to acquisition and verify all seller-provided information, oversee property improvements, and manage the entity that it created to own

the property on behalf of the members (which include both passive investors and the asset management team). The asset manager oversees the on-site property manager during ownership of the property, and then eventually packages the property for refinance or sale. The asset manager provides status and financial reports to members during ownership, and makes periodic distributions of distributable cash to itself and investors, as it becomes available.

Additionally, the asset manager contributes the “at-risk capital” needed to get deals to the closing table. At risk capital includes pre-closing expenses for such things as property deposits, inspections, lender fees, securities attorney legal fees, third party reports, and travel expenses, etc. Pre-closing expenses are reimbursable from the capital raised from investors (providing you raise enough capital). The pre-closing expenses are considered “at-risk” until the deal closes, because if something goes wrong and a deal doesn’t close, the pre-closing expenses will be lost. In this event, passive investor funds must be returned without deduction, so the asset manager suffers the loss. That’s why it’s considered at risk capital.

What is the Benefit to Participants?

Cash Distributions

In exchange for their capital and non-capital contributions, the members (investors and management) will be entitled to their respective share of cash flow during the period the syndicate or fund owns a property, and from equity (cash remaining after paying off debt and closing expenses)

generated on sale of the property. Distributable cash is how wealth is generated.

The asset management team typically earns 20-50% of the profits generated by the property. For commercial properties, asset managers generally earn 20-30% of the profits. For labor-intensive single-family “fix-and-flip” properties, asset managers may earn as much as 40-50% of the profits.

Asset Management Fees

Additionally, the asset manager earns fees for certain aspects of the syndicate. Fees may include acquisition fees based on the purchase price, asset management fees based on gross collected income, loan guarantor fees for those who sign on loans, refinance fees for obtaining a refinance loan, and disposition fees for working with the buyer to sell the property.

Fees are an expense of the syndicate and may be collected by the asset manager on when earned, or a monthly, quarterly or annual basis. In the event sufficient cash is not available to pay fees when earned, collection may be deferred, or even waived, by the asset manager. Fees are not the bulk of an asset manager’s earnings; they are designed to keep the asset management team from starving, or having to obtain other sources of income until the property begins to cash flow and profit distributions can be made.

The type of fees an asset manager may earn are:

1. Acquisition fee — 1% to 5% of the purchase price. The purpose of this fee is to compensate the asset manager for their efforts in finding and

conducting due diligence on the property, and coordinating the loan, and organizing the syndicate on behalf of the syndicate. The higher the purchase price, the lower the fee. This fee is earned on acquisition of a property.

2. Loan guarantor fee — 1% to 2% of the acquisition or refinance loan amount or a flat fee; this is usually paid to those persons who provide loan guarantees. Even non-recourse loans still require loan guarantors with collective net worth equal to or greater than the loan amount. This fee is earned on closing of the loan.
3. Asset management fee — 1% to 2% of gross collected income. This fee is paid for the asset manager's role in actively managing, on behalf of the syndicate or fund, the company that owns the property. This fee is earned monthly, but may be paid monthly, quarterly, or annually.
4. Refinance fee — 1% to 2% of the refinance loan amount. The purpose of this fee is to compensate the asset manager for their efforts in providing documentation and loan guarantors necessary to obtain the refinance loan on behalf of the syndicate or fund. This fee is earned on closing of the loan.
5. Disposition fee — 1% to 3% of the sale price; this is to compensate the asset manager for its efforts in providing documentation and working with a broker, prospective buyers and their lenders to sell the property on behalf of the syndicate.
6. Interest on loans made by the asset manager to the company typically yield 8% to 12% of the loan amount as simple interest. A good rule of

thumb is to match the preferred return, if applicable, so investors will perceive the amount as fair.

7. Real Estate Brokerage fee – An asset manager who is a licensed real estate broker or agent in the state where the property is located may also earn commissions or fees for providing licensed brokerage activities to the syndication, including:
 - a. Commissions on purchase of a property.
 - b. Commissions on sale of a property.
 - c. Property management fees.

Expense Reimbursement

In addition to the fees and distributions, an asset manager can get reimbursed for the at-risk capital it contributed to third parties during organization of the company, due diligence, acquisition or operation of the property, and for travel expenses, and legal and organizational expenses (i.e., syndication or fund formation and legal fees). Generally, in order to get reimbursed, the asset manager (or its members) must provide receipts or invoices for such expenses.

Key Takeaways

Why syndicate real estate? Because you can make a good living doing it, while you are also helping your family, friends and other investors achieve their investing goals.

Instead of just getting a return on your own cash investment when you invest on your own; you are instead able to earn fees and a share of profits

using other people's investment dollars. Syndication is a means of "leveraging" investor dollars and loans to buy bigger and more real estate deals than you could achieve on your own.

Now, can you see why this is an attractive option for real estate investors? If this sounds like a path you want to follow, read on.

Chapter 4 – Real Estate Attorney v. Securities Attorney

If you are using other people’s money to buy real estate, you will need two different types of attorneys to help you get your deal to the closing table; one is a “corporate securities attorney” (like Syndication Attorneys, PLLC), and the other is a “commercial real estate transactional attorney.”

What Does a Commercial Real Estate Transaction Attorney Do?

A commercial real estate transaction attorney will:

- Draft your purchase and sale agreement,
- Review loan documents,
- Help set up title and escrow,
- Make sure that all necessary documents and funds are provided to the appropriate parties prior to closing, and
- Draft or review vendor contracts (property managers, laundry providers, construction contractors, etc.)

Note: Syndication Attorneys, PLLC now offers commercial real estate transactional legal services to its syndication and fund clients.

What Does a Securities Attorney Do?

Your corporate securities attorney (securities attorney) will provide an organization chart for your lender’s approval, showing the legal entities you

will use to take title to the property and the members of your asset manager. It is important to get them involved at this stage as there are nuances in the way you structure your offerings that will ensure that only the appropriate people get underwritten and sign the loan documents. Setting this up wrong can cause you, other members of your asset management entity, and your investors a lot of extra time (which you may not have), as well as additional work (and legal fees).

Once you have a signed purchase agreement on your property, your securities attorney will start working on your securities offering documents. This includes:

- Helping you select and understand the rules of your securities exemption
- Forming your legal entities and drafting their operating agreements
- Drafting a private placement memorandum (disclosure document)
- Drafting a Subscription Agreement (for your investors to complete)
- Filing a Form D with the Securities and Exchange Commission and doing the appropriate “blue sky” filings required by the state securities agencies to comply with “blue sky” laws (i.e., state securities laws)

If any legal opinions are required, your securities attorney can help you coordinate them with Delaware-licensed or corporate counsel.

If corporate resolutions or closing certificates are required by your lender, your securities attorney can help with those, too.

Unless your real estate attorney is also a corporate securities attorney with the appropriate securities malpractice insurance (very few are) and

drafting securities offering documents and forming syndicates and funds is a routine part of their regular practice, then they shouldn't be drafting your offering documents. It is easy to fall into traps with investors and taxes that only an experienced corporate securities attorney can help you avoid. Our offering documents have evolved (and continue to do so) over 10 years of practice based on the real experiences of our syndication clients in hundreds of securities offerings – you should seek that level of experience when selecting your corporate securities counsel.

Where Should Your Attorneys be Licensed?

Your real estate attorney may need to be licensed to practice law in the state where your property is located, or they may need to associate with someone who is licensed in that state, as a portion of their services may be governed by state law.

Your securities attorney, however, typically operates under federal securities laws, so it doesn't matter where the firm is licensed as it is able to help clients under federal law in any state.

Beware of Hiring the Wrong Attorney

Some commercial real estate attorneys may offer both commercial real estate transactional services and securities offerings, but make sure that securities offerings are a substantial amount of their business, which it usually is not. Oftentimes, they understand the real estate transaction, but not securities compliance, and I've even seen numerous cases where they ignore securities compliance altogether (probably because they don't know

it's required) and will simply draft an operating agreement or limited partnership agreement, thinking it's sufficient. I've actually had several commercial real estate attorneys tell me "Oh, we just draft limited partnership agreements."

If you offer interests in your company to passive investors, you are offering "investment contracts," which are securities. When you offer securities to passive investors without the required securities compliance, it's at your peril, because you are the one who will have to answer to securities regulators if you haven't followed securities laws – even if your real estate attorney didn't advise you to do so. While you may have a malpractice claim against your real estate attorney, it may be difficult and expensive for you to pursue, and in the meantime, you may have been the subject of a securities investigation, which could ruin your reputation and your ability to raise capital for future offerings.

Think of this like hiring a doctor; you wouldn't hire a foot doctor to perform brain surgery on your kid, right? The legal and medical professions are both highly specialized, so make sure you are hiring an attorney with the right expertise before you proceed.

How can you tell if they have the right experience? Ask how many securities offerings they write every month? Ask how many they have done in their career? If they are vague about the pricing or how long it will take. This may be an indication that they don't do it much, as someone who does it a lot should have a very good idea of what it will cost and how long it will take. No-one likes surprises or uncertainty about legal fees or timing.

When Do I Need to Hire Them?

You should hire your commercial real estate transaction attorney when you get an accepted letter of intent. They can help you draft a purchase agreement with the appropriate terms related to your purchase of the property. Once you have a signed purchase agreement, you should hire your corporate securities attorney to help you structure your companies and draft the appropriate offering documents.

Beware of hiring either type of attorney too soon. Some may be happy to take your retainer and start incurring fees and setting up companies, even if you are pursuing deals that never happen. This is an unnecessary expense, as you don't need to set up your corporate structure for a syndicate or fund until you are ready to start raising capital.

One exception to this is setting up a "branded entity." A branded entity is a company that you can put on our business card, create a website to act as your storefront (i.e., to establish credibility with sellers, brokers, lenders and investors), and use to make offers on properties. You won't use this company to actually purchase property, but it can represent you in the corporate structure of your syndicate or fund (more on that in the structuring paragraph), and in promoting your business to prospective investors before you have deals to offer.

Syndication Attorneys, PLLC offers a pre-syndication retainer for a nominal fee that can give you access to us when you need us, and get you invited to our weekly Clients-Only Masterminds, where we can help gain a deeper understanding of securities compliance and you can network with

other syndicators and fund managers. Our clients find that this is a huge confidence builder when talking to investor.

You Need Both!

Both types of attorneys are necessary to successfully close a commercial real estate transaction, and letting them each play their respective roles will assist you in successfully getting your deal to the closing table. Your real estate attorney will help you get the loan closed and keep you from making costly mistakes with the seller. Your securities attorney will help you comply with securities laws, reduce your risk in dealing with investors, and help protect you and your investors from creating adverse tax consequences. They will provide all of the “organizational documents” your lender will need to close the deal.

Having the right securities attorney on your team can help you stay on track to a trouble-free, long-term syndication business.

SECTION 2 — HOW TO COMPLY WITH SECURITIES LAWS

Chapter 5 – Duties Owed to Investors

If you are selling securities via a private placement or public offering of securities to private investors, you have certain obligations and duties to your investors. Failure to heed them could result in lawsuits, civil fines and, in the worst case, criminal prosecution and jail. If you want to be a successful asset manager, you need to know and understand these important obligations.

Obligations Under Securities Laws

First, you have an obligation under securities laws to not make any misrepresentations or omit any material facts, or to otherwise mislead investors. You have a further obligation to provide all material facts investors need make “informed consent” prior to making their investment decision.

This means you, as the sponsor of the securities offering, are responsible for ensuring that every document you provide investors is complete and that every written and spoken statement made by you or any member of your asset management entity is 100% accurate.

The single thing many asset managers get wrong when describing an investment opportunity is failing to accurately describe their past experience and specific roles in other investment groups, claiming they “own” other assets. Unless an asset manager owns something on their own without investors, it is never accurate to say the asset manager “owns” other

properties, because ownership belongs to the entity that holds title and its members. If there are multiple members of the title holding entity, then they are the likely “owners” of the company and the asset.

If there are investors or other members in an ownership structure that an asset manager wants to claim as part of their track record, it would be accurate for an asset manager to say they “participate in ownership”. If the asset manager actually participated in management of such entities, it would be accurate to say they “participate in control” of a property. These may seem like trivial nuances to you, but securities regulators may see it as the difference between making a truthful or a fraudulent statement. I actually knew someone who was sued by the SEC, and one of their claims was that the asset manager made fraudulent statements when they stated that they “owned” several properties on a website. The SEC said, you don’t “own” the properties, investors do! Now, do you see the importance?

Asset managers must be precise in describing their past roles in other investments. Omissions or misrepresentations can lead to charges of fraud. The misrepresentation may also involve inaccurate statements contained in your offering documents or marketing materials. Such statements may become the basis of a complaint by the Securities and Exchange Commission (SEC), or a state securities regulator.

It is your responsibility to review all marketing materials and legal documents before circulating them to investors to make sure they are 100% accurate. This is not a responsibility you can pass off to someone else (even your attorney), as only you know the material facts related to the property you are acquiring and your background.

What Are Material Facts?

Under securities laws, you (as the issuer of the securities) have the obligation to provide all “material facts” necessary for investors to make informed consent, prior to investing. Material facts are anything that could influence an investor’s decision to invest, such as whether the members of an issuer’s asset management team have criminal convictions, a recent bankruptcy or other failed investments (yes – you need to disclose all of your track record, good, bad or ugly).

It’s actually beneficial to disclose bad deals as it helps investors realize that all deals aren’t good deals, so it’s harder for them to complain they didn’t know a deal could fail if you told them about a previous deal gone bad, and what happened – if it happened once, it or something else, could happen again. Things like the Great Recession of 2008, the COVID Pandemic, wind damage that the insurance company failed to cover, etc. – all could be causes of failed investments that investors are willing to risk, and are not something an asset manager could control. Don’t try to hide past failures. Instead, turn them into a success story – about how you worked your tail off to pay everyone back, etc.

What Happens if You Commit Fraud in a Securities Transaction?

Fraudulent, misleading statements or omitting material facts is illegal under the Securities Act of 1933 and may be grounds for rescission by investors. This means you would have to give all of their money back

(usually within 30 days) or could even be grounds for criminal prosecution—even if the statements are made innocently or by mistake.

If you are going to be an asset manager for a securities offering, you need to know and understand these obligations. Failure to do so can be the undoing of all you have achieved and could ultimately result in disaster for both you and your investors.

Chapter 6 – Joint Ventures or Securities: What’s the Difference?

What if you are selling joint ventures? Are you still selling securities? If you are using other people’s money for your real estate investments, you need to know the difference between a joint venture and a security. The questions you need to ask are:

1. Will investors invest money in a common venture with you?
2. Do your investors have an expectation of profits based solely on your efforts, skills or experience?

If the answer to both of these questions is yes, then you are selling securities and you must comply with securities laws. Conversely, if the answer to the second question is no, then it may be a joint venture. This requires that your investors are actively involved in managing the project along with you.

If you have determined you are selling joint ventures, you are not home-free, as joint ventures still require a Joint Venture Agreement, and a clear and written understanding of who will perform what tasks, and how each joint venture partner will be compensated.

Additionally, joint ventures have some drawbacks for both you and your investors.

So What if You Are Selling Securities?

Federal and state definitions of “securities” include the term “investment contract.” The definition of an investment contract is “an investment of money in a common enterprise, with an expectation of profits based solely on the efforts of the promoter” (Securities and Exchange Commission v. W.J. Howey Co., 328 U.S. 293—1946).

A typical investment contract may be an operating agreement for a manager-managed limited liability company, a limited partnership agreement, a corporate shareholder’s agreement or a trust agreement with multiple beneficiaries. In each of these entities, there is an asset manager and passive investors.

The sale of securities (i.e., investment contracts) must be registered (pre-approved by securities regulators) such as in a public offering, unless the securities or the transaction is exempt from registration. To follow a securities exemption, the asset manager must first decide which exemption is applicable and then have the appropriate documents drafted on behalf of the issuing entity. It is up to the asset manager (and each of its members) to document how they followed the rules for the exemption.

Typical rules for securities exemptions may include advertising restrictions, limits on who can invest (financial or geographic) or limits on the number of investors, and they usually require disclosure of the risks of the investment through a disclosure document.

Investors often don’t want to know they are selling securities (many are in denial), because they have heard that the rules are complex or that it’s too

expensive to draft the offering documents. Most people who don't follow securities laws either don't know about them or they have convinced themselves that securities laws don't apply to them (in denial).

The truth is that the consequences of non-compliance with securities laws are steep and simply not worth the risk. Securities litigation fees can rapidly approach six figures, in addition to steep fines that could be imposed by regulators, or in the worst cases, jail. Further, if you want to take your company to a higher level, where you are not dependent on your own resources, or just a few joint venture partners, you need to have a securities offering so that you can be in control of the investment.

Securities offering rules, once you take the time to learn them, can actually help you grow your business. They may allow you to have an unlimited number of investors and raise an unlimited amount of money. They will allow you to control the deal, and in exchange, you can earn fees and a share of profits from your efforts – not just the amount you invest. And with certain exemptions, you can advertise your offering with limited restrictions.

Why Not Just Do Joint Ventures?

A joint venture is “an undertaking between two individuals or companies for the purpose of carrying out a particular project.” Another name for a joint venture is a general partnership.

Joint ventures can range from simple to complex. In a simple joint venture, two or more individuals or companies may combine resources (money, labor or skills) to accomplish a common goal, such as buying and

rehabbing a house or forming an entity that acts as the manager of a syndicate or fund.

A complex joint venture could involve a private equity fund or family office and a syndicate or fund combining resources to acquire a large commercial property, where each puts up part of the money for the down payment and closing costs, signs on the purchase loan and shares in management responsibilities.

How is this different from an investment contract? In a joint venture, there may be an investment of money (or labor) in a common enterprise with an expectation of profits, but the fourth prong of the Howey Test is missing. The success of the project is not “based solely on the efforts of the promoter” (as in an investment contract) because the investors remain actively involved in management of the asset.

The downside of the joint venture structure is that every member is a manager, so no member can make decisions on behalf of the group like they can in a company that raises money via a securities offering. Further, investors with jobs may not have the time, inclination or ability to participate in management of a real estate joint venture.

From the practical side, do you really want your physician-investor telling you how to rehab a house or purchase an apartment complex after you’ve invested time and money learning how to do it from experts in the field?

The primary drawbacks to a joint venture are that investor earnings may be taxed at ordinary income rates, and the requirement of active involvement

by all participants could preclude self-directed IRA investors (due to prohibited transaction rules). Further, everyone is a manager, so decisions must be made by majority—or sometimes, unanimous—consent.

According to Investopedia.com, “it is estimated that nearly half of all joint ventures last less than four years and end in animosity,” generally due to disparities among expectations and contributions of the parties.

Typically, joint venture partners all share proportionately in the risks, revenues, expenses and other assets related to a property. They also share liability for the acts of each other. This is a burden your investors may not knowingly take on, because they don’t have the time or skill sets to actively participate, or they may not want to take on the liability that comes with being a managing member or responsible party in a joint venture.

The only advantage to doing joint ventures versus syndications is that a joint venture requires a more simplified joint venture agreement in lieu of securities offering documents, which may be cheaper to draft initially, but could cost much more later in legal fees and emotional turmoil if the deal turns sour.

Additionally, our experience is that more than 5 members in a joint venture is a recipe for disaster. We’ve seen this happen again and again. Here are some of the issues we’ve seen when too many joint venture members try to participate in a single project.

1. The first problem is that the deal usually doesn’t get to the closing table because of disagreements or non-participation by certain members.

2. The second problem is dissention or dissatisfaction as certain members almost always pull more weight than others, and then begin to resent the slackers.
3. The third problem is compensation – those who pull more weight want additional compensation, but the ones who don't pull their weight can't see what others are contributing that justifies it.
4. The fourth problem is that people who found the deal and are taking the lead on putting it together usually want to earn fees and a larger share of profits than they would get from their cash contributions – once you go down that road, you are squarely in the realm of selling investment contracts (securities) and not joint venture interests.
5. The worst case we saw were a group that started litigation on a project immediately after closing. The only winners in that deal were the litigation attorneys.

Trying to do joint ventures will cause you to stay with smaller deals. They will restrict your ability to scale up and buy bigger properties. If you want to scale, you need to syndicate. You can stop being afraid of syndicating with passive investors once you learn how to do it legally.

Key Takeaways

Many people try to claim they are selling joint ventures, when they are actually selling securities. They make these claims in an effort to avoid complying with securities rules. A former SEC commissioner once said:

“95% of the time when we are asked if something is a security, we determine that it is.”

To maintain a defensible joint venture, all parties must have an active management role in the common project or company. This role must be more than just a right to vote; each member should have an actual defined scope of work, and should be able to demonstrate that they actually did the work. Calling someone a joint venture partner and then treating that person as a passive investor is no defense.

It is not what you say, but rather how you run the company that will determine whether you have sold securities or joint venture interests. If your investors rely on you to generate the profits, it's a security. If you are not sure whether you are selling securities or joint ventures, you should consult a qualified securities attorney and figure it out. It's better to be safe than sorry.

Chapter 7 – Overview of Securities Exemptions

You have many choices about which securities exemptions to follow. Don't try to memorize all the different rules for each exemption described below. Instead, use the rules to "rule out" those that aren't appropriate.

To begin with, you need an idea of the type of exemptions that are available so you can figure out how to use them to your advantage. The stated regulatory objective of these exemptions is to "facilitate capital formation" by private parties — most of the people using these exemptions are real estate entrepreneurs, small businesses, or startups, just like yours.

The appropriate exemption can generally be determined by answering the following questions:

1. What are you buying with investor funds?
2. What does it cost? Will you get a loan for a portion of the purchase price?
3. Where is it?
4. Where do your investors live? Are they in one state, multiple states, or international?
5. How much money do you need to raise?
6. What are the financial qualifications of your investors?
7. How soon do you need the money? Is there a closing or project deadline, or can you take your time?

8. Who is raising the money? Is it you or someone else?
9. How will you raise the money? Will you raise it from friends, family and acquaintances, or do you need to advertise? If the latter, how do you plan to advertise?
10. How do you expect your investment opportunity to generate a return for investors? What has to happen before they will see a return on their investment?
11. How will you pay your investors back the money they invested? Is there some event that will allow you to return their investment all at once, or will they get it back over time?
12. How long do you plan to hold the property?

Your answers to these questions will help your corporate securities attorney figure out which securities exemption is appropriate and how to configure the corporate structure of your company. Even if you don't know all the answers now, your securities attorney should explain the available options to help you make the appropriate choices for your proposed offering.

Hint: If you can't explain how your business model will provide a return on investment and a return of capital to your investors, your offering isn't viable and you won't be successful raising money. I've talked to plenty of idealists who have an idea that doesn't generate cash flow, an eventual equity split, or any return on investment. Those are not securities offerings – they are perhaps more suitable for a non-profit company that is seeking donations but not offering a return. If you wish to form a non-profit, you should consult with an attorney that sets up non-profit companies, and make

sure you understand the regulations that apply to non-profit fundraising activities.

Who is Entitled to the Exemption?

The exemptions can be claimed by the issuer of the securities, and by extension, its asset management entity (and its members) who are organizing and running the syndicate or fund. Further, the asset management entity (or its members) are also members of the issuing entity by virtue of the ownership interests reserved for the asset management team.

The Securities Act defines the issuer of securities as “every person who issues or proposes to issue any security...” Another definition describes the issuer as “a legal entity ... that develops, registers and sells securities to the investing public in order to finance its own operations.”¹

Note that an exemption from registration does not alleviate an issuer (or the asset manager) of its obligations under the anti-fraud, civil liability, or other provisions of federal or state securities laws, or its obligation to avoid making misleading statements in its promotional materials.

Common Elements of All Exemptions

As discussed in the previous chapter, for federal offerings, the offer and sale of securities must be registered (per Section 5 of The Securities Act of

¹ www.investinganswers.com/financial-dictionary/investing/issuer-2236

1933)² unless exempt. The most common federal exemptions fall under Regulation D, which offers several exemptions defined by a set of “Rules,” including Rule 504, Rule 506(b) and Rule 506(c).

Every state has its own securities regulatory division and their own “intrastate securities exemptions.” Virtually all states have adopted the definitions of accredited and sophisticated investors set forth in the federal rules, and further described below.

Following an applicable exemption allows an issuer to avoid having to pre-register its offering with the SEC and/or state securities agencies, although notice filings may be required within certain timeframes.

Below are some considerations that apply to all exempt securities offerings:

- Securities laws (federal and state) generally prohibit paying commissions to anyone except for licensed securities brokers. This precludes paying finder’s fees to unlicensed persons who refer investors to a securities offering, with limited exceptions (See Chapter 26).
- Securities sold under securities exemptions are considered restricted securities and may not be re-sold within one year of purchase.

² See 15 U.S.C. 77a et seq., as amended.

- Securities exemptions are self-executing, meaning that the issuer must establish a recordkeeping system to be able to prove how it followed the specific rules of the selected exemption.³

Each securities exemption (federal or state) has a specific set of rules regarding who is allowed to invest or participate in management. Typical rules for securities exemptions may:

- Prohibit or restrict advertising for investors.
- Require the existence of a substantive, pre-existing relationship between the issuer and investors before securities may be offered or sold.
- Require investors to have certain income, net worth or investment experience.
- Require the issuer to disclose all material facts investors need to make informed consent.
- Exclude certain bad actors from becoming officers, directors, managers or promoters of an exempt offering, or from owning more than 20% of any voting class of securities in an offering (“Bad Actor Rules”). Certain bad actors are prohibited from participating and /or

³ See SEC publication Regulation D, “Rules Governing The Limited Offer And Sale Of Securities Without Registration Under The Securities Act of 1933.”

certain bad acts may have to be disclosed to investors in the offering materials. The issuer is required to make an inquiry to every potentially “covered person” to determine whether any of the Bad Actor prohibitions or disclosure obligations apply to them. To facilitate this for our clients, we require all members of management of an issuer (or members whose ownership triggers the inquiry) to undergo a Bad Actor/Background check before they can be named in the management or allowed to own more than 20% of any voting class of securities offered by the issuer.

- Require notice filings with the SEC and/or state securities agencies. This is fully discussed in Chapter 10.

Because securities exemptions are self-executing, the asset manager has the burden of proving the issuer complied with the rules of its selected exemption. Think of this like an Internal Revenue Service (IRS) tax deduction; if you meet the IRS criteria for a deduction, you can claim it, but if you are audited, you must provide documentation proving you qualified for the deduction, or it will be disallowed. If your exemption is disallowed, you could be found to have violated securities laws at the federal level, and in every state where you sold securities, triggering multiple enforcement actions.

Investor Qualifications

Before discussing the different exemptions, we need to define some of the terms that appear in this chapter. See the SEC publication at our Book Bonus page:

<https://RaiseCapitalForRealEstate.com/BookBonus.>

Accredited Investors

Who is an accredited investor? An accredited investor, in the context of a natural person, includes anyone who:

- Earned income that exceeded \$200,000 (or \$300,000 together with a spouse or spousal equivalent) in each of the prior two years, and reasonably expects the same for the current year, OR
- Has a net worth over \$1 million, either alone or together with a spouse or spousal equivalent (excluding the value of the person's primary residence), OR
- Holds in good standing a Securities or Financial professional license such as a Series 7, 65 or 82. The General Securities Representative license (Series 7), the Private Securities Offering Representative license (Series 82) and the Licensed Investment Adviser Representative (Series 65) are professional certifications and designations for financial professionals. In order to obtain and qualify for these licenses, an individual must pass the related exam. Whether one is considered in good standing is specific to the designation, and persons seeking accredited investor status as a Series 7, 65 or 82 license holder should consult FINRA rules and any state rules applicable to them.

There are other categories of accredited investors, including the following, which you may encounter:

- Any trust, with total assets in excess of \$5 million, not formed specifically to purchase the subject securities, whose purchase is directed by a sophisticated person, OR
- Most entities with total investments in excess of \$5 million, not formed to specifically purchase the subject securities, OR
- Any entity in which all of the equity owners are accredited investors.

There are other definitions of an accredited investor that you can look up online at www.SEC.gov, but they are infrequently used by our clients, so we have not included those definitions here.

How Do You Calculate Net Worth?

The SEC has an excellent reference describing how to calculate net worth. See the SEC publication at our Book Bonus page to download your copy:

<https://RaiseCapitalForRealEstate.com/BookBonus>

Sophisticated Investors

In this context, the term “sophisticated investor” means “an investor who either alone or together with his, her or its purchaser representative, has sufficient knowledge and experience with financial and business matters that the investor can evaluate the risks and merits of a contemplated investment.”

Technically, this term applies to both accredited and non-accredited investors who wish to invest in an exempt securities offering. However, even in SEC publications, the term is more frequently applied to non-

accredited investors who wish to qualify to invest in an exempt offering, and those investors who meet the definition of an accredited investor are presumed to be sophisticated.

To re-state this definition in plain English, the company or private fund offering the securities must reasonably believe that the investor has sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of the prospective investment, either by themselves, or with the assistance of a “purchaser representative.” A sophisticated investor is more than someone with just savings and a job and no prior investment, financial or business education or experience.

Who is a Purchaser Representative?

A purchaser representative should be someone who is NOT connected with the asset manager of your securities as an affiliate, director, officer or employee, and does not own more than 10% of any class of equity interests (unless related to the purchaser by blood, marriage or adoption and a familial relationship).

Who Determines if Someone is Sophisticated?

The asset manager, acting on behalf of the issuer, must make a subjective determination, during their initial interview with a prospective investor, and again on review of the prospective investor’s Subscription Agreement, as to whether they are sophisticated enough to participate, and that they can afford to lose the money. If the asset manager doesn’t believe that a prospective investor is sophisticated, and the exemption requires it, the issuer should promptly return the investor’s funds without deduction.

Intrastate Securities Exemptions

Rule 147 (Section 3(a)(11) of the Securities Act) gives states sole jurisdiction and enforcement authority over securities offerings if all of the investors and the issuer are residents of a single state. These exemptions are called intrastate exemptions. Call us even if you are thinking of doing an intrastate offering, as we may be able to offer you some guidance.

Intrastate exemptions typically include a requirement that 80% of the property or revenue is derived from activities within the state. Under Rule 147, each state has developed its own set of rules for its intrastate securities exemptions, commonly known as Blue Sky rules.

Including a description of the intrastate securities exemptions for each state is beyond the scope of this book, but a table comparing the federal rules to the Intrastate rules for California and Florida is provided in our Book Bonus page at:

<https://RaiseCapitalForRealEstate.com/BookBonus>

These exemptions provide examples of the rules typical of intrastate exemptions.

A summary of the rules typical of an intrastate offering are provided below:

- The issuer and investors are all residents of a single state;
- 80% of property or revenue is in the same state;
- The issuer must comply with state Blue Sky laws;
- No federal filing or reporting required.

Here are some common characteristics of intrastate securities exemptions:

- Most intrastate offerings allow accredited investors (as defined under the federal regulations), but they may also define their own investor qualifications, which could be more or less stringent than the accredited investor requirements.
- For certain state exemptions, no financial qualification may be required if a prior relationship exists and you don't advertise the opportunity.
- Certain state exemptions may limit the percentage of an investor's net worth that can be invested in a single offering.
- Some intrastate exemptions may restrict the number of persons to whom an issuer can make offers or sales within a 12-month period. The former restriction means you would have to keep track of how many people you tell about your offering.
- You may need to file notices with the state securities agency before you make offers or sales.
- Certain exemptions may require that you submit your offering documents and/or obtain pre-approval before you start making offers to investors.

If you choose an intrastate exemption for your securities offering, you should be able to recite the applicable state exemption by code number. If you don't know the code, how will you ever be able to comply with its rules?

If you are considering an intrastate offering, you should consult a corporate securities attorney to see what rules might be available to you locally. Once you start crossing state lines with investors from multiple states, or acquiring properties outside the issuer's home state, an intrastate exemption may not be the best choice. Instead, you might choose a federal exemption that supersedes intrastate Blue Sky laws so you only have to follow a single set of rules.

Contact information for state securities regulators, where you can research intrastate laws, can be found at the website for the North American Securities Administrators Association at:

<https://www.nasaa.org/contact-your-regulator>.

Chapter 8 – Federal Securities Exemptions You Need to Know

Federal Securities Exemptions Overview

There are three primary federal exemptions from registration under what is called “Regulation D.” Regulation D includes both Rules 504 and 506.⁴ The most widely used federal exemption is Regulation D, Rule 506, because it pre-empts (overrides) state securities laws — meaning you only have to follow one set of rules in order to sell securities in any state. Under Regulation D, there are two options – one allows advertising and one doesn’t. The details are discussed in a following chapter.

Rule 504 is less widely used than Rule 506 as it requires state pre-approval before securities can be sold. If you follow one of these exemptions, you don’t have to file periodic reports with the SEC as would be required for a registered “reporting” (i.e., public) company.

This chapter discusses specific securities exemptions that you can use to scale your real estate investing business when raising capital from private investors.

⁴ There was previously a Rule 505, but it was repealed as of May 22, 2017.

How Much Capital is Raised in Private Offerings?

In 2014 and 2015 the amount of money raised via private securities offerings substantially surpassed the amount raised via public offerings for the first time and the gap has continued to increase. Below are some 2022 SEC statistics regarding regulations that companies use to raise capital⁵:

Offering Type	Offering Amounts	Median Raise
Rule 506(b) Private Placements	\$2.3T	\$1.3M
Rule 506(c) Advertised Private Placements	\$148B	\$800k
Rule 504 Limited Offerings	\$624M	\$250k
Regulation A+ Offerings	\$1.8B	\$2.2M
Regulation Crowdfunding	\$368M	\$100k
Initial Public Offerings	\$126B	\$150M
Other Registered Offerings	\$1.1T	\$450M

As you can see from the above statistics, the capital raised in just Rule 506 offerings is more than twice as much as capital raised by publicly traded companies. These statistics represent a major shift in how capital is being raised and invested in the U.S. over the last decade.

⁵ U.S. Securities and Exchange Commission, Office of the Advocate for Small Business Capital Formation, Annual Report, Fiscal Year 2022, available at: <https://RaiseCapitalForRealEstate.com/BookBonus>

Rule 504 – Limited Offers of up to \$10 Million

Rule 504⁶ is the exemption for limited offerings not exceeding \$10 million in sales within a 12-month period. No ongoing reporting to the SEC is required, beyond filing of the initial Form D with the SEC.

The Rule 504 exemption, however, does not pre-empt state laws, so Rule 504 offerings are subject to state regulation. This means you must also follow the state's rules for an intrastate exemption before being allowed to sell Rule 504 securities in your state.

The state rules may allow advertising, but if advertising is allowed, the SEC restricts sales to accredited investors only. Successive Rule 504 offerings may be aggregated, meaning any securities sold within the past 12 months will be added to current sales to determine compliance with the rule.

In summary, the rules for a Rule 504 exemption are:

- The issuer can raise up to \$10 million in a rolling 12-month period;
- The issuer is allowed to have an unlimited number and type of investors — no investor prequalification or counting required;
- However, if you wish to advertise and the state allows it, all investors must be accredited.
- A federal Form D filing is required (see Chapter 10 re securities notice filings)

⁶ The complete regulation can be found at 17 CFR §230.504.

- Certain bad actors are prohibited from participating in management, promotion, or owning >20% of any voting class of securities in the offering.
- There offering may require compliance with additional state rules and disclosure requirements.
- The offering may require state filing or pre-approval of offering documents.

In my years of practice, no-one has wanted to follow Rule 504, because of the state pre-approval requirement. It is used, but not nearly as frequently as Rule 506, which we will discuss next. You probably won't use this exemption, but there is a link to the SEC's website if you want to learn more on our Book Bonus page:

<https://RaiseCapitalForRealEstate.com/BookBonus>.

Rule 506 – The Most Commonly Used Exemption

By far, the most commonly used exemption has been the Regulation D, Rule 506 exemption, as illustrated in the table above. This is the exemption many private hedge funds and private equity funds are using to raise billions of dollars, and it is the exemption you are most likely to use, too.

Prior to the inception of the Jumpstart Our Business Startups (JOBS) Act of 2012, there was only one option for a Rule 506 offering, and its primary characteristic was that it prohibited general solicitation or advertising. This exemption arose in the 1980s as the original “country club” offering. Real estate investors complained that the public registration

process was too arduous and argued that they should be able to offer small group investment opportunities to their close group of family, friends and acquaintances. Thus, Rule 506 was born, with the condition that the only people who could be offered investment opportunities had to be previously known to the issuer, and they had to have some level of financial status or sophistication to be able to protect their own interests.

Over time, the SEC developed additional rules issuers could use to prove they didn't advertise, such as establishing a record-keeping system to demonstrate that their relationship with each investor pre-dated the offer and that they had made a pre-offer inquiry into the issuer's financial status and/or sophistication to determine their suitability to invest in the thing being offered. The exemption is self-executing, meaning that these internal records would need to be produced by an issuer if they were ever asked by regulators or during discovery (or in an investor lawsuit), to prove how they followed the rules of the exemption.

The JOBS Act changed the name to Rule 506(b) and authorized a second version of Rule 506, called Rule 506(c), which allows advertising of offerings that include only verified accredited investors. Rule 506(c) requires the issuer to take reasonable steps to ensure all investors are accredited. This rule reversed nearly 40 years of prior regulations that disallowed advertising of exempt offerings.

Many issuers are finding that advertising for investors isn't as beneficial as expected. Only 10% of the population is estimated to be accredited. Their names are being sold by list brokers to issuers, all of whom are hoping to meet and attract new accredited investors to their offerings. Newer issuers

may also find it difficult to compete with other, more established capital raisers, as competition for accredited investors has become fierce.

The reality is that most capital is raised through relationships that have been established with prospective investors before the issuer has investment opportunities to offer, regardless of whether the exemption allows advertising. Issuers who adopt policies of meeting and establishing relationships with investors first, and only offering investments to those they already know, have the greatest likelihood of success.

Issuers who take the time to establish pre-existing relationships with prospective investors establish a robust database of loyal investors who will invest with them over and over again. Doing this can allow them to raise capital in ever-increasing amounts to fund more deals and/or bigger deals. Additionally, having a database of pre-vetted investors can minimize the risk of letting the wrong investor in their offering. Ask someone who is divorced if letting the wrong person into their lives can be disruptive and stressful; we all inherently know the answer to that question.

As a small issuer, you are naïve to believe that you can connect via social media or mail with people whose names you bought from a list of accredited investors, hoping to get \$100,000 wires flooding your bank account. For small issuers like you, raising private money is always going to be more successful and rewarding when you take the time to develop relationships built on credibility, familiarity and trust that only comes through getting to know your prospective investors.

Rule 506(b) – The Friends and Family Exemption

In a Regulation D, Rule 506 securities offering⁷, an issuer may sell their own securities in any state without:

- Registering the securities offering, or
- Being registered with the SEC or any state as a broker-dealer (see Chapter 26).

For a wall chart comparing Federal Securities Exemptions, go to our book bonus page:

<https://RaiseCapitalForRealEstate.com/BookBonus>

Requirements

The requirements for the Rule 506 private placement exemptions can be found under Regulation D (17 CFR § 230.501 et seq.). A summary is provided below:

In general, under the original Rule 506 — now known as Rule 506(b) — an issuer of securities has a “safe harbor” as long as they can prove through internal documentation and regulatory filings how they followed the rules of the exemption. Internal documentation is typically done using customer relations management software (CRM), or an investor

⁷ Rule 504 and Regulation A+ Offerings may require that issuers obtain a broker-dealer license at the state level in certain states that require it.

management platform (of which there are numerous options available). The exemption precludes the issuer from having to obtain SEC pre-approval of the offering or needing to obtain a securities license to sell their own securities. The “safe harbor” is a presumption that you followed all of the rules of the exemption.

While it’s not necessary to do the Form D filing to get the exemption, if you don’t file it, a regulator is likely to presume you didn’t follow the rules, giving you a higher burden of proof to establish that you did everything else correctly. Additionally, state regulators may not be so lenient if you didn’t do their Blue Sky filings, which require that you provide a copy of the Form D you filed with the SEC. It’s a catch 22, you simply need to be vigilant and do the filings (SEC and Blue Sky) within the prescribed timeframes.

Here is a description of the requirements for the Rule 506(b) exemption:

- You can raise an unlimited amount of money.
- From an unlimited number of accredited investors, and up to 35 non-accredited investors.
- All investors must be sophisticated.
- No advertising or general solicitation is allowed; to prove you didn’t advertise, you must be able to prove that you had a pre-existing substantive relationship with every investor that pre-dated your offer to them.
- A disclosure document (usually a private placement memorandum with specific content prescribed by the SEC) is required if you allow any non-accredited investors; and we highly recommend it if you will have more than 4 or 5 accredited investors.

- A Form D should be filed with the SEC within 15 days of when the first investment becomes “irrevocably contractually committed.” The date this occurs should be firmly established in your offering documents – and you need to know what it is – as this is the trigger for your filing deadline. If you miss the deadline, you could lose the “safe harbor”.
- The Rule 506 exemption pre-empts the application of additional burdens of state Blue Sky laws, but all states except Florida still require notices filings (with fees and a copy of the Form D filing) within 15 days of sales to investors in their jurisdiction. See Chapter 10 re securities notice filings.
- Certain bad actors are prohibited from participating in management, promotion, or owning >20% of any voting class of securities in the offering.

Pre-Existing Substantive Relationships

The way to prove that you didn’t advertise is to demonstrate that you had a “pre-existing, substantive relationship” with each investor.

“Pre-existing” means that the relationship pre-dated your offer to an investor to invest with you. “Substantive” means you have knowledge about each investor’s financial qualifications and “suitability” before you make offers to invest. See Chapter 25 for more information on establishing pre-existing, substantive relationships prior to soliciting investors.

Although large funds use registered investment advisers or licensed securities broker-dealers to raise funds for their private offerings, this

channel is not typically available for smaller offerings, as investment advisers and securities broker-dealers typically won't market securities offerings of less than \$10 million, and will only do so for those with significant track records with similar investments. When they do agree to take on your offering, they will likely charge a due diligence fee of \$50,000 to \$100,000 dollars to vet your asset management team and the deal. As a result, the bar to entry for small issuers is such that they must typically develop direct relationships with prospective investors and sell securities on their own.

All of our clients who have never raised money before, start with Rule 506(b) and many continue to use Rule 506(b) for all of their offerings. The reason is that your friends, family and acquaintances will invest with you while you develop a track record that is necessary to be able to advertise to strangers or to hire a crowdfunding platform or broker-dealer to sell securities on your behalf.

Rule 506(c) – Advertising Allowed

The pre-existing relationship and non-solicitation provisions of Rule 506(b) have been a source of great confusion, misinterpretation, and a significant impediment to the ability of private issuers to fund their securities offerings, especially in light of the popularity of the internet and social media. This problem was addressed with the advent of The JOBS Act, wherein Rule 506(c) was established that allows advertising.

Issuers under Rule 506(c) are able to advertise to anyone as long as they only accept verified accredited investors in their offerings and comply with the rest of the Rule 506(c) provisions.

Requirements

The requirements for the Rule 506(c) exemption are:

- The issuer can raise an unlimited amount of money.
- Funds can come from an unlimited number of verified accredited investors.
- Advertising of the offering is allowed.
- A Form D and Blue Sky filings are required within 15 days of the first sale. See Chapter 10 for more about securities notice filings.
- Certain bad actors are prohibited from participating in management, promotion, or owning >20% of any voting class of securities in the offering.

Who is Responsible for Ensuring Investors are Accredited?

The burden is on the issuer to demonstrate that reasonable steps were taken to ensure that all investors are accredited. The SEC has offered some non-exclusive methods to verify accredited status for natural persons, which include such things as:

- The issuer can verify income from the investor's past two years' tax returns and obtain written assertions from the investor that the income is expected to continue.

- The issuer can verify an investors' assets by reviewing statement balances from brokerage houses or banks, reviewing tax assessments/third-party appraisals of real estate holdings and verifying liabilities through an investor's credit report.
- The investor can also provide a written confirmation from their own securities broker-dealer, registered investment adviser, licensed attorney or CPA, who asserts they have taken reasonable steps to verify the investor's accredited status within the past 90 days and that the person is, in fact, accredited.
- There is a grandfather clause for investors who previously invested with an issuer as an accredited investor; and a provision that makes a verification good for five years, with re-affirmation by the investor for each successive offering with the same issuer.

Rule 506(d) – 'Bad Actor' Prohibitions

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) of 2010 required the SEC to adopt rules prohibiting the involvement of certain felons and other bad actors in the use of Rule 506 safe harbor exemptions. Rule 506(d) was born of this requirement and applies to all Rule 504, Rule 506, Regulation A+ and Regulation Crowdfunding offerings.

Rule 506(d) defines covered persons and identifies disqualifying events. If a covered person experienced any of the disqualifying events during specified periods of time (up to 10 years) prior to Sept. 23, 2013, mandatory disclosure to all investors is required. For covered persons who have

experienced disqualifying events after Sept. 23, 2013, the Rule 506 exemptions are unavailable, although an issuer can seek a waiver of this prohibition from the SEC by submitting a waiver request explaining the circumstances.

A more complete description of covered persons and disqualifying events follows:

Covered Persons

For all offerings subject to the Bad Actor prohibitions, the issuer must determine whether any covered persons are disqualified from claiming the subject exemption. Covered persons include:

- Individual members, officers, directors, managers, or employees of the issuer, or
- Any person who will be involved with promotion or soliciting investors for the company, or
- Any investor or member who will acquire 20% or more of the interests in any voting class of membership interests (determined at the time of their investment).

Disqualifying Events

Issuers have an obligation to inquire about the following disqualifying events with respect to all prospective covered persons who may participate in an offering⁸:

1. Certain criminal convictions
2. Certain court injunctions and restraining orders
3. Certain final orders of certain state and federal regulators
4. Certain SEC disciplinary orders
5. Certain SEC cease-and-desist orders
6. Suspension or expulsion from membership in a self-regulatory organization (SRO)
7. SEC stop orders
8. U.S. Postal Service false representation orders

⁸ See Securities and Exchange Commission, Fact Sheet, Disqualification of Felons and other “Bad Actors” from Rule 506 Offerings, SEC Open Meeting, July 10, 2013, <https://raisecapitalforrealestate.com/BookBonus>.

If any covered person associated with your offering has experienced any one of these disqualifying events, you should seek counsel from your attorney regarding the appropriate course of action as to whether any specific “look-back” periods apply. Typical look-back periods range from five to 10 years, depending on the disqualifying event.

Including a covered person who is subject to a disqualifying event may include mandatory disclosure to investors, denial of participation, or a limit on the amount of investment or type of investment or participation that can be allowed from such a person. Further, if a disqualifying event arises later with respect to one of the members of the asset management entity during the course of an offering, the issuer will be obligated to remove them from the covered person role.

As a courtesy for our clients, we require a Bad Actor/Background check for any covered persons at the inception of the offering to determine if any bad actor issues exist. However, it is ultimately the issuer’s obligation to ensure that no disqualifying events have occurred with respect to members of the asset management entity or other covered persons who participate in their offering. The best rule of thumb is, “if in doubt, leave them out,” as keeping them in could be a deterrent to your success in raising capital, or could cause the issuer to lose its exemption for failure to adhere to the Rule 506(d) prohibitions.

Regulation A+

Regulation A+ is a streamlined registration process for forming a company that can sell securities to the general public. You should have

successfully completed a series of Regulation D, Rule 506 offerings before you considering setting up a Regulation A+ Offering in order to get your marketing plans in order.

Traditionally, Regulation A was used for small public offerings of up to \$5 million. General solicitation was allowed, but unlike a public company, no ongoing reporting was required. The original Regulation A was little used because it required pre-approval by the SEC and state securities agencies, which was an expensive, lengthy and often frustrating process.

As a result of the JOBS Act, the SEC adopted Regulation A+ in order to facilitate easier access to private capital formation for small public companies. Regulation A+ updated and expanded on the former Regulation A exemption for unregistered public offerings and carved out two new sets of rules — Tier 1 and Tier 2, with recently updated annual limits of \$20 million and \$75 million, respectively. Regulation A+ is one of the options issuers have to advertise to the general public and to also allow anyone to invest with few financial limitations.

It is estimated that less than 10% of all investors in the United States are accredited. Thus, even with the ability to advertise under Rule 506(c), many issuers hit a wall when it comes to raising private money and many otherwise-qualified investors are left out in the cold.

Regulation A+ seeks to solve that problem by allowing advertising of securities offerings to the general public with a streamlined pre-approval process. Under Tier 1, anyone can invest with no financial limitations. Under Tier 2, an investor can invest up to 10% of their net worth or 10% of

their gross annual income (whichever is greater). This opens up a new audience for issuers who can't access enough accredited investors to fund their deals, and who already know a lot of non-accredited investors who would like to invest with them.

Both Tier 1 and Tier 2 issuers can “test the waters” by floating advertising materials amongst the public to gauge interest prior to approval of the offering. This can help Regulation A+ issuers figure out what to offer, and to build a prospective list of interested investors prior to launch of the offering. Until the offering has been approved by the applicable regulators, however, Regulation A+ issuers cannot collect any money.

Like Rule 506(c), Regulation A+ prohibits participation by certain bad actors. For more detailed information about Regulation A+, please go to our Book Bonus page at:

<https://RaiseCapitalForRealEstate.com/BookBonus>

Regulation A+, Tier 1

Regulation A+, Tier 1 is an amended version of the former Regulation A. Tier 1 issuers may now raise up to \$20 million as opposed to the pre-JOBS Act \$5 million limit. Tier 1 does not have any audit requirements. This is great if you are an issuer looking to save on audit and accounting costs, as audits can be expensive, but the tradeoff is that audits give investors peace of mind and a sense of transparency. As a Tier 1 issuer, you are still required to get federal and state pre-approval of the offering before your company is allowed to collect funds. This means that in order to sell its

securities, your Tier 1 company would have to subject itself to the scrutiny of every state regulator where it intends to sell securities.

The review fees for such states could potentially exceed the cost of an audit. Filing fees vary from state to state from as little as \$100 to as much as \$5,000.

A summary of the rules for Regulation A+ (Tier 1) offerings:

- The issuer is limited to raising \$20 million in a 12-month period
- The issuer may include investors with limited prequalification requirements
- State pre-approval is required
- Disclosures and SEC pre-approval are required
- No audit requirements

Tier 2 will allow issuers who meet certain requirements to raise up to \$75 million in a 12-month period. Issuers are required to perform an audit prior to SEC approval and for a minimum of two years following SEC approval. Issuers must use a transfer agent to handle funds and must meet certain ongoing reporting requirements similar to a public smaller reporting company, including filing annual, semiannual and current event reports. Despite the audit and additional filing requirements, Tier 2 pre-empts the state pre-approval requirements under Tier 1, making Tier 2 a more appealing option if you wish to raise money from investors in multiple states.

Filing of certain documents with certain state securities regulators is still required. The North American Securities Administrators Association

(NASAA) maintains information about the state filing requirements for Regulation A+ offerings at www.nasaa.org.

Below is a summary of the rules for Regulation A+ (Tier 2) offerings:

- The issuer is limited to raising \$75 million in a rolling 12-month period that may be renewed annually
- The issuer may include investors with limited prequalification requirements
- No state pre-approval is required
- Disclosures and SEC pre-approval are required
- The issuer is subject to certain annual audit requirements

Regulation Crowdfunding

Regulation Crowdfunding (also known as “Regulation CF”) was authorized in Title III of the JOBS Act. It specifically allows real estate entrepreneurs to raise capital on the internet, providing they follow a specific set of rules. The final regulations were adopted and Regulation Crowdfunding became legal on May 16, 2016 and have since been updated.

Recall that under current securities laws, a person who wished to raise money from private investors had to register the offering – a long and expensive pre-approval process – or qualify for an exemption from registration. Exemptions may impose limits on investor qualifications and advertising; and they can be cost-prohibitive for smaller offerings.

Unlike typical private offering exemptions, Regulation CF allows issuers to advertise to the general public and imposes no financial

requirements for investors who don't invest more than \$2,000 in an offering. The primary objective of Regulation CF is to create a securities exemption that allows entrepreneurs to use the internet to legally and inexpensively raise small amounts of money from large numbers of investors in a for-profit venture.

The rationale behind Regulation CF is that the wisdom of the crowd will organically determine whether a specific project is worthy of investment. If crowd wisdom functions as designed, offerings with solid issuer credentials and well-crafted business plans will be successful, while risky projects or those lacking in substance will remain largely unfunded. Regulation CF also has an open communications provision allowing investors to comment publicly on an issuer's performance. This provision is aimed at quickly exposing fraud or ineptitude before there can be significant loss to any single individual.

The rules for a Regulation CF offering include:

- Limit of \$5 million can be raised in a rolling 12-month period
- The offering must be for a specific project — no blind pools
- There is no limit on the number of investors
- No pre-qualification is required for investments of up to \$2,000
- Financial qualification and limits on investments of more than \$2,000
- Extensive disclosures and annual audits are required for raises above \$500,000 (could be costly)
- Securities must be offered only through an SEC or FINRA-approved funding portal; issuers can't solicit independently

Which Securities Exemption to Choose

Your track record is the driver. Strangers you meet through advertising won't invest in your offering unless the members of your asset management entity have significant experience acquiring and owning the same type of property you plan to acquire.

However, friends, family and acquaintances will invest with you while you are building a track record. For this reason, all of our clients who are new to syndication and buying commercial real estate will start with the Regulation D, Rule 506(b) exemption.

Only those who have successfully completed multiple specified offerings, for properties within the same asset class, or who have team members in management who have – will be able to successfully advertise and complete a Rule 506(c) offering.

Additionally, it doesn't make sense to start out with a much more expensive Regulation A+ Offering, until you have some proven success with Regulation D offerings, and it would only make sense then if you are having trouble finding sufficient capital to acquire deals from your current network of investors and need to reach a wider audience of non-accredited and unsophisticated investors (i.e., the general public).

Generally, you must have demonstrated success owning or controlling at least 5-6 similar properties with investors in a series of specified offerings before investors you meet through advertising will consider investing with you.

Chapter 9 – Regulation S: The Exemption for Non-U.S. Investors

Regulation S is a specific securities exemption that applies to raising funds from non-U.S. persons. For SEC purposes, non-U.S. persons are defined as persons who are:

- Not U.S. legal residents or citizens,
- Not living in the U.S. regardless of nationality,
- Not U.S. residents living abroad.
- Additionally, all funds from non-U.S. persons must be wired from an off-shore account (outside the U.S.) into the issuer's U.S. bank account.

If all investors in your offering will be non-U.S. persons, conducting your offering under the Regulation S exemption from registration is the appropriate choice.

The applicable laws are found in Regulation S (17 CFR §§ 230.901 through 230.905; also known as Rules 901 through 905) and Rule 144. Like Regulation D, Regulation S provides a safe harbor to issuers of securities from the registration requirements of The Securities Act of 1933, as long as the offer and sale of securities complies with the Regulation S rules. For Regulation S, that means the offering must occur exclusively offshore (no targeted selling efforts in the U.S.) and the offering must meet other conditions.

According to the SEC, compliance with the requirements of a Regulation S offering will require the professional skills of attorneys specializing in securities law.⁹

The following rules apply to a Regulation S offering:

- The offer or sale of securities for a Regulation S offering must occur in an offshore transaction. Per Rule 902(h), an offer or sale of securities is made in an offshore transaction if: a) the offer or sale is not made to a person in the United States and b) either the buyer is outside the United States at the time the subscription agreement (buy order) is executed, or the transaction is executed via a foreign securities exchange located outside the U.S. or through a designated offshore securities market.
- No directed selling efforts may be made in the U.S. by the issuer. No offers or sales may be made to U.S. persons.¹⁰
- Rule 144 prohibits foreign investors from reselling the securities to U.S. persons within one year of purchase. The offering documents must contain legends describing this restriction. The issuer must refuse

⁹ See footnote 28.

¹⁰ Summary of SEC Regulation S Dorsey & Whitney LLP, Broker-Dealer and Investment Adviser News.

to register any transfer of securities in violation of this rule.¹¹ (Rule 902(g)).

- The issuer must obtain certification and proof from foreign purchasers that they are non-U.S. persons. This is usually done via a subscription agreement specific to Non-U.S. Persons.

A Regulation S and a Rule 506(b) Offering can be combined under the same private placement memorandum, but will require a separate Subscription Agreement for non-U.S. investors.

Because of the restriction that prohibits targeted selling efforts in the U.S., an issuer cannot combine a Rule 506(c) Offering (which allows advertising in the U.S.) and a Regulation S Offering. The issuer must have a separate private placement memorandum and a separate subscription agreement, but could have both U.S. and non-U.S. Persons invest in the same company or property.

Benefits of a Regulation S Offering

The benefits of a Regulation S offering are described below:

¹¹ Amendments to Regulation S: New Restrictions on Offshore Equity Offerings by U.S. Issuers, Simpson Thacher & Bartlett LLP, March 6, 1998

- Under Regulation S, issuers can sell securities offshore without regard for the sophistication, number of investors, or dollar amount of the offering.
- Unlike Regulation D, Regulation S does not have specific disclosure or suitability requirements. Although a private placement memorandum is not required for a Regulation S offering, best practice is to provide one to ensure the non-U.S. investors understand the structure, risks and conflicts associated with an offering.
- Regulation S permits issuers and distributors to advertise the offering offshore, which may otherwise be prohibited in an offering to U.S. persons (for instance, under Regulation D, Rule 506(b)); however, the issuer must understand the private offering rules of the country in which they are advertising (if such rules exist).¹²
- No SEC or Blue Sky filings are required for a private Regulation S Offering.¹³
- An issuer who chooses to advertise an offering via a website may do so without jeopardizing their exemption by including prominent statements on the applicable web pages indicating that the offer is

¹² Final Rule: Offshore Offers and Sales (Regulation S), Part 1 of 2, Securities and Exchange Commission, 17 CFR Parts 230 and 249, (Release No. 33-7505; 34-39668; File No. S7-8-97, International Series Release No. 1118), RIN 3235-Ag34.

¹³ "There is no SEC reporting requirement for an initial issuance of Regulation S securities by a nonreporting Issuer," per telephone communication with L.A. Bavaria of SEC's Office of International Corporate Finance, ph. (202) 551-3450, on October 13, 2010.

directed only outside the U.S. and by implementing means to preclude sales to U.S. persons.¹⁴

Other Considerations for Offerings to Non-U.S. Persons

Many developed countries have securities laws similar to those in the U.S. They may include provisions regarding advertising prohibitions, registration of the offering with the foreign government, or translation of offering documents into the local language.

A securities attorney (or local equivalent) in the country where the securities will be offered should review any securities offering that will be made in a foreign country — before it is presented to that country’s residents.

For this reason alone, it may be impractical to make a single offering available to investors from multiple foreign countries. This can be done easily by drafting your offering as you would a U.S. securities offering and asking an attorney in the foreign jurisdiction to add language specific to the securities offering in their country, if applicable. Typically, those provisions will include such things as advertising limitations and financial suitability

¹⁴ SEC Adopts Amendments to Regulation S, By Charles C. Comey and Lloyd Harnetz of Morrison & Foerster LLP; See also Endnote 1.

requirements of investors. A non-U.S. investor who invests in a Regulation S offering should be required to certify in their subscription agreement that they have inquired and are in compliance with the rules of their own country regarding investment in a U.S. securities offering.

Before making an offer to foreign investors or stepping foot on foreign soil to solicit investors for a U.S. securities offering under Regulation D or Regulation S, you should make sure the offering is compliant with the laws of that country. Failure to do so could result in severe, unexpected penalties, such as arrest and incarceration in the foreign country. **DON'T GET LOCKED UP ABROAD!**

U.S. Tax Laws; FIRPTA

Under the U.S. Foreign Investors in Real Property Tax Act of 1980 (FIRPTA), the issuer must withhold a certain percentage of any distribution to non-U.S. persons.

The withholding amount must be remitted to the IRS on the investor's behalf, prior to sending funds to any non-U.S. person. The amount of tax due from a non-U.S. person depends on the terms of the tax treaty between their country and the U.S, if there is one. The non-U.S. person will have to obtain a U.S. taxpayer identification number and file a U.S. tax return in order to obtain a refund of the withheld tax, if any is due per the treaty.

However, for countries without a U.S. tax treaty or where the tax treaty does not qualify the investor for a refund, the tax paid will simply be their cost of doing business in the U.S.

You should advise any non-U.S. persons to consult with their own financial advisers regarding the tax implications of investing with you. For offerings directed to investors in a specific country, you should conduct your own investigation of the tax implications with assistance of a qualified international tax advisor.

Note: Bona fide loans with fixed interest and no relation to performance of a property, may be exempt from FIRPTA under what is called the “portfolio loan interest exemption.” The IRS has several web pages devoted to FIRPTA taxation that are informative and fairly easy to read.

When you anticipate including non-U.S. persons, your offering materials should include clauses regarding eligibility of non-U.S. persons to invest, and the risks of including non-U.S. persons in your offering. While there may be advantages to including a few non-U.S. persons in a Rule 506 securities offering, doing so may increase the overall accounting and legal expenses associated with the company, and it may increase your liability risks.

Best practice is to consult with international tax counsel, usually coordinated through your securities attorney, to come up with a corporate structure that will be most advantageous for your prospective investors from certain countries. This may include blocker companies in an offshore location that has a better tax treaty with the investor’s home country than their country has with the U.S., or that doesn’t require non-U.S. Persons to obtain a U.S. taxpayer identification number, which many non-U.S. Persons won’t want to do. As a result, many issuers set up an offshore blocker company that the non-U.S. persons invest in, and that, in turn, invests in

your U.S. company. This approach may provide tax savings to your investors in their home country. There is no “one size fits all” approach as to which offshore jurisdiction is best.

The best structure for your investors will ultimately depend on:

- The tax treaty between the U.S. and the investor’s home country,
- The tax treaty between the U.S. and the offshore jurisdiction, and
- That jurisdiction’s tax treaty with the investor’s home country.

If you plan to create an offshore blocker entity, you should anticipate that the costs of your syndication, as well as annual administration costs, will be substantially more than simply forming a U.S. entity and bringing foreign investors into your U.S. syndication.

Foreign Tax Laws

Non-U.S. persons may also be taxed in their own country on earnings from their U.S. investments. An issuer should avoid giving non-U.S. persons any tax or legal advice, but the issuer does have an obligation to warn non-U.S. persons that potential tax consequences may exist, which could dramatically affect their returns. A prospective non-U.S. investor should consult their own legal/tax advisers to determine the U.S. and non-U.S. tax consequences of investing in a U.S. securities offering; or you should do some advance tax planning to set up offshore blockers that will give them specific tax advantages.

USA PATRIOT Act & Homeland Security Laws

Certain sanctioned or blocked foreign nationals, nationals or residents of sanctioned countries designated by the U.S. government are prohibited from directly or indirectly investing in a U.S. company. These restrictions are aimed at persons or countries identified by the U.S. as rogue nations, terrorist facilitators, weapons of mass destruction (WMD) proliferators, money launderers, drug kingpins, and other national security threats.

Collectively, the laws imposing these restrictions are known as U.S. anti-money laundering (AML) laws. A list of prohibited persons and countries is maintained and periodically updated by the U.S. Department of the Treasury, Office of Foreign Assets Control (OFAC) under the USA PATRIOT Act and related Acts.

Please see the U.S. Department of Treasury's website for more information about these programs and to search the lists at:

<https://www.treasury.gov/resource-center/sanctions/SDN-List/Pages/default.aspx>.

Any issuer of securities to non-U.S. persons will have strict liability for conformance with these requirements. Failure to comply may subject the issuer to charges for participation in such activities. As a safeguard, for any non-U.S. person, the issuer should inquire, verify and maintain the identity of each investor and whether they are prohibited from investing in the U.S. by obtaining a copy of a passport or other applicable residency or company documentation and verifying it against the AML lists.

Word of caution: You should do this for everyone. Just because an investor is in the U.S. and speaks English, doesn't mean that person isn't on the list of sanctioned or prohibited persons, or that they aren't a non-U.S. Person. Further, the Corporate Transparency Act, effective January 1, 2024, will require that you report this information to the U.S. Financial Crimes Enforcement Network (FINCEN), a bureau within the U.S. Department of Treasury. For more information, see <https://www.fincen.gov/boi>.

Depending on the circumstances, an issuer may be obligated to file a suspicious activity report (SAR) with the FINCEN if:

- A transaction is conducted or attempted to be conducted by, at, or through the issuer's investment opportunity;
- The transaction exceeds \$5,000; and
- The issuer knows, suspects or has reason to suspect that the transaction, among other things, involves funds or is intended to disguise funds derived from illegal activity, or involves the use of the investment to facilitate criminal activity.

Reporting information is available on FinCEN's website at:

<http://www.fincen.gov>

In addition to the above requirements, U.S. banks may be required to report to various federal and/or state agencies certain deposits into a U.S. bank account by a non-U.S. person.

You should check with your banking institution to determine the applicable banking rules and whether deposits from non-U.S. persons will trigger such reporting, and whether the bank's due diligence is sufficient to

satisfy the issuer's AML due diligence and reporting obligations. Don't assume it is.

Some banks may not accept funds over a certain amount from non-U.S. persons or there may be a delay in clearing the funds. Such persons may wish to set up a custodial account with a trust institution to get the funds into the U.S. in advance of the offering.

Chapter 10 – Required Federal and State Securities Notice Filings

Most securities exemptions, except for certain intrastate offerings, require filing notices with the SEC and/or applicable securities agencies. This is your notice to the SEC and the states (where your investors reside), claiming that you are following the exemption under which the offering was made.

What notices must be filed with securities agencies for an exempt real estate syndicate or fund?

The following answer is involved, but well worth your time and attention to keep you out of trouble where the sales of securities is concerned.

Federal Securities Notices

A “safe harbor” exemption from registration is granted to the issuer of securities when an offer and sale of securities complies with the specific requirements of Regulation D, Rules 504, 505, or 506 under the federal Securities Act of 1933. The safe harbor exempts an issuer from both:

- Registration requirements under the Securities Act of 1933
- Licensing requirements for securities brokers and dealers under the Securities and Exchange Act of 1934

If you are reading this chapter, this probably means you are an issuer or are contemplating becoming one. An issuer could be an individual or an

entity whose officers, directors or employees are selling securities on behalf of the company.

Federal Filing Requirements—Form D

What Constitutes a Sale?

One of the requirements most often overlooked by an issuer who otherwise would be entitled to claim the safe harbor exemption is that a Form D must be filed with the SEC within 15 days of a “sale” of a federally exempt security. For this purpose, the SEC defines “the date of first sale is the date on which the first investor is irrevocably contractually committed to invest.” See SEC Publication, Filing and Amending a Form D Notice, A Compliance Guide for Small Entities and Others, available at our Book Bonus page:

<https://RaiseCapitalForRealEstate.com/BookBonus>

For different offerings, this date could be interpreted differently. In the case of a real estate securities offering, it could be variously defined in the offering documents as the date the investor’s subscription is accepted by the issuer, the date “impounds are broken” (when the minimum offering amount is raised) or the date the investor’s money is used to acquire the real estate, or some other event or time frame specified in the offering documents. But it most certainly occurs when an investor can no longer get their money back because it has been spent to further the objectives of a real estate acquisition or business. Additionally, sending investors receipts or certificates of ownership could trigger the filing deadlines if it is done prematurely.

It is possible to tie the filing trigger date to some specific date, such as the date on which the property is acquired. To do so, it must be clearly stated in the offering documents that the offer is revocable by the investor any time prior to acquisition of the property. An issuer shouldn't fear that this means investors will pull out, as it rarely happens unless a hardship occurs, and then, the right thing to do is let them out.

The issuer must understand the trigger for their specific offering, so they can ensure their Form D gets timely filed.

What is the Purpose of the Form D Filing?

The purpose of the Form D is to notify the SEC that securities are being sold to U.S. investors and giving it information about the offering and jurisdiction over the issuer in the event the agency wishes to conduct an audit or receive a complaint regarding potential securities violations. If the Form D isn't filed within the specified time, the issuer exemption may not apply to the offering. Further, the issuer may be found to have engaged in the unlicensed sale of securities and/or selling unregistered securities. Either case could subject the issuer to criminal or civil prosecution, fines, or a forced rescission, in which the issuer must refund everyone's money within a specified time frame.

Who Does the Filing — You or Your Attorney?

If you hire an attorney to draft your syndication offering documents, the attorney will likely do this filing for you. However, there are many non-attorneys who draft their own securities documents and fail to comply with

this required step. And there also are many attorneys who will draft the offering documents, but leave it to the issuer to file its own notices.

If the Form D is not filed in a timely manner, the safe harbor does not exist and the investment may be at risk, because the presumption will be that you didn't follow the rules. In that case, you could have a bigger burden to prove that you did follow the rest of the rules of the exemption. If you can't prove compliance, the SEC could file an injunction freezing all of the assets of the company and the issuer, and charge you will selling unregistered securities. Defending a charge of the unlicensed or unregistered sale of securities will likely consume all of the assets of the company and could result in a total loss of the investment for the issuer and all of its investors.

State 'Blue Sky' Notice Filings for Regulation D, Rule 506 Offerings

One of the primary benefits of a federally exempt Regulation D, Rule 506 securities offering is that it generally pre-empts additional state requirements regarding such things as additional investor financial qualifications, limits on investment amounts as a percentage of an investor's total net worth, or a state securities agency's pre-approval of a securities offering. Most state securities agencies simply require that the issuer send them a copy of the Form D that was filed with the SEC, along with payment of a required filing fee. This is called a "Blue Sky" notice.

The purpose of these Blue Sky notice filings is to notify the state securities agencies when a security has been sold to one or more of their residents and giving those states information and jurisdiction over the issuer

(i.e., the right to serve the out-of-state issuer with a lawsuit) in case a securities violation is found to have occurred.

If the Blue Sky notice isn't filed within the specified time (usually 15 days from the first sale in that state), the state may disallow the federal exemption, and the issuer may be found to have engaged in the unlicensed sale of securities as well as selling unregistered securities within the state. That could leave the issuer open to prosecution by the state's attorney general or in its state courts for violating its state laws.

Blue Sky notice filing fees typically range from \$0 to \$600 each. However, only one notice must be filed in a state regardless of the number of investors from that state. Beware New York, however, as its Blue Sky filing fees are \$1,200, and other northeast states have more expensive fees, depending on the amount of the offering.

Other Federally Exempt Offerings

Offerings qualifying for an exemption under Rule 147, or Regulation D, Rules 504 or 505 may require much more extensive filings with the states, ranging from a pre-review process to sending a copy of the offering documents and/or filing additional state forms.

Consequences for Failure to Timely File

Most states won't allow late filings of securities notices. If an issuer fails to file the state notice within the required time frame, there may not be an opportunity to fix it later. In that case, the issuer is operating on a wing and prayer for the entire duration of the investment. If something goes

wrong and an investor complains or if the state learns of the sale of securities within its jurisdiction without the required Blue Sky filing, it could elect to prosecute the issuer at any time.

As a matter of public policy, a company cannot indemnify the issuer for securities violations. Thus, the defense of a securities violation will be borne solely by the issuer. Once the door is opened for the state or federal government (or a private civil attorney representing a disgruntled investor) to scrutinize the offering, it is possible that other violations could be found (such as misrepresentation and fraud), or paying unlicensed brokers for referring investors, subjecting the issuer to further liability and putting the entire investment at risk. Additionally, state securities agencies have monthly meetings, so an enforcement action in one state could cause other state securities agencies to investigate and file suit against the issuer.

Further, if you have failed to comply with the rules of the exemption for a federal offering (e.g., you didn't file the Form D, or you otherwise violated the rules for your federal exemption), you will likely be in violation of the state's exemption from registration of your offering at the state level.

It is far more likely that you will be investigated by a state securities agency than the SEC. The SEC seems to prosecute matters where tens of millions of dollars are at stake. I get weekly bulletins from the SEC that list the open investigations and litigation matters.

However, I have seen the Colorado securities division investigate an issuer for issuing promissory notes to three investors in the state of Colorado, and an issuer who advertised for private investors on Craigslist. I have also seen the Washington securities division investigate and stop

someone from doing an unregistered promissory note offering to Washington investors. The states seem far more likely to investigate smaller securities infractions.

How Failures Occur and How You Can Avoid Them

People who try to draft their own offering documents often don't realize that federal and state filings are required to claim the exemption, and inadvertently end up with no exemption! On the flip side, many issuers pay attorneys considerable fees to have their offering documents professionally drafted and then blow their exemption by failing to notify their attorneys when they make a "sale" to an investor from a new state so the Blue Sky notices can be timely filed!!! Make sure you don't fall into either of those traps.

Issuers need to understand that compliance with the Form D and Blue Sky filing requirements and deadlines are their responsibility. While an attorney can draft the documents, help structure the offering and advise the issuer regarding the rules associated with the exemption, it is ultimately up to the issuer to make sure its offering and actions comply with all of the legal requirements for its securities exemption—including the required filings.

The attorney who drafts the documents and files the Form D and Blue Sky notices is generally not involved with raising money from investors. Thus, they have no way of knowing when the issuer breaks impounds or makes a sale to a resident from a new state, triggering the typical 15-day

period in which the notice must be filed. If the attorney is doing the filings on behalf of the issuer as part of its legal services, the issuer has a duty to keep the attorney informed of its progress so that the Form D and Blue Sky notices can be timely filed; or to file them themselves.

The easiest way to comply with federal and Blue Sky notice filing requirements is to provide your attorney with a list of states where your investors claim residency before you break impounds and use their money. If you continue to raise money beyond that date, then you will need to update your attorney if you accept a subscription from an investor from a new state so the attorney can file a new state notice within the required time frame.

Another common source of securities violations includes self-drafted, or “cut-and-paste,” documents. Issuers of securities who copy another’s offering often overlook or are unaware of the required federal and Blue Sky notice filings. If the filings are not timely made, the exemption may not apply, regardless of whether the documents comply with disclosure requirements, or even if the issuer has followed the rest of the rules for the appropriate exemption (which is unlikely if the issuer cut-and-pasted someone else’s documents).

Asset Protection – Can You Keep Your Name Out of the Public Record?

We often get calls from people who believe they can use an asset protection strategy to keep their name out of the public record. While this may be true for your personal entities that you use to acquire and own properties on your own, it does not apply to securities offerings, which

require complete transparency and public disclosure of the persons involved in management of an issuer. Information about the “related persons” must be disclosed for publication in the SEC’s EDGAR database that is searchable by the general public.

Additionally, reporting of all persons in management and with over 25% ownership are to be reported the Financial Crimes Enforcement Network (FINCEN), starting January 1, 2024 (see <https://www.fincen.gov/boi>).

It is important to keep your asset protection entity out of the management of a syndicate or fund for that reason, but also in the event you are sued by investors, if you have equity in entities you used in management of a syndicate or fund, they may be at risk of attack, particularly if you do something illegal (like commingle funds or violate securities laws), even if the violation was an innocent mistake.

Annual Filing Requirements

If an issuer is still raising money more than one year after the start date of its offering (usually stated on the front cover of its private placement memorandum), it may be required to file an amendment to its Form D. The Form D amendment must be filed prior to the anniversary date. The amendment may ask for additional information, such as what states the issuer raised money from and how much has been raised to date.

Certain states (California, for example) may require new Blue Sky filings, even in states where the Blue Sky notices were previously filed, for any new investors from that state that invest after the anniversary of the offering. This is less likely to occur in a syndicate that is buying a specific

property, but could easily occur in a fund, where the investment period could be open for a longer time frame as multiple properties are acquired.

Chapter 11 – What’s in a Securities Offering?

A private placement securities offering includes a number of documents, which collectively comprise the offering package. Each document has the specific purpose described below:

The Private Placement Memorandum

The private placement memorandum (PPM) essentially “tells the story” of the investment. Legally, it is the disclosure document required by the SEC or applicable state securities agency for certain private placement offerings. It describes such things as the structure of the company, projected returns to investors and compensation to the manager, the risks of investing, potential conflicts of interest and a summary of how the company will be operated, among other things. The rest of the documents within the offering package are attached to the private placement memorandum.

The Investment Agreement

The “investment agreement” is the enforceable contract between the issuer of the securities and the investors. It can take many forms. The most common agreements used in real estate securities offerings are described below.

Limited Liability Company Agreement or Operating Agreement

This document describes how a limited liability company will be operated. Legally, it is the governing document for a limited liability company and describes in detail such things as:

- The rights and duties of the members (investors) and the asset manager,
- What investors are buying (units or interests),
- How meetings and votes of the members will be conducted and the required percentage for a measure to pass,
- How and when cash distributions will be made and the associated “waterfall” for distributions in various stages of the company,
- Management fees,
- Liquidation of company assets, and admission or disassociation of members, among other things.

When a limited liability company is managed by a manager (i.e., “manager-managed”), and the members include passive investors (who are not involved in management) the operating agreement creates an “investment contract”. As described previously, investment contracts fall within the definition of Securities in The Securities Act of 1933 and all state securities acts – and thus all sales of passive interests in a limited liability company to passive investors must comply with securities laws.

When a limited liability company is managed by its members (i.e., “member-managed”) and all members are actively involved in generating their own profits, the operating agreement is not an investment contract, and

does not require compliance with securities laws. In that case, it would be a “joint venture”, and all that would be needed is the operating agreement.

Limited Partnership Agreement

This document has the same role as a limited liability company agreement, but for a limited partnership. It describes the rights and duties of the “general partner” (who has the same role as the manager of a limited liability company) and the limited partners (investors). It also describes what the investors are buying (usually limited partnership interests or “LP” interests).

When a limited partnership is selling interests to passive investors, the limited partnership agreement is an investment contract, within the definition of Securities – and thus all sales of interests to passive investors (who are not members of the “general partner”) must comply with securities laws.

Shareholder Agreement

This document has the same role as a limited liability company agreement, but for a corporation. It describes the rights and duties of the officers (managers) and board of directors and the shareholders or stockholders (investors) of the corporation. It also describes what the investors are buying (shares or stock).

When a corporation is selling interests to passive investors (who become shareholders or stockholders), the shareholder agreement is an investment contract, within the definition of Securities – and thus all sales of stock or shares to passive investors must comply with securities laws.

Trust Agreement

This document has the same role as a limited liability company agreement, but for a business trust (such as a Delaware Statutory Trust) or title holding trust with multiple beneficiaries. It describes the rights and duties of the trustee (manager) and beneficiaries (investors) of the trust. It also describes what the beneficiaries are buying (beneficial interests).

When a trust is selling beneficial interests to passive investors, the trust agreement is an investment contract, within the definition of securities – and thus all sales of beneficial interests in a trust to passive investors must comply with securities laws.

Promissory Note

This is not an investment contract, as it is a separate category in the definition of securities under The Securities Act of 1933 and state securities acts.

This is the contractual agreement used when an investor makes a loan in exchange for promise to pay, signed by the borrower (i.e., a “promissory note”). Promissory notes generally describe the terms of the loan.

The issuer of the promissory note is the borrower, and the lender is the investor. The lender could be an institutional lender such as a bank or credit union, a hard money lender or a private individual. The promissory note describes such things as:

- The purpose of the loan,
- The principal loan amount,

- The payment schedule, and whether the payment is interest-only or principal plus interest,
- Interest or shared profits to be paid to the lender (how calculated, when due),
- Points or origination fees owed to the lender,
- The duration and maturity (end date when principal must be repaid),
- Whether the borrower's personal guarantee is required,
- What constitutes a default and lender remedies in case of default, and
- Collateral for the loan (i.e., property the lender can acquire if the loan is not repaid according to the terms of the note).

The Subscription Booklet

The subscription booklet is document that tells the issuer about the potential investor. In filling out this booklet, investors make representations and warranties as to their qualifications and suitability to invest. The booklet also includes a place for the issuer's acceptance and acknowledgement of the investment. The investor will attest, usually under penalty of perjury, that:

- They meet the qualifications of the exemption the issuer is using;
- They have read all of the documents provided by the issuer and have obtained satisfactory answers to all of their questions;
- They have sought all legal, financial or tax advice they deemed appropriate;
- They understand the risks of the investment;
- They can afford to lose the money;

- The amount they plan to invest, and
- How they plan to own their interests.

The Investment Summary

The “investment summary” is a document containing information about the property that is the subject of the offering and biographical information about the members of the asset management entity.

The “investment summary” is a marketing piece that is meant to describe the investment opportunity, in plain English. For specified offerings (See Chapter 13), it will describe the specific property being acquired. For a blind pool fund or a fund of funds (See Chapter 15), it will describe the business plan or plan of operations for the fund.

This document should be professionally designed. Its purpose is to catch the attention of prospective investors. The more professionally prepared it is, the more likely they are to be interested in the investment. The investment summary is where investors will make their buying decision. Trust me, no one will decide to invest in your offering by reading 160 pages of legal documents!

Some attorneys will imbed the details about the investment into the private placement memorandum, but we prefer that our clients use a stand-alone marketing piece that they can show investors prior to providing the legal offering package. Investors will most likely make their buying decision when reading the investment summary, and the details about the investment could easily get lost if they are buried in a hundred plus pages of legal documents. My experience is that the attorneys who imbed business

plans into the legal docs tend to charge more for their offerings than those who allow the issuer to attach a stand-alone marketing piece.

Additional Exhibits

Additional exhibits may be attached to the private placement memorandum. Their purpose is to further describe or provide additional, relevant information related to the company, the asset manager, its affiliates, and the property. This could include such things as a purchase agreement, title report, appraisal, or property inspection report. For a development project, it may include a feasibility study, entitlements, drawings or plans, etc.

Collectively, the private placement memorandum and its attached documents are meant to provide investors with all the information they need to make informed consent prior to making their investment decision. Each prospective investor should be advised to carefully review the private placement memorandum and each of its associated documents. Further, they should to be encouraged ask the issuer any questions they may have, and consult with their financial, tax, or legal advisers.

Chapter 12 – The Perils of Drafting Your Own Offering Documents

What are the perils of drafting your own real estate syndication documents?

Leaving Money on the Table

A competent securities attorney will help you structure your offering in a way that is fair to the manager and investors. You may overlook opportunities for management compensation via acceptable fees and/or distributions if you don't have competent securities advice. Here's an example of how many of issuers leave money on the table:

1. Do you offer a preferred return and then split what's left?
2. Do you offer a split, but make distributions in a way that gives 100% of the cash to investors until they achieve a hurdle rate (preferred return), but gives the management class the right to recoup an unpaid portion of the split later on from cash flow or a capital transaction ("catchup")?

Hint: It makes a small difference in income to investors if you pick option 2, but a huge difference to income of the asset management team (as Class B members). Rookie asset managers often choose option 1; but usually only do it one time before they come to understand the difference.

Increased Liability for Failure to Follow Industry Standards – Negligence

Your risk of personal liability will be increased if you prepare your own offering documents, as it is customary to hire securities counsel for group real estate investments/ syndications. If the deal ends badly, it is possible that poorly drafted documents won't protect you, or that your investors will be able to claim they weren't fully informed of the risks – placing the liability back on you.

Failure to follow industry standards for issuers of securities – who customarily hire experienced corporate securities counsel to draft their offerings – could subject you to personal liability for negligence, and could result in a complete loss of compensation for your efforts. Why would investors want to invest in an offering where the asset manager took shortcuts in order to save money, while putting the entire investment at risk from future litigation from disgruntled investors and/or regulatory agencies that could have been avoided with well-drafted legal documents?

Required Filings

The offering documents aren't the only thing required of a securities offering. Notices of your offering must be filed with federal and/or state agencies within specific time frames (usually 15 days from an offer or sale of a security to an investor), or else any exemptions that would otherwise be applicable could be lost, and you could be accused of selling unregistered securities by either the SEC, the state securities agencies, or both. If you

copy someone else's documents, you might not realize that filings are also required, and doing it correctly can be tricky. Is it worth taking on that risk?

Selecting the Wrong Exemption

There are a variety of federal and state securities exemptions that may be applicable to your offering, and without advice of counsel you may be selecting an exemption that is inappropriate, too restrictive, or overly burdensome.

Selecting the Wrong Entity or Jurisdiction

Selection of jurisdiction for an offering is an important consideration, and doing this incorrectly could require revising your filing documents and/or registering your offering in multiple states with potentially burdensome legal compliance and tax consequences. Or, you might have to re-structure your company if you want to refinance into more favorable agency (non-recourse) debt.

Tax Consequences

There may be huge tax implications for you and your investors if you use the wrong entity or legal structure; for instance, using a member-managed versus manager-managed limited liability company; or using a corporation versus a limited liability company. The value of any ownership interest an asset manager takes in exchange for managing the syndication may be wholly taxable in the first year if you don't set it up right and make management interests subordinate to investor interests!

Misleading or Conflicting Documents

You may inadvertently make statements about your offering or the property that are misleading or omit material facts, or which could subject you to personal (and perhaps criminal) liability if such representations turn out to be false. An attorney should be able to help you guard against making statements that could be construed as false.

For example, in discussing other properties you own – do you own them or do other investors own them and you simply “control” them as an asset manager? The regulators understand the difference and will call you on it (I’ve seen them do this), so you have to be extremely careful about how you say things related to your prior track record, or that of your asset management team.

Improper or Incomplete Disclosure

You may inadvertently fail to advise potential investors of risks associated with your offering, which could subject you to continuing liability for the duration of your offering. A competent corporate securities attorney will help you identify all of the direct and indirect risks of your offering, including many of which you might overlook on your own.

Practicing Law Without a License

The unauthorized practice of law is defined as drafting legal documents that define the rights and duties of people other than yourself. You can sell your own house without a real estate license, and you can draft your own will or represent yourself in court. But if third parties, other than you and

your spouse, will be signing legal documents that you self-prepare, you are practicing law without a license and could be prosecuted. In certain jurisdictions, the unauthorized practice of law is a criminal offense. Attorneys are generally prohibited by state bar rules from assisting non-attorneys with the unauthorized practice of law.

Litigation Costs Far Exceed the Costs of Proper Syndication

Undoing or fixing an incorrectly structured or noncompliant offering will cost you many times more in legal fees than it would have cost you to hire a competent corporate securities attorney to help you do it right in the first place.

You Can't Be Indemnified for Securities Violations

In addition to the offering documents and notice filings, there are specific rules that must be followed for any exemption to be applicable, particularly with respect to solicitation of the opportunity and suitability standards for your investors, etc. Failure to follow the specific rules of the exemption you are claiming may allow the investors an extended right of rescission, which they or a regulatory agency could invoke at any time. In this event, you might have only 30 days to give everyone their money back! Failure to comply could result in civil fines or possibly criminal penalties.

No limited liability entity can protect you from violations of the law. And as a matter of public policy, an issuer (and its asset management team) cannot be indemnified by the issuer for securities violations.

Legal Fees Are Reimbursable

Legal fees for formation of a syndicate or fund are reimbursable, assuming you account for them in your raise amount. All of your pre-closing expenses, including anything you can produce a receipt for that is related to the acquisition, are reimbursable. This includes pre-closing expenses the asset manager (or its members) paid out of pocket for inspections, travel to the site, legal fees, lender fees, appraisal fees, surveys, property deposits, etc. Consider your investment in competent corporate securities counsel to be an insurance policy that will protect YOU and will be reimbursed by your investors.

Hiring the Wrong Attorney Can Cost You More Than Hiring the Right One

Make sure the attorney you've hired is experienced in real estate syndication or funds. Ask how many offerings the firm has done in the recent past and whether it has the correct liability insurance to cover securities offerings. Securities insurance coverage is one of the highest premiums an attorney can pay. There's a reason for that.

Also, an attorney who is interested in this area of practice may try to learn it on your dime. Don't take the risk. Would you hire someone interested in learning brake mechanics to fix the brakes on your daughter's

car? Don't chance it, hire a professional who works specifically in the corporate securities practice area.

Key Takeaways

Drafting your own syndication documents without an experienced corporate securities attorney is bound to cost more in the long run than hiring one to assist you with the proper structure and appropriate exemption in the first place. Failure to do so may place your personal assets at risk. There's no need to take on this risk for the sake of saving a few dollars. If you want to be in the syndication business long-term, don't try to take shortcuts that could backfire and cost you your reputation and syndication or fund management career.

SECTION 3 — WHAT OFFERING MODEL WILL YOU USE?

There are multiple offering models. The most common is the specified offering or syndicate model, where capital is being raised to acquire a specific property. Then there are blind pool funds, where capital is being raised to acquire multiple properties described in the fund's business plan. There are a variety of hybrid offerings. We'll explore some of the more common offering models below:

Chapter 13 – Specified Offerings or Syndicates

A specified offering means you are raising money for specific, pre-identified purpose. This is the “syndication” model. Syndication often involves the purchase of one or more existing commercial properties or acquiring land for development.

**A specified offering for a pre-identified property
is the easiest way to raise money.**

Property Information

For a specified offering, the asset manager will draft a property information package (or investment summary) explaining details about the project, such as:

- A basic description of the property
- Location and demographics
- The plan of operation to add value or develop the property (this could include a list of proposed improvements, estimated costs, etc.)
- Sources and uses of funds (where the acquisition is money coming from and how it will be spent)
- Projected returns over a specified timeframe based on estimated or past income and expenses, taking into account your plan of operation and a projected sales price (also called the pro forma)
- Your proposed exit strategy; for real estate that could include a refinance, sale, 1031 exchange or indefinite hold

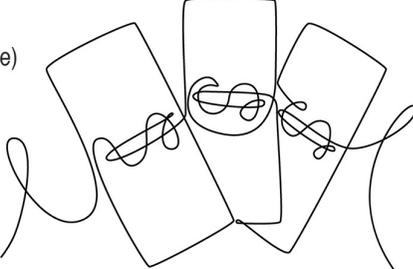
- The asset management team members and their track records with similar investments

Sources and Uses of Funds

Below is a list of things you need to raise capital for in a typical real estate syndicate.

What Your Raise Includes

- Down Payment
- Legal Fees (Securities & Real Estate)
- Closing Costs
- Lender Fees
- Capital Improvements
- Operating Capital & Reserves
- Manager Acquisition Fees



When you apply a dollar amount to each of the above categories and add it all together, it's called the "uses of funds". Next, you will generate a "sources and uses" of funds table showing what you need to acquire the property. Hint: The collective sources of funds must equal the uses of funds. Go to the book resources page at:

<https://RaiseCapitalForRealEstate.com/BookBonus>

In a specified real estate offering, the "sources of funds" will typically include institutional or bridge financing for a portion of the purchase price plus capital raised from investors to cover the remaining funds needed to acquire the property.

To calculate the amount you need to raise from investors, subtract the bank loan from the total uses of funds. The difference is the amount of capital you need to raise from investors. It's important not to separate what you will contribute from this number, as you can be an investor, treated exactly like any other investor, for any amount you contribute or leave unreimbursed in a specific property.

Value Add Projects

The “uses of funds” will typically include the following acquisition costs:

- Down payment,
- Legal fees (real estate and corporate securities counsel; plus lender's legal fees),
- Due diligence expenses,
- Capital improvement budget,
- Closing costs,
- An acquisition fee that gets paid to the asset manager,
- Working capital and reserves. and
- Lender-required reserves

Development Projects

For a real estate development project, all of the money might be raised from private investors to acquire the land and obtain entitlements. Entitlements typically include engineering, architectural design, government approvals or permits, re-zoning, etc. Once the project is

entitled, the developer can obtain construction financing, or may sell the entitled land to a builder.

Prior to issuing the construction loan, the construction lender will obtain an appraisal of the entitled land. Often, the land value will have appreciated during the entitlement process sufficiently that no additional down payment is required, or another capital raise may be needed to cover the down payment for the construction loan.

The equity generated from entitling the land is equity that the original investors can keep. It's important to structure a development deal properly from the start so that additional financing can be obtained as the project progresses, or you want the ability to raise additional capital without having to re-structure your company. Permanent financing becomes available when the project begins to produce sufficient cash flow through rental income or occupancy.

Phases of a Syndicate

A typical syndicate has three phases and an established waterfall for paying distributions to investors during each phase. Below are some common examples of an asset manager's duties in the various phases of a typical syndicate. Waterfalls in a syndication can be quite simple or very complex. We will cover simple waterfalls here, since that is where most beginning asset managers will start.

Acquisition Phase

In the acquisition phase, the asset manager will:

- Identify a suitable property;
- Perform financial and physical due diligence, and conduct market research and feasibility studies, if necessary;
- Form a legal entity that will take title to the asset;
- Obtain financing from institutional or bridge debt sources, if available;
- Hire a securities attorney to structure your company and prepare your offering materials for investors;
- Raise money from investors, either on your own or through crowdfunding;
- Close on the property; and
- Take over operations.

Operations Phase

In the operations phase, the asset manager will:

- Hire a professional property manager or manage the property yourself to manage day-to-day operations;
- Oversee capital improvements such as rehabilitation or development of the property;
- Oversee the on-site property manager on behalf of your investors;
- Maintain books and records for the property and the investment entity;
- Make distributions to investors and the asset manager according to the operations waterfall distribution schedule established in the company's governing document.

Liquidation or Disposition Phase

In this phase, the asset manager will:

- Prepare and market the property for refinance or sale (i.e., a “capital transaction”).
- Ensure that all outstanding debts get paid before making final distributions. Otherwise the asset manager could get stuck with them after the company dissolves, or have to ask investors to give back money.
- Follow the capital transaction waterfall established in the company’s governing document. The capital transaction waterfall will describe the order in which cash the company generates from a capital transaction gets distributed.

As you can see from the above lists, an asset manager wears a lot of hats. For this reason, it is important to decide how you will share or delegate some of these responsibilities, as it may be too much for a single person to handle on their own. Most successful asset managers either have management-level partners or paid staff. Which model will work for you?

Types of Raises

There are a variety of capital raising strategies. Some work better than others. Below are descriptions of common capital raising strategies:

All or Nothing

In an all or nothing raise, you will only be able to use investor funds after you raise a specific dollar amount. This can be risky as there could be

some amount less than the amount of your projected need that would still allow you to buy the property, while you continue raising money after acquisition. If you set a specific number, you would need investor permission to deviate from it if you fall short or later discover you need additional funds.

Best Efforts

In a best-efforts raise, you will establish a maximum dollar amount for your offering and then attempt to raise it. You can use investor funds after you have raised any amount.

This type of raise may be the riskiest for your investors because there is no minimum established amount that must be raised before investor funds can be used. With a best-efforts raise, you could be under-capitalized to the point where your plans for the property can't possibly succeed. Using investor funds pre-maturely puts investor funds at the greatest risk of being lost if you are never able to raise enough to meet your objectives for the property.

Minimum-Maximum Offering

In a minimum-maximum raise, you will establish a minimum dollar amount that must be raised before any investor funds can be used. The point at which you begin to use investor funds is called "breaking impounds." If you don't raise the minimum dollar amount, then you can't break impounds and you are obligated to give all money back to investors without deduction. The alternative is to get investor permission to break impounds with a lower minimum dollar amount. However, the minimum dollar amount is what you

need to do the deal, while you continue to raise money for additional capital improvements, management reimbursements, and acquisition fees. The less you raise of your projected need before closing on the property, the less likely your syndicate or fund is to be successful.

Sometimes the right thing to do is to give investors their money back without deduction and walk away from the deal. If you get into an undercapitalized deal, you will likely have the same issues the seller had and are unlikely to achieve your projected performance goals – unless you quickly fill the remaining subscriptions and achieve your target dollar amount shortly after closing. It becomes harder to raise money post-closing than before, due to the fact that you may learn detrimental things about the property after closing that now have to disclose to new investors.

The maximum dollar amount should be the target amount you would like to raise plus a cushion of 10%-20% that will allow you to raise additional funds if needed. This could happen if you discover some unexpected expense items, or experience higher improvement costs than anticipated.

The minimum-maximum raise is the most common type of raise that our law firm clients use.

Open-Ended or Evergreen Offering

In an open-ended or evergreen raise, there is no maximum dollar amount established and there may or may not be a minimum dollar amount.

Evergreen funds work best for mortgage funds or hard money lending funds where the fund investments are periodically redeemed by the fund's

borrowers. For instance, some mortgage funds that offer 1-3-year bridge loans may offer renewable promissory notes to their investors with durations that coincide with the loans the fund is making to its borrowers. In that case, if one investor/lender decides not to renew, they can be paid back from the next outstanding fund loan that redeems; and new investors/lenders could be brought in at any time that would replace the previous lender. This doesn't work as well for a fund that buys and holds real estate for 3-7 years, as the investor who wants to redeem its interests would have to: a) wait until an asset sells, or b) find a suitable transferee for its investment, or c) sell the interests to the fund manager or other investors, perhaps at a discount from what they originally paid.

Some states won't allow evergreen funds; and it becomes a harder sell for investors. Investors like to invest in a business model that has a finite goal, with an anticipated termination, typically 5-7 years. This helps them gauge when they will get their original investment back, and most investors do have future plans for their investment dollars.

Redemption Options

If you do an evergreen fund, you will have to offer some type of redemption for investors, such as a renewable promissory note, that can be canceled for those who decide they want out.

It can be dangerous to offer a redemption option as:

- Offering redeemable securities could cause your fund to have to register as an Investment Company, subject to registration under the Investment Company Act of 1940;

- You have to create rules for your syndicate or fund (stated in the operating agreement) regarding how much can be withdrawn and when, so that redemptions coincide with capital transactions (such as asset sales) so that you actually have the cash to do the redemption; and are not relying on future investments to pay back previous investors, as that is the hallmark of a classic Ponzi Scheme; and
- You can't selectively cash out investors (unless your offering documents allow this), unless you seek member permission (for instance, to buy out a litigious investor).

Multi-Asset Specified Offering

This is a specified offering whose purpose is to acquire multiple real estate assets. This model works when you have multiple properties under contract at the same time that you expect to close within the next six months or so. In this case, you can create a single syndicate (i.e., pool of investors) that acquires all of them. The structure will be similar to a fund structure, but instead of raising money while you look for properties to acquire for a fund, you will be raising money to acquire a finite number of pre-identified properties.

Segregated Offering

This option is another hybrid that combines the benefits of a specified offering without having to draft a completely new offering package each time. For a segregated offering, you will create a series of separate offerings with a common master private placement memorandum and investment summary. The investment summary will describe the criteria for the

properties you plan to acquire. Each investment opportunity will be treated as a separate securities offering, with a separate asset, separate investors, a separate investment vehicle (such as a promissory note or operating agreement), and separate securities notice filings.

The upside is that you can save some legal drafting fees and drafting time for future offerings as you won't need a whole new private placement memorandum each time. However, the downside is that you have additional documents (such as a master private placement memorandum and investment summary) to show investors for what is essentially a specified offering. This can get a little confusing for those who are used to seeing specified offering documents.

The segregated offering can work for asset managers who want to buy a series of single-family or smaller commercial properties with raises of only a few hundred thousand dollars, because it helps limit your syndication legal costs. For bigger offerings where you are raising \$500,000 or more, a specified offering may be a better option and will be more palatable for your investors.

Caution Regarding Retirement Fund Investors

The Employment Retirement Security Act of 1974 (ERISA), Department of Labor Regulations state that, unless exempt, when a retirement plan (whether self-directed or not) owns twenty-five percent (25%) or more of the total value of the interests sold in a company, the interests may be deemed a “plan asset.” Once deemed plan assets, the issuer

then becomes subject to ERISA fiduciary rules, and additional regulation and reporting requirements.

For specified offerings or syndicates created to acquire a specific property, the interests are exempt from constituting a plan asset under the “real estate operating company (REOC) exemption” that is available when at least fifty percent (50%) of the assets owned and operated by the entity are directly owned real estate assets.

What does this mean for syndicates? There is no limit on the percentage of interests that may be sold to self-directed retirement plan investors (such as self-directed individual retirement accounts or 401(k) plans) by a syndicate – essentially, 100% of the funds could be raised from self-directed retirement account holders – as long as the syndicate directly owns the real estate.

However, this may not be the case if the syndicate is investing in something other than real estate (such as securities in someone else’s offering), or the syndicate will not directly own the real estate asset. If that is the case, make sure you keep track of the percentage interests owned by your pension fund investors and don’t exceed the 25% limit. As in any regulatory framework, there will be penalties for non-compliance, which could be severe.

Chapter 14 – Blind Pool Funds

Blind pool funds are not usually called syndicates, although the mechanism for raising money is identical. The difference is that a blind pool fund involves 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 that acquires multiple properties. Fund managers raise money based on the investment summary (business plan) for the fund.

**Blind pool funds are the hardest way to raise money
and are much more complicated than specified offerings.**

Blind pool funds can be used to acquire any type of real estate asset class as well as to buy promissory notes, to form a hard money lending fund, or to invest in other people's syndicates.

For a blind pool offering, you will prepare an investment summary (business plan) for your fund, describing:

- The type of properties in which your company will invest,
- The criteria the properties must meet to be considered for acquisition,
- The strategies you will employ to acquire, operate and ultimately dispose of the properties,
- How you expect to generate profit you can share with your investors and what has to happen before they get their original investment back,
- The track record and relevant experience of your asset manager team members.

As an example, a real estate blind pool fund might have a business plan to acquire multifamily properties ranging in size from 100 to 300 units in the central United States, with a plan to add value, and own and operate them for 5-7 years.

The blind pool fund structure allows diversification of the investors' risks because the company will own multiple properties, allowing it to legally use the earnings from one asset to offset losses in another. In any other context, this would be considered "co-mingling" of funds. However, since your company is a common owner, it can consolidate earnings from all of its properties at the investment company level. You or members of your asset management team must have sufficient experience with similar businesses or properties before investors will invest in your blind pool fund.

While it may sound attractive to create a blind pool fund and raise money before you need it, this truly is the hardest possible way to raise money.

Proceed With Caution – many investors have blind pool fund documents that sit in a drawer and have never raised a dime; or they have a \$20M fund that only raised \$1M or \$2M dollars.

Your Track Record is Key to the Success of Your Fund

Few investors will invest in your fund unless your asset management team has significant experience acquiring and owning the same type of properties your fund plans to acquire.

Your track record may take the form of a spreadsheet identifying similar property that members of your asset management team have owned or

controlled and how they have performed, or it could be displayed in a series of photos with relevant details about each property. Generally, your asset management team needs to show success with owning or controlling at least 5-6 similar properties acquired with investors in a series of specified offerings before investors will consider investing in their fund.

What if you don't have that type of experience? Invite members to your asset management entity who have the track record your fund needs to be successful. Pooling funds to buy real estate is a leverage game. You leverage low-interest bank financing to generate better returns for investors, and you can leverage off others' experience in managing similar investments to elevate your own status. But make sure your marketing materials represent that the experience belongs to certain members of the asset management team (not you, personally), as that would be misleading and a fraudulent statement.

Where Will You Find Fund Investors?

To successfully launch a blind pool fund, you should create a list of prior investors who have expressed willingness to invest in a blind pool fund model. How can you create this list? Poll your investors.

Many specified offering investors will never invest in a blind pool fund – they like the idea of deciding whether to invest in a specific property and aren't comfortable handing over their investment dollars to someone who is "looking" for property to invest in.

If you do have a fund and are having trouble raising money, the best thing you can do is get a property that meets your investment criteria under contract and raise money for it. After you close on that property, wait until you have another property under contract and then re-open the raise to a new round of investors. This is called raising money in "tranches" or a series of "closings."

Even though a blind pool fund technically allows you to raise money before you have a specific property to acquire, investors will often wait until you get a property under contract before they invest.

Complexities of Blind Pool Funds

Blind Pool Fund documents can be quite complex, as you will likely be raising money for multiple years, and you will be acquiring multiple properties acquired over a period of time.

Truing Up

Early investors may feel like they created equity in the early projects, but later investors get the benefit. It is common to have a built in "truing up" formula in your offering documents that adjusts the amount later investors pay to buy into the fund. The adjusted cost for new investors is based on a formula that calculates appreciation your fund has created in its previously acquired properties. Options for determining appreciation includes

determining “net asset value” using comps and applying the “IRV formula”. This formula takes into account “net operating income” of fund-owned properties along with market “capitalization rates” for similar properties to arrive at current estimated “market value.” Once you have an estimate of current market value, you can subtract the amount invested in each property to date, to determine how much appreciation early investors’ funds have appreciated.

After determining the percentage appreciation in current properties, you can charge the same percentage as a premium for investors who come in later. They are effectively paying a higher price per interest than previous investors to account for the appreciation. The premium paid by later investors gets distributed pro rata among earlier investors, who then feel they have been compensated for the appreciation their early investments generated, and so that later investors are now ”on par” with earlier investors, when it comes to liquidating fund properties.

Investment, Harvest and Liquidation Periods

A blind pool fund typically has an “investment period” of 3-4 years, sometimes followed by a “harvest period”, which is then followed by a “liquidation period.” The total expected lifetime of a fund is usually 7-10 years. Properties acquired by the fund are typically held for 5-7 years before they are sold.

The Life Cycle of a Real Estate Fund

An illustration showing the life cycle of a real estate fund that acquires and owns multiple properties is provided below:

Life Cycle of a Real Estate Fund With Multiple Properties



1. Investment Period: Properties and investors acquired
2. Harvest Period: Properties optimized and operated for cash flow
3. Liquidation Period: Properties liquidated and investor funds returned; equity shared with members

For example, if properties will be owned for up to 7 years each in a 10-year fund, the Investment period would be the first 3 years, the Harvest Period would be the next 4 years, and the Liquidation Period would be the last 3 years.

During the investment period, a) new investors can be accepted and b) invested capital returned to the fund from sales of properties (if applicable),

can be re-invested in new properties that meet the fund's investment criteria. Sold properties can be exchanged by the fund for larger properties using IRS "1031 Exchange" rules. The Investment Period is typically 1-4 years. During this time, additional members (investors) may be added and additional properties may be acquired. The fund manager obtains acquisition financing for individual properties as they are acquired. The principle from any properties that may be sold during this time can be reinvested in new properties, or properties can be 1031 exchanged by the Fund for other properties; however, profits must be distributed to avoid "phantom income" for the members.

During the "harvest period", if applicable, properties are optimized to maximize income and decrease expenses (increasing net operating income, and thus, market value). The asset manager and investors split profits generated by rental income.

During the "liquidation period," proceeds from sales of properties are used to pay back the proportionate portion of investor funds used to acquire each asset, plus their share of profits from the sale of each asset, until all properties are sold and all funds disbursed.

It is important for you to understand that profit generated from any sale of a fund asset that is not deferred (via a 1031 Exchange) must be distributed to investors in the year it is generated, as investors will have to pay tax on the gain whether you give them a distribution or not.

Blind Pool Fund Capital Raising Models

There are two primary capital raising models for blind pool funds:

Raise as You Need it

This model means you only raise money as you need it to acquire specific properties. This is the most common model chosen by new fund managers. You will want to use this model unless you have a long list of ready, willing, and able investors who are ready to pre-commit the maximum fund amount.

Commitments and Capital Calls

In this model, you will get commitments from investors for the full amount of your fund as quickly after your fund launches as possible, but you will only call for a portion of the capital each investor has committed as you need it to acquire a specific asset. Your fund documents will include built-in penalties for investors who fail to honor their required commitments. You will use this model only if you have a long list of ready, willing, and able investors who are ready to pre-commit the maximum fund amount shortly after the fund is launched.

Blind Pool Distribution Models

There are two primary distribution models for blind pool funds:

Whole Fund Model

This model blends the returns from each property owned by the fund at the fund level. This model is advantageous if you will have different properties in different stages of acquisition, renovation, operation or sale, and you want to offset losses from one against another. This gives your investors the diversity that comes from investing in multiple properties, but

sharing in blended returns from all properties owned by the fund. In this model, fund management fees and profit splits are calculated at the fund level.

Deal-by-Deal Fund Model

In this model, fund management fees and profit splits are calculated at the asset level. This model typically requires “claw back” provisions requiring the fund manager to pay back a portion of its fees or profits if the fund doesn’t meet its overall goals for investors, usually due to non-performing or under-performing properties.

Practicalities of Creating a Fund

Start Small and Scale Up

Don’t make your fund bigger than the amount of money you can reasonably raise and deploy within a specified investment period of 1 to 5 years.

While you may be tempted to create a \$50M fund, investors will ask how much you have raised in your fund before they make their investment decision. If you have only raised a fraction of the fund maximum, they may sit on the sidelines waiting for you to raise more money and acquire more properties. If you never achieve your maximum fund-raising goal, your fund may appear to be a failed fund. It’s better to do a series of smaller funds with a finite, achievable maximum, than it is to have a larger fund, with a maximum raise that you fail to achieve.

For example, your fund objective could be, “We expect to acquire up to 4 properties, each of which will require investment of \$2M-\$3M, so our maximum fund goal is \$12M.”

It’s better to fully subscribe your fund; close it to new investors and start another than it is to aim too high and never reach the maximum. If you build each successive fund larger than the one before, you will be building a track record that will boost your credibility as a fund manager. When investors ask, “Have you done this before?” You’ll be able to say, “This is our second fund; the previous one is fully deployed.” That sounds a lot better than saying, “We have a \$50M fund, but we’ve only raised \$5M so far.”

Another strategy is to do a smaller fund, but retain the option to “extend” it. For instance, you could create a \$2M fund with the option to extend the maximum offering amount to \$5M. That way, if you only raise \$2M, and decide not to extend it, you still have a successful \$2M fund. But a fund with a \$5M stated maximum that only raises \$2M looks like a failure.

Don’t Raise More at One Time Than the Fund Can Deploy Within 3-4 Months

Even with a fund, you will only raise money when you have a place to invest it. It’s dangerous for a fund to have too much cash in the bank that isn’t generating a return as it dilutes the returns to all investors. Investors will typically allow a fund manager 90-120 days to put their funds to work before they expect a return on their investment, or a refund.

If you haven’t invested their money by then, you may have to give their capital contributions back without deduction. One way to mitigate this is to

offer a nominal interest rate (better than what banks pay) for funds that are not deployed. This may entice investors to leave their investment with your fund for a longer period of time without deploying it in a fund investment that will cause their returns to accrue. If you are going to offer this, the fund manager should have sufficient funds to cover the interest, or you will simply open an interest bearing account and pass the interest on to investors.

Having too much capital is almost as bad as not having enough. I had a client who raised over \$5M in the first week of a fund launch, but couldn't find deals fast enough and ended up giving the money back and liquidating the fund.

Investors fear that you are going to use their funds to pursue deals that don't happen, or worse, that you will use their funds to support your lifestyle before the fund starts generating income. This is a real fear. You only need to read the SEC's Weekly Digest Bulletin to see how many people actually steal investor funds – and eventually get caught.

Plan a 'Launch' for Your Fund

Just like a best-selling book, a successful fund needs a "launch plan". Fund documents don't raise money by themselves. You need to market your fund aggressively, by sharing your fund investment summary, one pager, and pitch deck, a month or so before you are ready to start raising capital. You send out emails to prospective investors in advance, telling them the fund is coming, and getting them excited to invest.

Your initial fund raise will be easier if you have a property under contract at the time you launch your fund. This will show investors they are

already investing in something tangible, and not just a concept or business plan that might never come to fruition.

You might be launching it on a specific day, and you might even offer a bonus to those who invest early. Bonuses could be extra interests for early investors, or a higher preferred return than will be offered to later investors.

Consider How You Will Deal With Fund Administration

Managing a fund is more complex than managing a specified offering. Your investors will expect detailed financial reports for each of the properties and the fund as a whole on a quarterly and annual basis.

An “investor management platform” can help you control communications and reporting to investors in your fund. Alternatively, you may wish to hire a “fund manager.”

Both can help you keep track of properties, investors, distributions, quarterly and annual financials and status reports, and tax reporting. A fund manager will calculate your distributions and coordinate your fund’s bookkeeping with the CPA who will do your required tax filings. If you are more of a do-it-yourselfer, or have in-house bookkeeping capabilities, you may be better suited for an investor management platform. If you like everything done for you, you may be happier with a fund manager.

Caution Regarding Retirement Fund Investors

The Employment Retirement Security Act of 1974 (ERISA), Department of Labor Regulations state that, unless exempt, when a retirement plan (whether self-directed or not) owns twenty-five percent

(25%) or more of the total value of the interests sold in a company, the interests may be deemed a “plan asset.” Once deemed plan assets, the interests then become subject to ERISA fiduciary rules, and additional regulation and reporting requirements.

For blind pool funds created to directly own real estate, the interests are exempt from constituting a plan asset under the “real estate operating company (REOC) exemption” that is available when at least fifty percent (50%) of the assets owned and operated by the entity are directly owned real estate assets.

What does this mean for fund issuers? There is no limit on the percentage of interests that may be sold to self-directed retirement plan investors (such as self-directed individual retirement accounts or 401k plans) – essentially, 100% of the funds could be raised from self-directed retirement account holders – as long as the fund directly owns the real estate.

However, this may not be the case if the fund is investing in something other than real estate, such as buying securities in others’ offerings. In this case, the fund would be limited to only accepting investments from pension plans or self-directed retirement account holders for up to 25% of the interests sold. If this applies, make sure you keep track of the percentage interests owned by your pension fund investors and don’t exceed the 25% limit. As in any regulatory framework, there will be penalties for non-compliance, which could be severe.

Chapter 15 – Funds of Funds

Some people think the new panacea for raising private money to invest in real estate (or other businesses) is to create your own “fund of funds” whose purpose is to invest in other people’s deals. The reasons investors think about this model is because:

1. They can’t find their own properties, which could be due to a lack of time, knowledge, or effort.
2. Or they are trying to build a track record on deals with investors and with lenders.
3. Or perhaps they don’t have the fund-raising capacity to take down bigger properties on their own that may have better returns than smaller properties. In this case, they look for bigger offerings where they can become part of the asset management team and bring their own investors to the deal.

This, then poses the question: “How do I keep the other asset management team members from stealing my investors for their future deals?” Investors think, “Hey, why don’t I just form my own limited liability company with my own investors and invest in others’ deals as a single investor? That way, I don’t have to give up their contact info and no-one can steal my investors. And I don’t have to go out and find my own deals.”

It’s not as easy as you might think and this chapter explains why. For those that want the bottom line up-front, skip to the Key Takeaways at the

end of this chapter. For those who want the analysis explaining why a fund of funds is not as easy as it sounds, read on:

First, What is a Fund of Funds?

A “fund of funds” is an investment vehicle, such as a limited liability company, that allows an issuer to pool funds from a group of investors, that will invest as a single investor in others’ offerings.

What Can You Gain by Creating a Fund of Funds?

- You can earn fees from your investors.
- You can earn a share of profits from your investors; however, doing so will dilute their returns versus what they would have received if they had invested directly on their own.
- If you bring enough money, you may be able to insert yourself into the asset management entity for the deal where you invested the funds, giving you some syndicate or fund management experience, and a share of their asset management team’s fees and profits.

What you CANNOT get is compensation that is based on the amount of money you brought to a deal. That’s a big “No-No”, as it would be construed as a “transaction-based compensation”, which can only legally be earned by licensed securities broker-dealers.

Should I become a licensed Securities Broker-Dealer, you might ask? Not unless you want to start a full-time business investing other people’s money and earning commissions for it. It’s a long and tortuous path to get

there and involves a lot of regulatory oversight. If that's not your ultimate goal, don't go down that path.

Why Would Anyone Invest in a Fund of Funds?

If you bring enough money to someone else's deal, you should be able to negotiate better terms from the company you are investing in, such as additional voting privileges, or a higher return than they are offering their smaller investors. This could be done with a "side letter" or a "joint venture agreement", or even a "preferred class" within their limited liability company.

Additionally, your investors may be able to invest in deals that would otherwise not be available to them. For example:

- You may be investing in a Rule 506(b) Offering that requires a pre-existing relationship, and they don't know issuers with deals, but you do.
- Or the minimum raise amount may be more than your investors can handle on their own. For instance, there could be a \$500k or \$1M minimum, and your investors individually either can't or don't want to put that much into a single deal.
- Your investors don't know about real estate, but you do. Your investors are relying on you to vet the deal and the issuer of the securities your company is investing in, and its asset management team, in order to recommend sound investments on their behalf. This is where a fund of funds gets dicey, regulation-wise, as your investors

(and securities regulators) start viewing you as an investment adviser to your company's investors.

What Do Investors Expect of a Fund of Funds Manager?

Investors expect:

- That you have fully vetted the asset manager on their behalf and that you are satisfied that they have sufficient knowledge and experience (i.e., a track record of past successes with similar investments) to be able to successfully invest your investors' funds. If you don't do this and the deal fails, you might be accused of negligence. So – don't go raising money from your hard-won group of investors to invest in someone's first deal. If it tanks, you may have some defending to do.
- That you have fully vetted the deal and that it makes sense for your investors and matches their investment goals.
- That you will be minding the store – and making sure that the issuer is doing what it said it was going to do with your investors' money, and that the property is being operated competently and profitably. If not, your investors expect that you are taking steps to remedy the problem.
- That you will keep them informed of activities related to: a) the company that your fund of funds invested in, b) the investment property, and c) you. For instance, if something catastrophic happened at the property or business – you get to be the bearer of bad news. Or, if you suddenly decide to move out of the of country, or have become

ill and can no longer manage their investment, they have a right to know so they can act appropriately to manage their investment.

Remember, your investors invested in you and are relying on you to sagely invest their hard-earned savings. You had better know what you're investing in and who you're investing with, because if they fail, it's your reputation on the line.

Regulatory Considerations

It is possible to create a member-managed limited liability company to make the investment without triggering compliance with the following securities laws. Read Chapter 6 regarding Joint Ventures and Chapter 16 regarding Investment Clubs. Either of these models is only applicable if all members are actively involved in generating their own profits – and none are relying on the promoter to choose the investment, vet it, oversee operations, and report to them.

However, if that's not your business model, please read the following section carefully for an outline of the regulatory requirements.

First, You Need an Exemption Under The Securities Act of 1933

If you're creating a manager-managed limited liability company, you're creating your own securities offering. This means your offering must qualify for an exemption from registration under The Securities Act of 1933 or an applicable intrastate offering exemption. This generally means that you must have your own disclosure document (PPM), subscription agreement,

and do the federal and state filings that your securities exemption requires; all of which will drive up your costs. Most people choose Regulation D, Rule 506 for their funds of funds exemption (see Chapter 8) so that they can raise money from investors in any state and invest in projects in any state.

Second, You Need an Exemption From The Investment Company Act of 1940

The definition of an Investment Company is:

“any issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities...”¹⁵

Your Fund of Funds is buying securities in someone else’s offering. Therefore, it meets the definition of an investment company. Unless it qualifies for an “exception,” it must register as an investment company and will become subject to extensive regulation, technical requirements, and regulatory compliance; including a requirement that it must at all times have a board of directors; 75% of whose members are independent from the company, plus additional restrictions.¹⁶

Here are some investment company act exceptions that may be applicable:

¹⁵ 15 USC §80a-3(a).

¹⁶ Shartsis Friese LLP, U.S. Regulation of Hedge Funds, Second Edition (2013), p. 69.

The 3(c)(5)(C) Real Estate Company Exception

First, under 15 USC §80a-3(c)(5)(C), there is a widely used “Real Estate Company Exception” from Investment Company registration for companies who meet the following criteria:

*Any person who is **not engaged in the business of issuing redeemable securities**,¹⁷ ..., and who is primarily engaged in ... purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. [**Emphasis added**].*

In other words, the Company must be “primarily engaged” in purchasing or acquiring mortgages and other liens on, and interests in real estate.¹⁸

What are ‘Redeemable Securities’?

A “redeemable security” is any security, where the holder may withdraw or redeem its interests periodically on request. To avoid this restriction, don’t allow people to ask for their capital contributions back until you liquidate the fund’s investments.

¹⁷ See Shartsis Friese LLP, U.S. Regulation of Hedge Funds, Second Edition (2013), pp. 163.

¹⁸ Cunningham, Richard P., and Voekler, Thomas G., Hirschler Fleischer, A Professional Corporation, Real Estate Programs – Avoiding the Scope of the Investment Company Act, 2008.

How would you accommodate such a request anyway, unless you raise money from new investors to pay back previous investors? This is the classic definition of a Ponzi Scheme.

What Kind of Investments Qualify as Mortgages, Liens or Interests in Real Estate?

According to Attorneys Richard P. Cunningham and Thomas G. Voekler of Hirschler Fleisher, a Professional Corporation, in their 2008 Article, Real Estate Programs, Avoiding the Scope of the Investment Company Act,¹⁹ per the SEC, in order to qualify for the 3(c)(5)(C) Exception:

1. At least 55% of the assets owned by the Company must consist of mortgages, liens on, or interests in real estate, and the other 45% must be primarily real estate-related investments;
2. Further, a fund of funds that buys interests in another company that buys real estate, may not qualify under this exception, unless it has the ability to remove and replace the general partners (asset managers) in the company invested in, with or without cause;²⁰ and
3. If the fund of funds invests in another entity that owns the real estate assets (such as a single purpose venture or joint venture), it must

¹⁹ Ibid.

²⁰ This makes the case for doing side by side joint ventures instead of investing as a fund of funds.

generally own 50% or more of the voting interests in the title holding entity or joint venture.²¹

The “No-Action Letter” by the SEC that seems to squarely address this issue is United States Property Investments, N.V. Concerning Sections 2(a)(32) and 3(c)(5) of the Investment Company Act of 1940. The original Request and the SEC’s response issued on April 14, 1989 can be found at the following in our Book Bonus page:

<https://RaiseCapitalForRealEstate.com/BookBonus>

Bottom line – If your fund can qualify for the Investment Company Act 3(c)(5)(C) Real Estate Company exception, you are not required to register as an investment company and there is no limit on the number of investors you can have in your company. However, if your offering fails any of the tests above, you must find another exception to The Investment Company Act of 1940, or register as an investment company.

But, here’s the hitch – Your fund of funds won’t qualify for this exception unless it owns and operates the real estate! This is the reason real estate offerings (syndicates or funds) don’t have to register as investment companies, nor do their asset managers have to register as investment advisers.

²¹ Ibid. Note: The authors seemed to be citing an SEC no-action letter, but did not provide the citation.

If you become part of the asset management team for the offering in which your fund of funds invests, you at least have an argument that you were “in control of the real estate.” Whether this argument would be a sufficient defense to a charge of acting as an unregistered investment company is impossible to determine. You must be in a management position, such as co-manager, co-GP, and have authority to remove or influence and participate in the removal of others from their responsibilities that are not doing a good job, such as a property manager.

However, all is not lost if you don’t control the real estate, your fund of funds may be able to qualify under a different exception to the Investment Company Act. See below:

The 3(c)(1) Exception/100-Owner Test

The “3(c)(1)” Exception or “100-Owner Test,” also commonly known as the “99 Investor Rule,” offers an exception from registration as an Investment Company for:

*Any issuer whose outstanding securities ... are **beneficially owned by not more than one hundred persons** and which is not making and does not presently propose to make a public offering of its securities.²² [**Emphasis added**]*

²² 15 USC §80a-3(c)(1).

Most fund of funds issuers will try to qualify under this exception.

Third, You Must Comply With The Investment Advisers Act of 1940

If you are advising your Company's investors on the purchase of securities (traditional fund of funds model), and you don't qualify for the Real Estate Company exception to the Investment Company Act, you fall within the definition of an investment adviser. This means you must now comply with The Investment Advisers Act of 1940 (Advisers Act). A summary of compliance requirements for the Advisers Act is provided below:

Federal Investor Adviser Requirements

Investment advisers must register with either federal or state securities authorities, depending on the amount of assets under management. "Small advisers," with less than \$25 million in regulatory assets under management (RAUM), and "mid-sized advisers," with \$25 million to \$110 million in RAUM, generally may only register with state securities authorities.

A private fund adviser who is exempt from registration under the so-called "small adviser exemption," under Section 203A(a)(1)(A) of the Investment Advisers Act, may nonetheless be required to file a truncated Form ADV because such filing is necessary to take advantage of the NASAA Registration Exemption for Investment Advisers to Private Funds Model Rule. The small adviser exemption is actually a provision of the Investment Advisers Act that prohibits any adviser (with a few exceptions) with assets under management of under \$25 million from registering with

the SEC. Private fund advisers that take advantage of the small adviser exemption are not exempt reporting advisers under federal law because they are not making use of the venture capital fund adviser exemption or the private fund adviser exemption.

State Requirements

Exempt reporting adviser states, to name just a few examples, such as, Arizona, California, Delaware, Indiana, Iowa, Maine, Maryland, Massachusetts, Minnesota, Missouri, Nebraska, New Mexico, Oklahoma, Oregon, Rhode Island, Texas, Vermont, Virginia, Washington, Wisconsin and Wyoming, each use the NASAA model rule (or a variation thereof). As a condition to using the NASAA model rule, the private fund adviser must file Form ADV Part 1 to register as an exempt reporting adviser.

The SEC's Form ADV Part 1 is 83 pages long. You can review it at:

<https://www.sec.gov/about/forms/formadv-part1a.pdf>

The form ADV is daunting, to say the least, and will take you many, many hours to complete, if you can even get through it. You will likely need to hire a company that specializes in RIA registrations to help you complete it. Additionally, you must file annual updates (at a minimum) and may become subject to other reporting requirements.

If your state (or the states where your investors reside) requires it, you may also have to register your asset management company (or a member of your company) as an investment adviser in those states. State investment adviser requirements vary from widely from state to state. Some states have no requirements until you achieve a certain level of AUM. Others may

require that you take a test, get a license, and make periodic reports to the state. The state could also place further restrictions on whom you can allow to invest, over and above the accredited and sophisticated requirements imposed by The Securities Act of 1933. You will likely need to hire a company that specializes in RIA registrations to help you do this. It is important to note that each state may have different rules and requirements, and you should consult with the securities regulator in the state where you are located (or where you have investors) to determine if registration is required.

ERA With Less Than 15 Clients

If you are an exempt reporting advisor using as an exemption 3(c)(1) or 3(c)(5)(c) and have less than 15 clients, you may not have to register with the state securities regulator in some states. It depends on the state in which you are located and the specific rules of that state. Generally, states have their own regulations governing the registration of investment advisors and the exemptions available to them.

Additionally, there may be other factors that could trigger registration requirements even if you have fewer than 15 clients, such as the amount of assets under management or the types of clients you serve. That being said, it is important to note that each state may have different rules and requirements, and you should consult with the securities regulator in the state where you are located to determine if registration is required.

Proposed Legislation

In 2022, there was proposed legislation at the federal level that would require every fund of funds to provide audited financial reports from each company the fund of funds invested in. Who will even want your money if that rule goes into effect? No-one, as most private securities offerings are not required to provide audited financials and they aren't going to spend tens of thousands of dollars and hundreds of hours of time to do it just for you and your investors.

It's impossible to know if this legislation will pass, or if it will get revived at some point in the future, but it's something you need to be aware of. If such a rule became law, it could cause the company your fund of funds invested in to recapitalize and kick you and your investors out, and your fund of funds would essentially be out of business.

Caution Regarding Retirement Fund Investors

The Employment Retirement Security Act of 1974 (ERISA), Department of Labor Regulations state that, unless exempt, when a retirement plan (whether self-directed or not) owns twenty-five percent (25%) or more of the total value of the interests sold in a company, the interests may be deemed a "plan asset." Once deemed plan assets, the issuer becomes subject to ERISA fiduciary rules, and additional regulation and reporting requirements – which is not something you want to trigger.

The very nature of a fund of funds is that it will invest in securities in others' offerings, and it will not directly own the real estate. Thus, the interests in a fund of funds are NOT exempt from constituting a plan asset

under the “real estate operating company (REOC) exemption.” This exemption is only available when at least fifty percent (50%) of the assets owned and operated by the issuer are directly owned real estate assets.

What does this mean for fund of funds issuers? There is a 25% limit on the percentage of interests in your fund of funds that may be raised from self-directed retirement plan investors (such as self-directed individual retirement accounts or 401k plans, or pension plans). Make sure you keep track of the percentage interests in your fund of funds owned by your pension fund investors and don’t exceed this limit. As in any regulatory framework, there will be penalties for non-compliance, which could be severe.

Don’t Lose Sight of Your True Objective

When considering whether to create a fund of funds so you can be a “capital raiser” for others, consider your original objectives.

1. Did you learn about real estate syndication because you wanted to buy and syndicate real estate with your own asset management team; or
2. Did you learn to syndicate real estate so that you could manage other people’s money?

If the latter, go take a test, become an investment adviser, and give up your dreams of syndicating real estate. If the former, you should view a fund of funds as a stepping stone that can tide you over until you find your own properties to buy, with your own asset management team – not as your ultimate business model.

Key Takeaway – There is an Easier Solution

If you want to have your investors invest in someone else's deal; a simpler option is to become part of their asset management team and have your investors invest directly in their offering. This is commonly, but incorrectly called a “co-GP” as most offerings use limited liability companies, which don't have GPs, they have managers. The correct term for this is “co-manager.”

This model allows you to raise capital under the issuer's securities exemption, as you are part of the issuer's asset management team, and are thus entitled to the “issuer exemption”. This model also means there is far less risk that your company will be charged with acting as an investment company or that you are acting as an investment adviser. This model doesn't require you to create your own securities offering, keeping your legal fees down. To deter other co-managers from harvesting your investors for future deals that don't include you, you can use a “non-disclosure and non-circumvent agreement.” Additionally, certain investor management platforms offer a way for co-managers (or co-GPs) to segregate investor contact information and communications, isolating them from communication by anyone in asset management other than the members of the co-manager who referred them to the offering, and the main sponsor of the issuer – who is required to have the information.

How you get compensated as a co-manager is another, separate topic of discussion. Please see the in-depth discussion of How to Legally Compensate Capital Raisers and Finders in Chapter 26.

Chapter 16 – How to Start an Investment Club

What is an Investment Club?

Typically, to create an investment club, you would form a meetup that meets periodically, such as weekly or monthly. One portion of club meetings should be set aside for investment education such as teaching members how to review offering materials, how to analyze deals, how to vet “deal sponsors,” etc.

The second part of the meeting is for members to present investment opportunities to the group along with the accompanying offering or investment materials they have gathered from the deal sponsors.

During the meeting (or a subsequent meeting after everyone has reviewed the offering materials) the group should vote on whether to invest. If you get commitments in writing, you can have each “yes” member indicate how much they will invest. Only those who vote “yes” are obligated to invest.

How an Investment Club Makes Investments

The investments will be made via a series of member-managed limited liability companies (the joint venture structure we discussed earlier) encompassing only those club members who were present and agreed to invest.

Each member's profit share would be determined by calculating their percentage interest. This is calculated based on how much they invested in relation to the total amount all members contribute.

Rules for Your Investment Club

From a regulatory perspective:

1. You can't use a manager-managed limited liability company or each investment could be considered its own securities offering. This would require selection of an exemption, securities compliance, investor suitability determinations, etc., which would drive up your legal costs, exclude non-sophisticated investors, and create fiduciary responsibilities for the club organizers.
2. The operating agreement would designate:
 - a. Who is authorized to open and close bank accounts and sign checks, and
 - b. Who can sign a subscription agreement on behalf of the group, and
 - c. For security, each of the above should include at least two unrelated club members.
3. Your group must be limited to less than 100 members so it doesn't have to register as an investment company. However, you have to be careful about how you count members as a limited liability company with multiple members may count as more than one member.

4. To avoid having to register as an investment adviser, no person can be paid a fee in connection with any investment, nor should any one person select investments for the club. However, you can have “club dues” that people pay to club organizers to market the group; remind people to attend, or to provide refreshments for live meetings, etc. You could also have some criteria, such as a minimum amount that each member must invest in club offerings each year to maintain their membership, and to prevent the club from turning into a social gathering.
5. The club should be limited to accredited investors so that it meets the definition of an accredited investor (i.e., any entity in which all members are accredited investors) so that it can invest in any offering that allows accredited investors.
 - a. If the club has non-accredited investors, they would only be able to invest in Rule 506(b) offerings, and the issuer in which the club invests might have to count your non-accredited investors toward its 35-person limit.

Why Start an Investment Club?

An investment club could be a good choice if you want to help your friends and colleagues be exposed to more investment opportunities, without having them invest passively in a group you organize (i.e., syndicate). It could also work for situations where you want to offer club members the ability to invest less than the required minimum investment (\$50k-\$100k) that most syndicates or funds require.

This model probably doesn't work if you are trying to acquire property directly as someone will have to take an active role in managing it on behalf of the group (turning it into a passive investment for them), which would be better operated as a syndicate.

Caution Regarding Retirement Fund Investors

The Employment Retirement Security Act of 1974 (ERISA), Department of Labor Regulations state that, unless exempt, when a retirement plan (whether self-directed or not) owns twenty-five percent (25%) or more of the total value of the interests sold in a company, the interests may be deemed a "plan asset." Once deemed plan assets, the issuer becomes subject to ERISA fiduciary rules, and additional regulation and reporting requirements – which is not something you want to trigger.

In many cases an investment club will invest in securities in others' offerings, versus directly owning real estate. In those cases, the interests offered by the investment club are NOT exempt from constituting a plan asset under the "real estate operating company (REOC) exemption." This exemption is only available when at least fifty percent (50%) of the assets owned and operated by the issuer are directly owned real estate assets.

What does this mean for investment clubs? There is a 25% limit on the percentage interests of an investment club that may be raised from pension plan investors (such as self-directed individual retirement accounts or 401k plans, or pension plans). Make sure you keep track of the percentage interests owned by your pension fund investors and don't exceed this limit.

As in any regulatory framework, there will be penalties for non-compliance, which could be severe.

Additional Resources

If you want to know more, here is a link to an SEC publication regarding Investment Clubs, go to our Book Resources Page at:

<https://RaiseCapitalForRealEstate/BookBonus>.

Chapter 17 – Is Your Offering Viable?

How can you tell if your offering is viable? There are two hurdles you have to overcome to have a viable offering.

- Is it legal?
- Will anyone invest in it?

Is Your Offering Legal?

The first hurdle, “Is it legal,” is easily answered: If you are raising money from passive investors by selling interests in your company and they are relying on you to generate profits, you are selling “Investment Contracts,” which are securities, so your offering must comply with securities laws. The alternative is to do a joint venture, where all members are actively involved in generating their own profits.

The easiest way to make sure your offering is legal is to hire an experienced corporate securities attorney to help you correctly structure your offering, choose a securities exemption, form your companies, draft your investor agreements and securities compliance documents, and do the appropriate securities notice filings within the prescribed deadlines.

Your securities counsel should be frank (and experienced) enough to tell you if what you want to offer investors is outside the norm such that it will be undesirable to investors, and thus, doomed to fail or only marginally successful.

Is Your Offering Marketable?

The second hurdle, “Is your offering marketable,” is also something you can run past an experienced corporate securities counsel. They should be in tune with what investors are looking for and what will make them willing to invest with you. Some attorneys might just take your money and draft the offering materials whether your deal is marketable to investors or not – we won’t. We’ll try to talk you out of doing an offering that is doomed to fail as failure is disheartening – mostly for you – but our mission is to help you succeed, so your failure is a disappointment for us too.

Here are some things to consider when deciding whether your offering is viable:

1. Specified offerings are the easiest way to raise money: Our statistics show that clients who do “specified offerings” to raise money for a specific, pre-identified project, are 85% successful in raising the money and closing on the project. Get something under contract, calculate your pro forma projections, create a business plan to show what you will do to make the property profitable and your planned exit strategy; show investors how and when you expect to pay them back their original investment and how you will generate a return on their investment. If your terms are within market parameters, investors will invest with you.
2. A fund that has no pre-identified properties is the hardest way to raise money: While it sounds great to be able to raise money before you have an identified project; in reality, this only works if you have a

long, proven track record of successful, similar prior projects. If you don't have this, you are likely wasting your money and time by trying to create and launch a fund. I have talked to many investors who spent money on fund documents to the tune of \$25-\$50,000, and never raised a dime.

The Offerings Described Below Are Likely to Fail

You Are Trying to Invest in Too Many Different Things.

Fund offerings that purport to invest in too many different things - like multiple asset classes of real estate, or combining crypto, other securities (stocks, bonds, mutual funds, startups, small businesses, etc.) with real estate, are doomed to fail. I call these “kitchen sink” offerings – and they rarely work. Targeted offerings that invest only in a specific asset class in which you (and/or other members of your asset management entity) have a direct, prior and successful history are the most likely to succeed.

You Are Advertising for Investors Before You Have a Track Record.

Until you have a long, proven track record of successful, similar prior projects, no stranger is going to invest with you.

You Are Trying to Allow the Wrong People to Invest.

Securities laws are designed to protect “retail investors.” That means people like you and me, your family, friends and acquaintances. If your family, friends and acquaintances are not sophisticated investors and they

are not accredited, they may be prohibited – by securities laws designed to protect them - from investing in your private securities offering. You can help make them sophisticated by embarking on a formal training program that teaches them about the types of properties your offering will invest in, and how group investments work, and how they can go wrong.

To include non-accredited, unsophisticated investors, you would be limited to doing joint ventures or the investment club model discussed in earlier chapters.

The only other way to admit unsophisticated investors is to do a “registered” public offering that requires pre-approval from securities regulators. Until you have a long, proven track record of successful, similar projects, this will be an expensive, and speculative venture, which could easily fail. A public offering requires an intense marketing strategy.

You Are Spending Your Time Chasing Single-Check Writers Instead of Developing Relationships With \$50k-\$100k Investors.

Family offices, private equity funds and high net worth investors will only invest with you after you have a proven track record with similar investments. Your family and friends will invest in you early on, before you have a track record, because they believe in you. They are the people who can help you build a track record – so that later on, you can successfully consider creating a fund or joint venturing with family offices, private equity funds or high net worth investors.

You Are Allowing People to Invest With Too Many Investment Vehicles.

You are trying to get people to invest using too many investment vehicles. This could include trying to allow crypto, or NFT sales, etc. to support your offering. Every investment has to be converted to cash in order for you to use it to buy real estate. Do you want to take on the responsibility of converting these investments to cash (and bear the risk of the fluctuating markets surrounding them), or do you want that to be your investors' burden?

Why are they using these investment vehicles? Are they trying to avoid taxes? The IRS is going to get the tax money one way or another. Do you want to be the one holding the bag if the IRS says you owe the money (because your investor is outside the U.S. and their jurisdiction but you're here); or what if the crypto or NFT becomes worthless, but you still owe the investor their money back? Do you understand these things well enough that you can explain them to investors – and make a profit off them? Do your other investors understand the risk that these other types of investments pose to your offering? Few people do.

Your Offering Terms Are Not In Line With Market Norms.

For decades, investors have wanted 8% cash flow returns (often called “preferred returns”) from private offerings, plus a share of profits on exit that will bump their annualized returns to a current market return rate that has fluctuated over time.

- From 2008 through 2015, we saw many deals that offered 60/40 splits with annualized returns in the low to mid 20s.
- From 2015-on we saw a shift to 70/30 splits with annualized returns in the mid to high teens.
- For larger deals, we've seen more 80/20 splits.

Anything that deviates too far from the current market return rate is doomed to fail or only be marginally successful. You might get away with offering a slightly lower return than the norm if your project also has a social good aspect, but you still can't get too far away from normal terms or few people will invest.

You Have Too Many Steps in Your Distribution Waterfalls.

If your distribution waterfalls are too complicated for investors to understand, they are likely to say "no." Keep them simple.

Your Fees Are Too High.

Investors expect that the asset manager of a private offering will earn certain fees; but there are normal fees, and there are abnormal fees. A property management fee of 20% is going to be too high and is likely going to turn off investors. Find out what the norm is by getting bids from multiple property managers in the area where your property is located and adjust your proposed fees accordingly. Ask your corporate securities attorney what the norm is for your offering type and stay within those norms.

You Are Living an Extravagant Lifestyle and Flaunting it on Social Media.

There's a difference between appearing successful, and appearing to be a con artist. Be careful not to cross the line, as it will come back to bite you the minute one of your investments fail. You can live a quality lifestyle without flaunting it. If you don't want to attract negative attention from securities regulators or become a lawsuit target, try to stay low-key.

Key Takeaways

Set yourself up for success by keeping your offerings simple and staying within industry standards for offerings like yours. If a deal doesn't fit with industry norms (returns are too low, etc.), it simply may not be viable as a "for-profit" venture; so you might want to consider instead doing it as a "non-profit" company, or you might need to get out of that geographic market and look for deals that make sense in other markets. If your deal is not viable, don't waste your time or money hiring corporate securities attorneys to set up an offering up for you – and then have it sit in a drawer because no-one you talk to is interested in investing.

Go after your dreams, but get some coaching on which deals are viable and which are not, so you don't spend your time chasing rainbows. Be sure to hire honest securities attorneys who will give you a frank opinion about your chances of success, and listen if they tell you your deal is not viable.

SECTION 4 – WHAT CORPORATE STRUCTURE WILL YOU USE?

Chapter 18 – How to Structure Entities For a JV, Syndicate, or Fund

This chapter describes some of the more common corporate structures used to acquire and own real estate with investors. This chapter takes a look at joint ventures, syndicates, multi-property offerings, blind pool funds, development projects and residential assisted living facilities. 1031 exchange options are covered in the following chapter.

Joint Venture

The entity of choice for a joint venture is a “member-managed limited liability company.” A limited liability company is formed by filing a form with the secretary of state called a certificate of formation or articles of organization. On formation, you have the option of selecting whether the limited liability company will be managed by its members or managed by a manager.

In a member-managed limited liability company, every member is considered by law to be a managing member, each of whom has the right to open and close bank accounts and contractually bind the company. For the SEC and state securities regulators to consider your entity a joint venture (versus selling passive interests, which triggers compliance with securities laws), all members must be actively involved in generating their own profits.

The problem with joint ventures is that they aren't scale-able, as more than 5 members in a member-managed entity is usually dysfunctional. It's too hard to get the members to agree or even show up for meetings that they are required to participate in. Joint ventures are good for small groups of 1-5 people, where everyone is contributing time, effort and money – and no one member is taking on a management role.

This is not the structure to use for a group that wishes to delegate management to one or more members; for that, you would use a “manager-managed limited liability company” or a limited partnership (more on that below).

A joint venture is not a structure where one or more of the members will manage the investment on behalf of the group and be separately compensated for it (with fees and a share of profits for their sweat equity), as that structure would cause the joint venture to look much more like a syndicate with passive investors, and would subject it to compliance with securities laws.

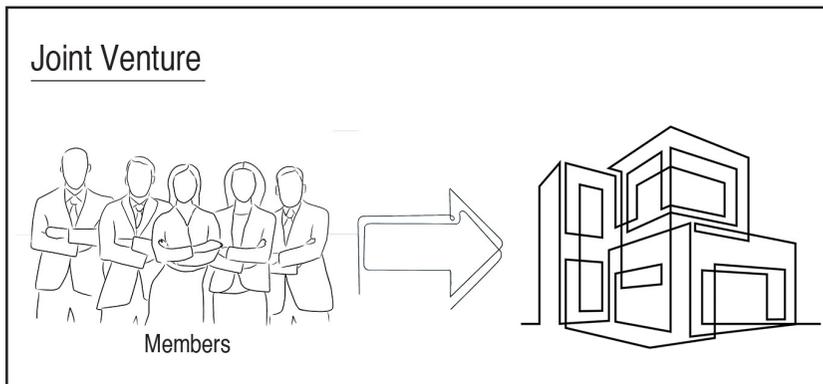
Cash distributions in a joint venture generally follow percentage ownership, which is often determined by capital contributions.

Joint ventures can be successfully used in the following applications for real estate group investments:

- To own and acquire smaller properties with up to 5 members, all of whom are actively involved in generating their own profits through the contribution of time, effort and money.

- To manage a real estate syndicate or fund. In this application, the asset manager is a joint venture whose members' jobs are to syndicate a property, and all that that entails.
- To enhance the buying power of your syndicate or fund in a joint venture, where your syndicate or fund is one member and the other member is a private equity fund or family office that contributes ½ or more of the funds needed to acquire the property. In this scenario, the joint venture owns the property, and the joint venture members split profits at the property level.

We'll start with a joint venture, a diagram of which is shown below:

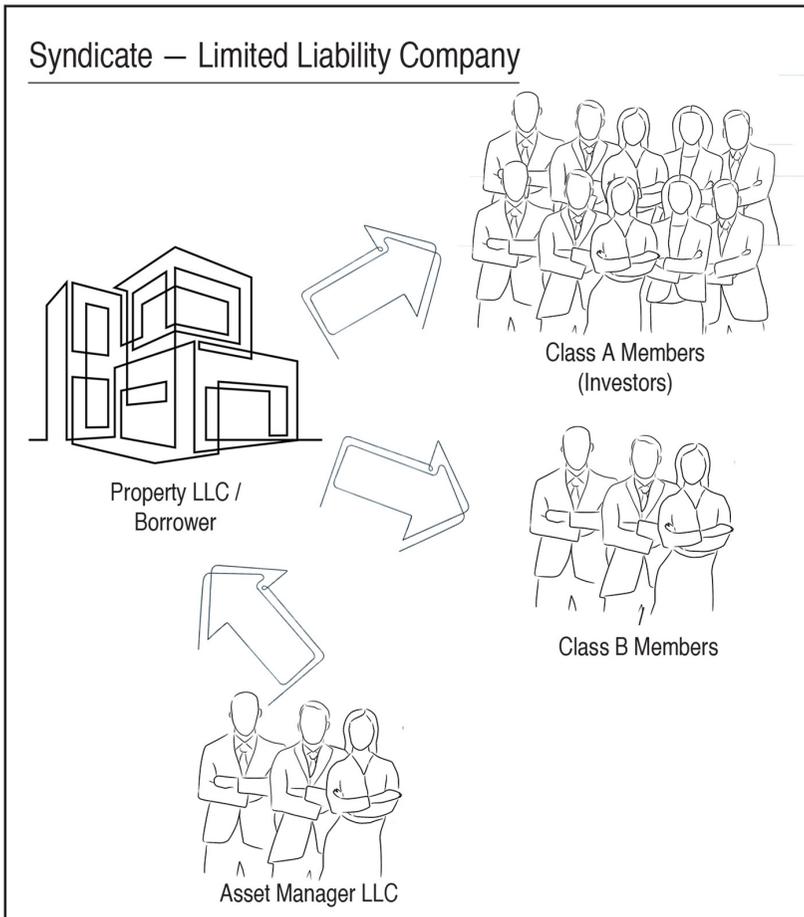


Specified Offering

The following model describes a specified offering (i.e., syndicate) using equity investors (Class A), a management class (Class B) and a separate asset management entity, whose purpose is to acquire a single, commercial property.

Limited Liability Company

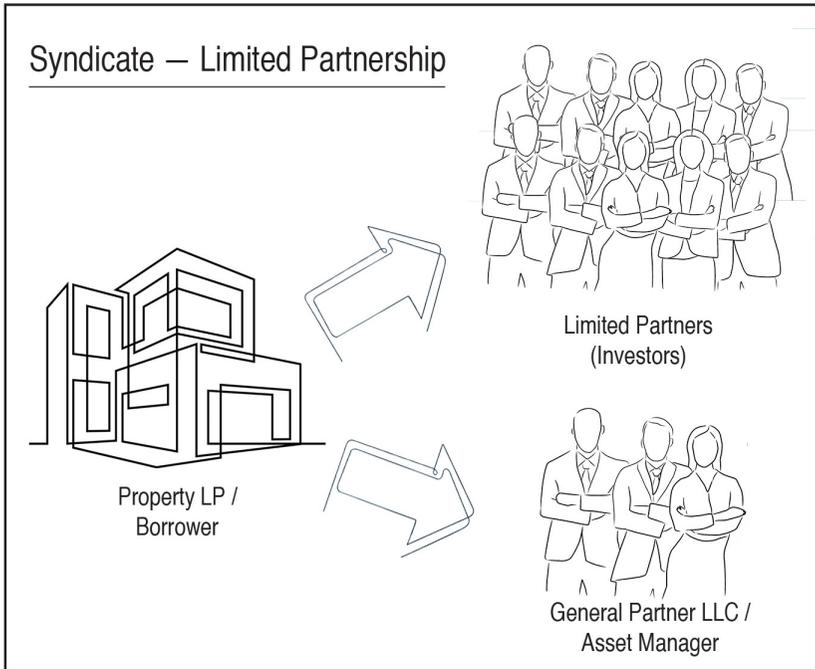
The organization chart below shows the typical corporate structure for a specified offering using a limited liability company. In this scenario, the “Property LLC” is the title holding entity, borrower on the bank loan, syndicate (or issuer of securities) that sells interests to investors.



The Property LLC will be designated as “manager-managed” on formation. The “manager” will be a separate limited liability company; possibly a joint venture as described above. The Class A members are the passive investors, and the Class B members are the management class. Class A and Class B split distributable cash; the asset management entity will earn fees.

Limited Partnership

A syndicate may be a “limited partnership” (LP). Limited partnerships were the original syndicate model, before limited liability companies existed. Now, limited liability companies are the syndicate entity of choice. A typical limited partnership structure is provided below:

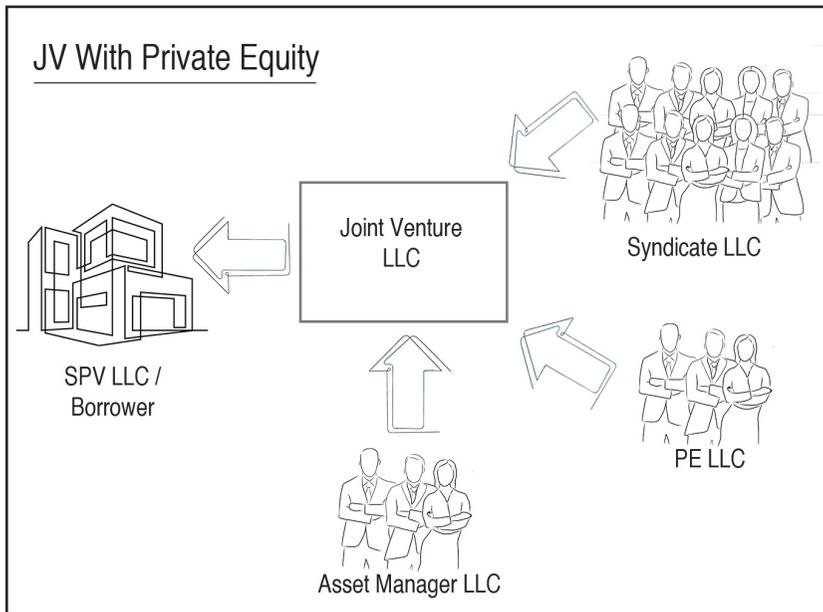


In a limited partnership, the “general partner” (GP) has unlimited liability for all acts of the partnership. Best practice is for the GP to be a separate limited liability company comprising the asset manager (possibly a joint venture, as described above). The GP is the asset manager and the management class and “limited partners” (LPs) are the passive investor class.

You will need to use the LP model if you expect to have Canadian investors, as the tax treaty between the U.S. and Canada offers tax benefits to Canadians who invest in U.S. LPs, but it was written before limited liability companies existed, so it doesn’t apply to them.

JV With Private Equity

Below is a typical structure for a specified offering owned by a joint venture whose members are a syndicate and a private equity fund:



As you can see, there are at least 5 limited liability companies involved in this structure. The “SPV” is a single purpose venture/single member limited liability company that holds title to the property and becomes the borrower on the bank loan. The “asset manager” will be a separate limited liability company; possibly a joint venture between the asset manager of a syndicate or fund and the private equity fund manager. The syndicate will have its own Class A and Class B members and an asset management entity, as described above for a specified offering. The private equity fund will have

its own internal structure, which will likely be similar to the structure of your syndicate. The syndicate and private equity fund will form a joint venture, that owns the SPV.

This model can be used to enhance the buying power of your syndicate or fund. The private equity fund or family office usually makes a capital contribution to the joint venture of ½ or more of the funds needed to acquire the property. Percentage interests in the joint venture are allocated according to the respective capital contributions of the joint venture members. You typically won't entertain this model until you are raising \$4M or more from investors, as most asset managers can raise \$1M-\$2M on their own, but may struggle when it comes to raising more – if they haven't cultivated relationships with a large enough investor database. In this scenario, the joint venture owns the property, and the joint venture members split profits at the property level.

This method will not work until you have a demonstrated track record with similar investments as private equity funds will only invest if you have a sufficient, successful track record. The private equity funds will typically leave your asset management entity in control of the property, with the private equity fund manager as a silent partner. The joint venture agreement will include certain performance criteria and reporting requirements. If your asset management team fails to meet the performance criteria or make timely reports, the private equity fund will have the right to take over and acquire the property; sometimes for just what they are owed – stripping you and your investors of their equity in the property.

Most private equity funds would rather offer mezzanine debt (i.e., a second position loan) than joint venture. Lenders, however, won't allow subordinate debt, but they will allow joint ventures as long as each joint venture member puts forth their own loan guarantors.

Private equity investors typically want returns of up to 15% annually, which they will insist on taking before your syndicate or fund gets its cut. The private equity fund partner will often demand that their annual returns be paid, and that they be paid back their principal within 3 to 5 years. Additionally, they will make the syndicate pay for their pre-acquisition legal fees, which can range from \$60k-\$80k. Also, look for a "breakup fee", which the private equity fund may impose if the deal goes south after they have performed due diligence. You will owe this even if you don't do the deal at all.

The relationship begins with a term sheet provided by the private equity fund in which the expected returns, their fees, buy-out clauses and deliverables are described. The time to get corporate securities counsel involved is when you receive the term sheet – but before you accept it. We may be able to help you negotiate better terms.

Once the syndicate accepts the term sheet, the private equity fund's legal counsel will draft the joint venture operating agreement, which may be long and complicated. You will need your own corporate securities counsel to help you understand your obligations under this agreement.

Entering into a joint venture with a private equity fund or family office adds additional risk to your investors, as failure to meet their conditions could result in forfeiture of the property, and a complete loss of your

investors' equity. I have seen this happen, where the asset manager didn't understand their obligations, and then failed to perform. The private equity fund ended up with the property, and the syndicate investors lost several millions of dollars. Don't let this happen to your syndicate or fund.

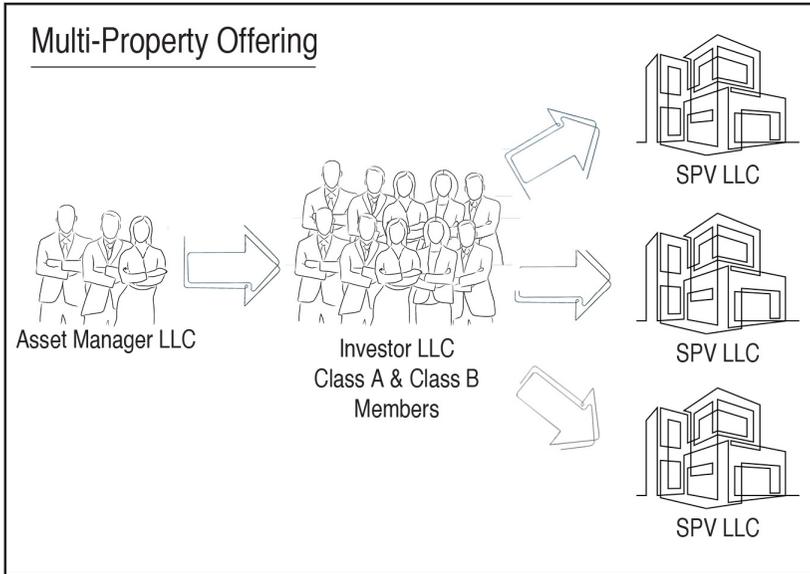
Most of our clients who use private equity funds will try to cash them out as soon as possible (on refinancing), to alleviate themselves of the burden they impose on the asset manager. They quickly learn that cultivating their own investors is much more lucrative for the syndicate manager and their investors, than meeting the needs of private equity funds or family offices.

Multi-Property Specified Offering

A multi-property offering is exactly like the specified offering structure, except that each property acquired by the syndicate or fund will be held in a separate single purpose venture (SPV). Each SPV will hold title to a single property, and will become the borrower on the bank loan for that specific property. The SPVs will each be wholly owned by the syndicate, although it is possible that the syndicate could form a joint venture at the SPV level with a private equity fund or family office to acquire a specific property.

This structure works well for asset managers who are buying smaller properties that they don't want to syndicate individually, or where they have multiple properties of a similar asset class under contract at one time. For this to be a "specified offering" all properties need to be identified at the time the offering documents are created.

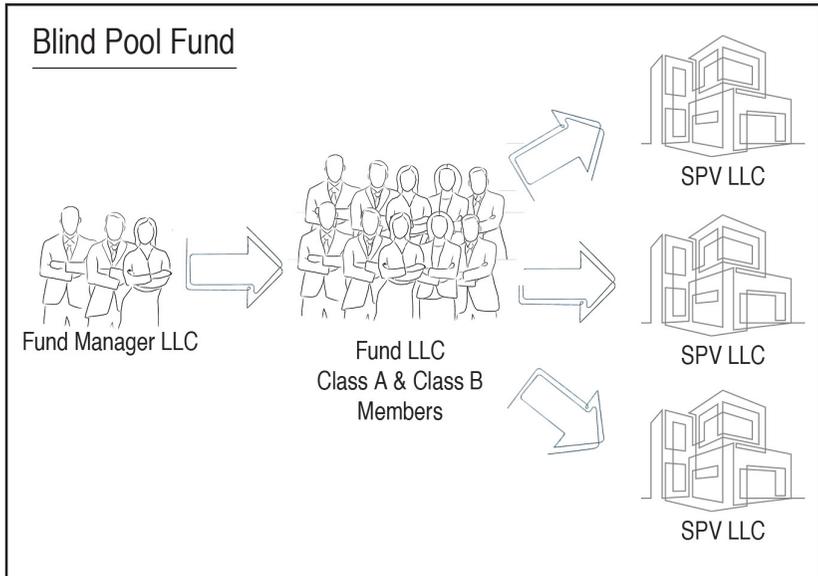
Below is a typical structure for a multi-property specified offering owned by a syndicate with a single group of investors owning all of the properties:



Blind Pool Fund

The blind pool fund structure is exactly like the multi-property specified offering structure, except that properties to be acquired by the syndicate have not yet been identified. Instead of describing specified properties that the fund will acquire, the fund will have an “investment summary” describing its business plan, and what it plans to acquire. See Chapter 14 re blind pool funds. The “Fund LLC” shown below, will usually have the same structure as a syndicate, with both Class A and Class B members, and a separate asset manager or “fund manager.”

Below is a typical structure for a blind pool fund:

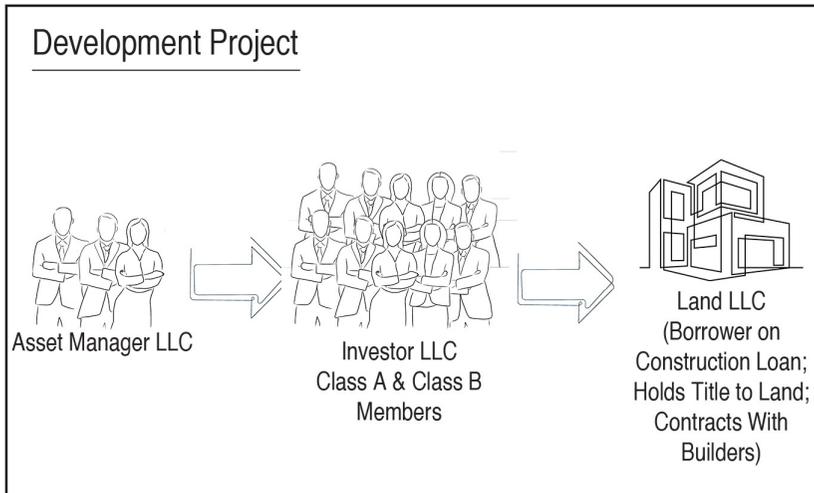


Development Project

For development projects, the lender will require that each property be held in a separate SPV that is wholly (or partially) owned by the syndicate or fund where investors' funds are pooled. This is important as it keeps investors one step removed from construction liabilities that might arise during or after construction. The SPV can obtain construction liability insurance – and will become the defendant in any lawsuit filed by an injured party for any damages or contract disputes that might happen at the property. You don't want the syndicate or fund (and its investors) to get embroiled in litigation.

The SPV will acquire the land, obtain the entitlements, and qualify for the construction loan, and it will contract with builders and other contractors for SPV for a development project. When the developer is ready to raise funds from investors, the developer will form a syndicate (Investor LLC), and then sell its interests in the SPV to the syndicate. The development company will typically manage the syndicate.

A typical development project organization chart is provided below:



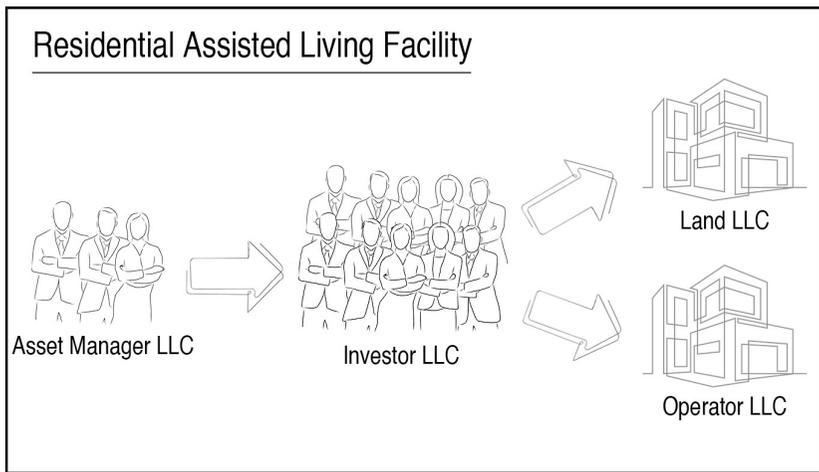
Residential Assisted Living Project

Several of our clients acquire or develop residential assisted living facilities.

This syndication structure (Investor and Manager LLC) is the same as for a specified offering. The title holding entity (Land LLC) acquires the land, obtains loans for acquisition and construction, and contracts with

building professionals. This entity leases the facility to the Operator LLC. The Operator LLC obtains required permits and licenses, hires staff, provides assisted living services, and collects rent from residents. It pays the lease payments to the title holding entity. The Investor LLC (syndicate) typically owns both the Land LLC and the Operator LLC, participating in profits from both, or may only participate in the lease payments from the Land LLC.

This structure requires an investment entity, as well as a title holding entity, and an operations entity, as shown in the organization chart below:



General Guidelines For Legal Entities

The over-arching objective of every one of the corporate structures described above is to isolate liabilities for certain activities within a specific limited liability company.

Here are some general guidelines that will save you a lot of headaches later on:

Guidelines for Title-Holding Entities

Use a separate single purpose venture (SPV) entity to hold title to every commercial property you acquire. Do not mix up liabilities by owning multiple commercial properties in a single entity. Commercial lenders won't allow this, but some local banks might. Doing this creates a mess that you'll have to fix later if you try to obtain commercial financing on one of the properties – or syndicate it, in the future. If you try to change title in the future, it could cause re-assessment and a taxable event, as well as transfer taxes and fees, and a new title insurance policy.

For single-family properties – you may wish to have 2-5 single-family properties owned by the same entity, or make a rule regarding the maximum equity you'll allow under a single entity. The equity in all properties owned by a single entity are at risk from things that happen at other properties owned by the same entity. Someone injured at one of the properties can sue (and perhaps win) a judgment for all of the equity in all of the properties that entity owns.

Use separate title holding SPVs, one step removed from your syndicate or fund entity, to hold title to land for development projects and for any property with a loan balance over \$10M, even if the initial lender (such as a bridge lender) doesn't require it. If you don't and you want to get agency debt or a commercial loan later on, you would need to restructure your company – which could require investor approval.

Guidelines for Asset Management Entities

Use a separate asset management entity as the manager of a syndicate or fund – do not name individuals as the managers of a fund or syndicate. Doing so puts equity in anything they personally own (like their primary residence) at risk, and would require investor approval if you needed to make a change in management.

Don't use an entity that already owns something or holds a license as the asset manager of a syndicate or fund. If the offering fails, investors will attack your license, and the liability insurance for your license could deny coverage for engaging in non-covered activities.

If you are going to provide property management services, which does require a license in some jurisdictions, use a separate entity (not the asset management entity) for that. Use that entity to hire property management employees, and to deal directly with tenants. Make sure you get property management insurance for that entity.

Chapter 19 – 1031 Exchange Options, TICs & DSTs

We often get calls from clients who ask the question: “Can I include a 1031 investor in a syndicate or fund?” The sad truth is that syndication and 1031 investors don’t mix well.

Before we begin our discussion, just what is a 1031 Exchange? According to the United States Internal Revenue Service (IRS), IRS Tax Code 26 USC §1031 allows a taxpayer to postpone paying tax on the gain from the sale of a business or investment property, as long as they reinvest the proceeds in similar property in a “like-kind” exchange. This is commonly known as a “1031 Exchange.”

The problem that arises for asset managers is that most syndicates are structured as limited liability companies (LLCs) or limited partnerships (LPs). The interests in a limited liability company or limited partnership are legally considered “personal property” interests, while interests in real estate are considered “real property” interests. Thus, if someone sells real estate, and wishes to exchange the proceeds for interests in a syndicate or fund, the exchange won’t qualify because it is not a “like-kind” exchange (i.e., they are trying to exchange real property for personal property interests).

Additionally, the IRS classifies limited liability company interests as partnership interests, which are specifically disallowed from being exchanged under 1031 Exchange rules. See IRS Rev Proc 2001-22.

So, short answer: No, a 1031 investor cannot become a member of a syndicate or fund. Here is what you can do:

Tenant In Common Ownership

What can you do with a 1031 investor if you're an asset manager? If the investor is bringing enough cash to the deal, you might consider structuring your offering as a Tenant in Common (TIC) offering instead of a syndicate. In a TIC, each investor holds direct title to the real estate – thus it becomes eligible for exchange as the 1031 investor is exchanging real property for real property.

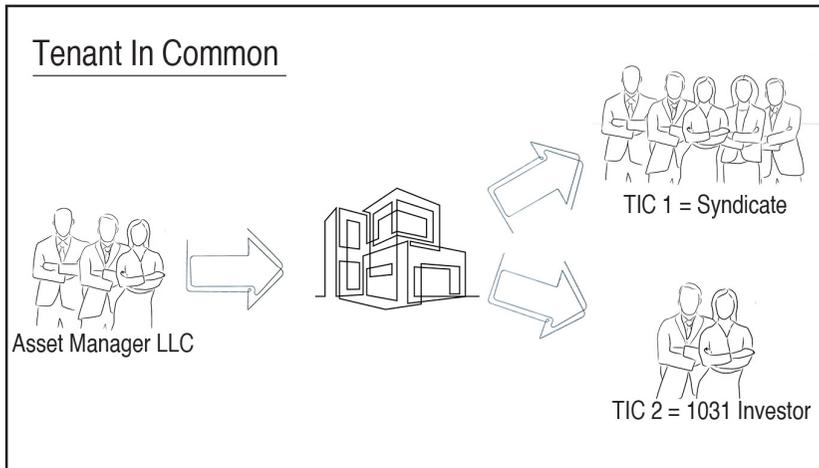
You can have up to 35 tenants in common, all taking title to their own slice of the pie, or just two TIC owners (tenants) – one being the 1031 investor and the other being your syndicate or fund. The portion owned by each will be directly related to the amount of cash contributed by each tenant in common.

The upside is that you may be able to close on a deal that requires more money than your syndicate or fund can raise on its own. The downsides are:

- In addition to the traditional syndication documents (i.e., private placement memorandum, Operating Agreement, Subscription Agreement), you will need additional legal documents between the tenants (i.e., a TIC Agreement and an Asset Management Agreement) which will require extra legal fees;
- You will have to find a lender willing to lend to a TIC (Note: all tenants must be underwritten for the loan);

- Unanimous consent is required for certain major decisions (Hint: Your TIC Agreement should have a reciprocal buyout clause that can be invoked in the event of a stalemate);
- Property Management agreements must be renewed annually; and
- The big downside is that any splits between investors and management can only be derived from the portion of the property owned by your syndicate or fund, although you might still be able to collect reasonable and customary asset management fees from the other tenant. For example, if a 1031 investor exchanged into your deal for 50% of the equity, and your syndicate or fund kept the other 50%, the asset manager could only earn fees and profit distributions generated from the 50% of the property owned by the syndicate.

If you take a typical syndicate structure and divide all of the income in half, it might not be worth the asset manager's time and risk to do the deal. Thus, unless the 1031 investor is bringing sufficient capital to the deal that the syndicate can't raise on its own, it's probably not worth the extra legal fees and lost participation in profits for the syndicate manager to allow them in your deal.



Delaware Statutory Trust

A Delaware Statutory Trust (DST) is an unincorporated association recognized as an entity separate from its owners. This is another option you can use with 1031 investors.

A DST is formed by executing a DST agreement and filing a Certificate of Trust with the Delaware Department of State, Division of Corporations. Basically, DSTs are an alternative group investment structure that includes a trustee (management) and beneficiaries (investors). This structure is the only group investment structure that allows the trust to own real estate and the beneficiaries to acquire interests without recognition of gain or loss under Section 1031 of the IRS Code.

The problem with DSTs is that they are very restrictive. They specifically disallow the trustee to engage in certain activities that are critical to most income-producing real estate, such as:

- Negotiating new or refinance loans or new or existing leases,
- No new equity investments can be accepted (even from existing beneficiaries) once the offering is closed, and
- Investors are truly passive – they actually can't have a say in how the property is operated,
- The Trustee can only perform normal repair and maintenance or minor non-structural capital improvements, and
- The property of the trust must be held for investment purposes only and not for active conduct of a business (hence, the popularity of DSTs for triple net property ownership).

To learn more, do a Google search for the “7 Deadly Sins” of DSTs and you'll see the complete list of prohibited activities. These restrictions make it difficult – and potentially risky – to use a DST to purchase a property that requires frequent leasing, may need periodic cash infusions, and/or occasional refinancing, like an apartment complex or other multi-tenant building, other than a triple net leased property with long-term leases already in place.

To combat these limitations, lawyers create a complicated (i.e., expensive) structure that involves the following:

- The “Depositor” (you) gets a property under contract and assigns the contract to a DST. The Depositor keeps a portion of the DST Interests for itself and sells the rest to beneficiaries. Each beneficiary acquires an undivided fractional interest in the trust.

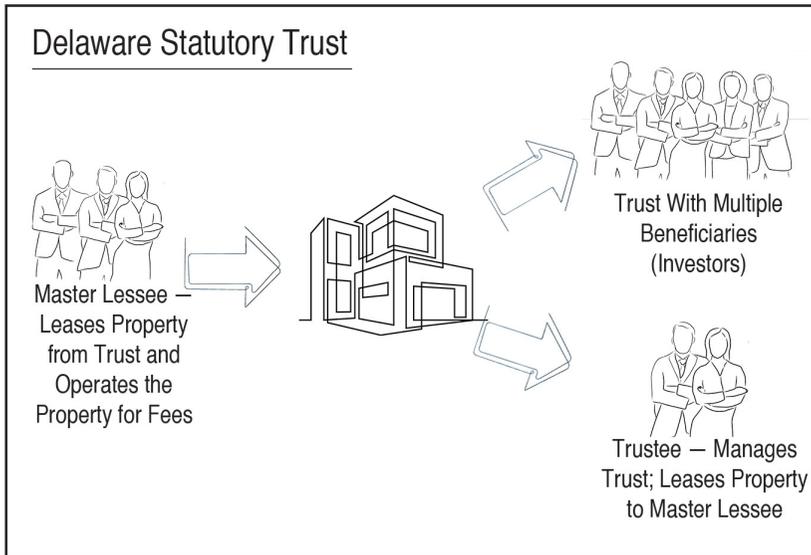
- Each DST has a “Signatory Trustee” (manager of the trust) and a Delaware Trustee.
- The Depositor and Signatory Trustee are both 100% owned by the “sponsor” of the deal (you).
- The DST holds title on its own or through a wholly owned subsidiary entity.
- DST beneficiaries have the same limitation on personal liability as do shareholders in a Delaware corporation. Because of this, they can take title to their beneficial interests individually and are treated as if they own undivided interests in the underlying real estate for federal tax purposes.
- The DST will typically have a Master Lease Agreement with a third party Lessee so that the Master Lessee can negotiate leases (remember, the DST can’t do this on its own). The sponsor (or an Affiliate) can be the Lessee; however, the Master Lessee cannot refinance the property. If it does, the DST will convert to a limited liability company – which could trigger taxation of the 1031 Exchange investors/beneficiaries. Yikes!
- The structure may include a “Springing LLC” with a pre-written operating agreement that the trustee can invoke and convert the DST to a limited liability company if the property is in danger of being lost due to DST limitations; doing this would allow additional funds to be raised or to attract better financing or negotiate new leases.

All of this is great for attorneys because there are lots of legal documents to create, but it will drive up the legal costs and time needed to get the deal

done; latest estimates are \$60,000 in organization expenses. Additionally, you will have to find a lender willing to loan to a DST, which won't be your run-of-the-mill commercial lender.

One major benefit of a DST, however, is that unlike TICs (which are limited to ≤ 35 investors) there is no restriction on the number of beneficiaries in a DST, making a DST a better choice for larger deals where the 35-investor limit would not be feasible.

Below is a typical structure for a Delaware Statutory Trust:



Can A Syndicate or Fund 1031 Exchange Its Own Property?

A syndicate can exchange its property for another.

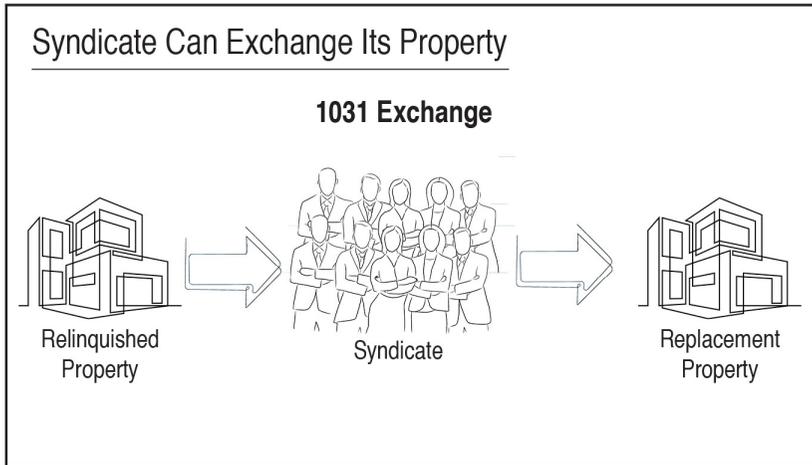
If all of the syndicate members agree, the syndicate can exchange its property for another instead of selling it and cashing out the members. But what if some of the investors want to cash out and others don't?

There are 2 options:

1. You can do a "Swap and Drop." Basically, this means you will go ahead with the exchange, close on the new property, and then buy out the investors who want out. They'll owe the tax on their gain, but the rest of the members can carry happily on, tax-deferred.
2. The other option is called a "Drop and Swap." In this scenario, the asset manager would distribute the syndicate's property "in kind" (via quit claim deeds) as tenant in common interests to all of the members who don't want to stay in the syndicate, according to their respective percentage interests. This must occur prior to entering into a sale agreement. That's the "Drop." The individual tenants then proceed under a temporary TIC Agreement to the sale, with all individual tenants participating in the sale and signing the sale documents. Ideally, this should all occur within a few weeks of the actual sale, before the lender can ramp up and call the note due on sale. After the sale, the tenants would each be responsible for entering into their own 1031 Exchange, and the original syndicate entity would be dissolved.

In either of the above situations, it is likely that some investors will want to stay with the syndicate, which will participate in the replacement property as a single entity, while other tenants may wish to proceed as individuals, and some may just take the tax hit and cash out.

Here is a diagram showing what it would look like for a syndicate (or fund) to exchange its property for another:



Key Takeaways

In summary, the rules regarding 1031 Exchanges are complex when it comes to group real estate investment structures and legal documentation. Each group investment structure has its own advantages and disadvantages. It's up to the sponsor, with the help of knowledgeable corporate securities counsel, to determine which is the best fit for its investors, and to execute the appropriate strategy.

Chapter 20 – Assigning Member Rights and Duties

In each of the syndicate or fund corporate structures shown in the previous chapter, the common elements are an investor class and management class (we called them Class A and Class B Members), and a separate asset management entity. Each of these of which have separate rights and duties with respect to the syndicate. The investor agreement, and rights and duties of each of these respective elements are provided in the operating agreement for your syndicate or fund, or in a separate operating agreement for the asset management entity. They are also summarized below.

The operating agreement for your syndicate or fund, coupled with the separate operating agreement for your asset management entity, collectively describe how you will allocate funds your syndicate or fund earns, among investors, and among the members of the asset management entity.

The Investor Agreement

Your syndicate or fund will need an agreement between the asset manager and investors that will govern how the company will operate. For a limited liability company, this will be an operating agreement. For a limited partnership, it will be a limited partnership agreement. Throughout this book, we use terminology consistent with a limited liability company (manager and members), as this is by far the most common entity that syndicates currently use.

The operating agreement will define the asset manager and investor rights and duties and how cash will be distributed to each of the participants. Below is a general description of the typical rights and duties of the respective member classes in your syndicate or fund.

Member Classes

Class A

Class A members contribute 100% of the capital contributions necessary to capitalize the company but only purchase a portion of the ownership interests. Class A includes ALL cash-paying investors, including members of the asset management entity, who wish to contribute cash or convert pre-closing expenses or fees into a cash investment in the property.

Class A Sub-Classes

Class A may be further divided into sub-classes (Class A-1, Class A-2, etc.), if certain investors will have different rights than other classes. For instance, Class A-1 could be:

- A fixed return class that gets bought out on a refinance. This is good for short-term investors or seller financing.
- A private equity fund or family office that gets a preferred return higher than and prior to your equity investors, and likely gets cashed out on a refinance; and who also usually has the right to force a sale or take over operations if the property (or your asset management team) isn't performing.

Class A-2 could be your equity class that splits distributable cash with the management class (Class B).

Alternatively, sub-classes can be used to offer higher returns to those who invest more, help co-guarantee loans, or invest early.

Class B

Class B includes members of the asset manager and/or others who provide services to the company. They keep a percentage of the ownership interests in the company in exchange for a nominal amount (e.g., \$1,000 total). Class B members typically only get their share of distributable cash after Class A members receive their share of distributable cash for the year (i.e., a “preferred return”), although this can be calculated and paid in quarterly increments. As such, Class B returns are subordinate to Class A’s preferred returns, which is important for tax reasons.

Management

For the asset manager, you should have a separate limited liability company that includes the active management team as its members. These members may be individuals or other entities.

People often ask – how should I take title to my management interests? Many of our clients use a limited liability company that they have branded for this purpose.

In truth, the primary reason to have a limited liability company inside of a limited liability company is if you are concerned about being sued by the other members of the limited liability company. It probably isn’t as

necessary to have individual limited liability companies represent the members of the asset management entity, but it still seems to be preferred by most clients. Because the management entity could be sued by investors in a syndicate or fund, we always suggest that the asset management entity should be a separate limited liability company.

If an individual is named as the manager of a fund or syndicate, the company can be harmed if something happens to that person, as it will no longer have a manager until the members can elect a replacement. If the manager is a multi-member limited liability company, the asset management entity will continue to exist as long as it has members, and the investors will be unaffected if something happens to one of the members of the asset management entity. Further, if there is dissent among the asset management team (which is the most likely place for problems to occur), it can be dealt with separately, without having to involve investors, which always makes them nervous.

In the organization charts we showed you in Chapter 18, the asset manager is a not a member of the limited liability company, so it doesn't have any ownership interests or voting rights in the syndicate or fund. Instead, the asset manager earns certain fees for its active role in managing the syndicate or fund.

Why Use Two Classes of Members?

Below are several reasons we suggest you use a two-class membership structure with a separate asset management entity for your syndicates and funds:

1. This structure can help to preserve Class B distributions for the asset management class if the asset manager resigns or is removed by a vote of the Class A members. If provided in the operating agreement, the asset management entity can resign or be removed, but its Class B membership interests can remain intact. If the acting manager is no longer providing services to the syndicate or fund, and also owns the Class B interests, the investors may argue that the asset manager should be stripped of all of its ownership and management rights – and if the issue comes before an arbitrator, jury or judge, they might agree.
2. This class structure can help you segregate earnings from asset management fees from profit distributions for tax purposes. Since your Class B interests are earned on acquisition for your past efforts in getting the deal to the closing table or a creating your fund, will pay for your Class B interests (~\$1,000 total), you will establish a cost basis in your Class B interests, allowing earnings on your Class B ownership interests at sale to be taxable at capital gains rates. Whereas your asset manager’s fees will always be taxed at ordinary income rates as they are earned for your active role in managing the asset, meaning you will pay self-employment taxes on those earnings.
3. If provided in the operating agreement for the syndicate, the asset manager may be able to allocate Class B interests as it sees fit amongst persons who provide services to the company, regardless of whether they are members of the asset management entity. The documents we draft contain clauses that allow the asset manager to do this without a vote of Class A members and without having to admit such persons as

a member of the asset management entity. This is useful for people whom you want to compensate with a share of profits, such as deal-finders, employees or contractors, etc., but to whom you don't want to (or can't) give an asset management role. Note, however, that granting Class B interests without membership in the asset management entity might not work for a loan guarantor, as the bank usually wants the loan guarantor to be a member of the asset manager with a major decision-making role in management.

Determining Member Percentage Interests

A members' percentage interests are calculated either as a percentage of their interests in a class (such as Class A or Class B) or as a percentage of the total interests in the company. Unless superseded by a separate agreement, the percentage interests will determine both a member's voting rights and its right to distributions, all of which will be spelled out in the operating agreement. Percentage interests are determined by dividing the percentage owned by a single member in a class against the amount contributed by all members of the same class. The result is the member's "percentage interest" in that class.

If the class only owns a portion of the total interests in the syndicate or fund (such as 70%), then the member's percentage interests will be further multiplied by the percentage owned by its membership class to determine its ultimate ownership percentage in the syndicate or fund.

For example, if a syndicate or fund raises \$1M from the sale of Class A interests, and Class A owns 70% of the syndicate:

- How much does a \$100k Class A member own of Class A? Answer: 10%.
- How much does this same investor own of the total interests in a syndicate or fund? Answer: 7%; (10% owned in Class A x 70% Class A percent of total interests = 7% of the total interests in the syndicate or fund).

Percentage interests are only used at specific points in time, and are subject to change until all capital has been raised and the asset manager declares the fundraising period to be over. The ownership percentages will continue to change with admission of each new member.

Dilution

When investors ask about “dilution”, you need to explain this to them. The percentage interests they own will fluctuate as you raise capital, but as you bring in additional members, the company’s equity grows, so they may own a smaller percentage but, it’s a percentage of a larger piece of equity.

Another way to explain this is that the first investor owns 100% of the Class A interests, if someone else invests the same amount, each own 50%. This division continues until all of the interests in that class are sold. The only way for an investor to guarantee a fixed percentage interest in your company is: a) to invest enough that you are willing to carve out a special class with a specific percentage interest just for them, or b) acquire all of the interests you are selling.

Your lender will be interested in total percentage interests. They will have internal policies governed by bank laws and regulations, and usually

based on the type of loan, that requires them to underwrite members (or sometimes seek loan guarantees) from members who own over a certain percentage of the total interests in your syndicate or fund and/or in your asset management entity.

Distribution Rights

The percentage of distributions does not have to match an investor's percentage interest if a different split is described in the company's governing documents. You could sell 99% of the interests in your company to investors, while the asset manager keeps 1% of the ownership and voting rights for itself but has the right to receive 30% of the distributable cash.

In the example we described above, a \$100k investor in a \$1M offering where Class A owns 70% of the total interests in the syndicate or fund, will get 10% of any distributions made to Class A members. If your company makes a distribution to all members, this investor will get 7% of those distributions.

Voting Rights

For real estate offerings, even passive investors generally have some limited voting rights regarding major decisions affecting the property. The asset manager will make all of the day-to-day decisions regarding the property, but certain major decisions are left to investors. For instance, if you want to extend the raise period, increase the maximum dollar amount, 1031 exchange the company's property for a different property, buy something other than the property that you raised the capital for, add an

unplanned development, acquire an adjacent property, invest excess cash in something else, or make any substantive change to the operating agreement they signed up for, you will probably need a vote of the members.

If there is a vote in which only Class A participates, and voting is by percentage interests, a \$100k investor in a \$1M offering where Class A owns 70% of the total interests in the syndicate or fund, will have 10% of the voting power of Class A members. If your syndicate or fund calls for a vote of all members, this investor will have a vote equal to 7% of the total vote.

Chapter 21 – How to Split Cash in a Syndicate or Fund

The percentage of ownership retained by the asset manager is determined by projecting the “annualized cash on cash” return for a property, both from cash flow and sales proceeds, and then figuring out how much of that you need to give investors to get them a return that will entice them to invest, and how much you can keep for the management class. If the annualized cash on cash return for a property isn’t close to 20%, it might not be worth your time and effort.

There are many real estate books, written by very talented real estate investors and trainers, such as David Lindahl, Jake and Gino, Rod Khleif, Vinney Chopra, and Hunter Thompson, to name a few, that will help you make these calculations much better than I can. Additionally, there are many real estate analyzer software programs out there (Bob Bowman’s Commercial Underwriter software is an example, and each of the above authors also offer them to their students) that will help you do this.

Consider this chapter to be a brief overview to help you understand that numbers drive the splits with investors and all things related to real estate investment. The only reason I include a brief discussion here is that I speak to a fair number of potential clients who don’t have any idea of how this is done, so I wanted to provide the overview, and then direct you to the experts to get a more detailed education on the subject.

For the past several years, the target annualized cash on cash return for investors has been in the mid to high teens. Prior to that, investors were seeking deals with cash on cash returns in the low to mid 20s. You can expect the investor cash on cash return target to fluctuate with changing market conditions, usually driven by such things as mortgage interest rates and higher demand for properties, etc.

Step 1: Determine How Much You Need to Raise

Determine how much you need to acquire the property. This is calculated from the “uses of funds” that we discussed in Chapter 13.

As an example; if you are acquiring a \$4M property and can get a loan from an institutional lender with a 75% loan to value ratio, the loan amount will be \$3M. You will need \$1M for the down payment, as well as additional funds for capital improvements, closing costs, legal fees, lender fees and escrows, working capital and reserves and the asset manager’s acquisition fee. See Chapter 22 for a deeper discussion of this.

A good rule of thumb for determining your raise amount for a value-add project is to estimate approximately 1/3 of the purchase price as the amount you need to raise. In our example, 1/3 of a \$4M purchase price is \$1.3M, so to be conservative, we’ll estimate that you will need to raise up to \$1.5M from investors for our example project. The biggest variable is the capital improvement budget, which can skew this number.

Step 2: Calculate Your Annual Cash on Cash Return From Cash Flow

To start these calculations, you need to calculate the annual cash on cash return from cash flow that the property will generate on a \$1.5M investment over the period you expect to own the property. At this point, we aren't trying to determine how much to give investors or to keep for yourself, because the deal may not even be viable if the overall return is insufficient – we are looking for the overall return the property will generate. For this example, we'll select a hold period of 5 years, which is what most of our clients use.

To do this, you will prepare a pro-forma projection, showing the property's anticipated income and expenses for each year of the 5 year hold period. The amount left after payment of expenses is your "net operating income." For the operations period, you will make a further adjustment, deducting the loan payment and withholding operating capital and reserves, to determine "distributable cash."

You will then add up your projected distributable cash for all 5 years of ownership (we'll call this "overall cash flow distributions"). Hold on to this number; you are going to use it later.

Make sure to note the assumptions you made in generating this pro-forma and your overall cash flow distributions, as you will need to disclose these to investors in your offering materials.

Step 3: Calculate Your Cash on Cash Return From Sale

Next, you need to calculate your distributable cash from the sale.

You will need to first model a proposed exit strategy to calculate the projected sale price. To do this, you will use the 5 year pro forma you created above for net operating income at the time of sale. Then you will apply the “IRV” formula, where R equals the capitalization rate; I equals net operating income, and V equals the estimated sale price. In this case, we are solving for V, so the formula is $V = I/R$. In plain English, the estimated sale price equals net operating income divided by the capitalization rate.

Again, make sure you note the assumptions you made to arrive at these numbers. Because you can't predict the future, a safe assumption is that you will sell the property at the same capitalization rate as when you purchased it or higher.

Next, you need to determine the distributable cash generated from the sale. Using the value (V) that you calculated above, you will then deduct:

- Anticipated costs of sale and outstanding liabilities,
- The remaining loan balance*;
- The amount owed to investors for their unreturned capital contributions.
- The remainder is the distributable cash that can be paid to members from the sale.

*Regarding repayment of the original loan, if you have made interest-only payments up to the time of sale; the loan balance due on sale will be

the same as the original loan balance. If you have made some principal payments during the period of ownership, you may owe a slightly lesser amount. A loan amortization schedule, available on the internet, can help you figure out the remaining balance.

Step 4: Calculate Your Annualized Cash on Cash Returns

Now, you simply add up all of the distributable cash paid to anyone (investors and management) over the life of the deal, including both distributions from cash flow and capital transactions. The combined total, is the “overall cash on cash return” for the property.

Next, you divide that amount by the number of years you have held the property to get your annualized cash on cash return. This is a dollar amount.

In the example above, if you hit your 20% cash on cash return target, you should have achieved an overall cash on cash return of \$1.5M, resulting in a \$300k/year annualized cash distribution.

Now, divide the annualized cash return (\$300k) by the total cash invested (\$1.5M) and convert it to a percentage. That’s the “annualized return on investment” that the property will generate. Back to our targets – we are looking for properties where the overall cash on cash return is 20% or more. If the property you just analyzed doesn’t come close, it may not be viable for syndication. Get over it and move on.

Step 5: Calculate Your Split With Investors

Next, you determine your split by dividing the target return you want to offer investors by the total annualized cash on cash return for the property. If you projected an overall annualized cash on cash return of 20% and you want investors to get a 15% annualized cash on cash return, you will use the following equation:

$$\frac{15\% \text{ target return}}{20\% \text{ overall annualized return}} = 75 \text{ percent}$$

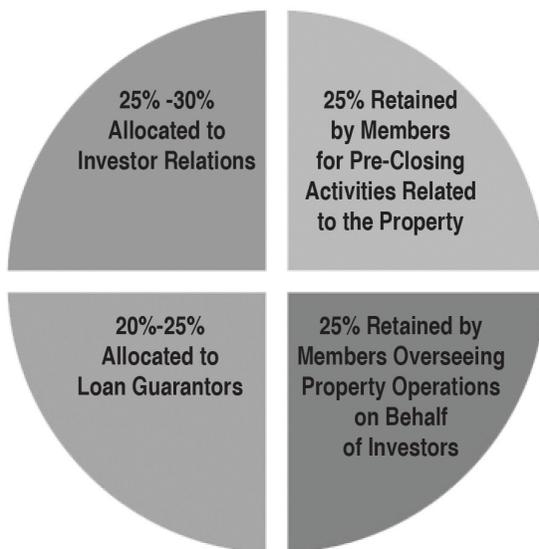
In this example, if you want investors to get a 15% annualized return, you will have to give them 75% of the deal. In other words, the profit split between investors (Class A) and management (Class B) would be 75/25. This is the equivalent of giving investors \$225k/year and \$75k/year to be split among the members of the asset manager.

This is one of the reasons I say, “Don’t have more than 5 people in the asset management entity of a syndicate or fund”. While 25% of a property’s annual earnings may seem like a lot of money, \$75k/year carved up 5 ways might be as little as \$15k per person per year. Don’t quit your day job just yet; you’ll need a few more deals.

How to Split Management Earnings

Below is a model for carving up management of a syndicate or fund with respect to allocation of both manager’s fees and Class B (profit) distributions.

How to Split Management Earnings



The ownership interest a member has in a fund or syndicate management entity is likely going to be the same as the member's percentage of Class B (management) interests. However, it is possible to allocate a disproportionate share of certain manager's fees according to who is actually performing specific tasks. This is common for such things as asset management fees, loan guarantor fees, etc.

Additionally, it is possible for the asset manager to share some of their Class B interests with others who provide services to the syndicate, but won't participate in management decisions or guaranteeing loans. In this

case, the asset manager could grant someone interests as a Class B member without making them a member of the asset management entity.

The manager could also allocate some of the Class B interests as additional compensation to an investor or private equity fund who invests a large amount or who helps guarantee a loan. This can be contractually agreed to in what is known as a “side letter.” But, be aware that the SEC is currently looking askance at side letters and making rumblings that they would like to prohibit them in private offerings.

In general, we see a lot of asset management percentage interests carved up like this:

1. 25% is retained by the members for pre-closing activities related to the property, such as:
 - a. Those who found the property (5% or less is typically allocated to bird dogs),
 - b. Those who are conducting the due diligence,
 - c. Those who are coordinating the loan,
 - d. Those who are organizing the corporate structure,
 - e. Those who are working with the securities attorney to draft the offering materials for the syndicate or fund, and
 - f. Those who are working with the real estate attorney on purchase agreements, title, escrow, property management and other property-related contracts, and loan documents.
2. 25% is retained by the members who will be overseeing property operations on behalf of investors. This group meets with property

managers and contractors on a regular basis, may make frequent visits to the property, and oversees bookkeeping and accounting, and tax filings. They're in it for the long haul and need adequate compensation to keep them engaged for the entire duration of ownership.

3. 20-25% is allocated to loan guarantors; even non-recourse loans require that you provide members of the asset management entity with collective net worth equal to or greater than the loan amount before they will approve the loan.
4. 25-30% is allocated to investor relations. This includes people who raise the money but also includes maintaining an investor management platform, communicating with investors, providing status updates, coordinating meetings, etc. Technically, everyone in this category may not be compensated based on the amount they raise. They must be compensated for the role they have in management other than raising money. All capital raisers must also have another role that determines their compensation, unless they are a licensed securities broker-dealer – see Chapter 26.

Chapter 22 – Cash Distributions & Waterfalls

Member distributions will be clearly spelled out in the offering documents prepared by your corporate securities attorney. Management will evaluate, usually quarterly during property operations, whether there is distributable cash to disburse to the members.

Each phase of operation of the syndicate (cash flow, refinance, or sale) could have a separate distribution schedule, called a “distribution waterfall.” The waterfall describes the order in which cash is distributed during each phase, until all of it has all been disbursed.

Simple waterfalls sell; complicated waterfalls don’t. I’ve seen documents with 10-12 steps in the distribution waterfall, that no-one could understand. When investors don’t understand, they simply don’t invest.

Pari Passu V. Pro Rata Distributions

Your company will typically make distributions to cash-paying investors pro rata or pari passu. Pro rata distributions mean they are allocated in accordance with each investor’s percentage interests. Pari passu generally means distributions will be made in order of priority.

As an example, certain classes may receive distributions first (pari passu), but the distributions will be further allocated amongst those class members according to their percentage interests in that class (pro rata).

Making Cash Distributions

Distributions From Cash Flow

Option 1: During the period of ownership of a property, a typical syndicate may offer investors a straight split of distributable cash between the investors and the asset manager, usually on a *pari passu* basis (by class), and then *pro rata* (within each class).

Option 2: An alternative structure (and perhaps more common) is to offer a cumulative “preferred return” (typically 6% to 8%) to investors from cash flow. Preferred returns are calculated against the amount of the investor’s capital contributions, with any remaining distributable cash split between the management class and investors.

Option 3: The real question is whether the management class should take a catchup distribution. We’ll explore all 3 of these options in this chapter.

Distributions From a Capital Transaction

When a capital transaction occurs, such as a refinance or sale, cash proceeds will be distributed in an order designed to pay back member capital contributions first, and then to make up arrearages in preferred returns, and finally splitting remaining cash between investors and management.

Example Distribution Waterfalls

In each scenario below, we’ll do an “Analysis” that shows how this would look in numbers, using the following assumptions:

In each Waterfall scenario below, the table shows how this would look in numbers, using the following assumptions:

- Class A contributed \$10M
- The property generated \$1M/year from cash flow (\$5M total)
- The property generated \$5M of additional distributable cash on sale (after paying all closing expenses, loans, and returning capital to investors).
- Adding this all together, the property generated a total return of \$10M over 5 years; equaling an annualized cash on cash return of \$2M/year
- A \$2M annualized return /\$10M total capital contributions = a 20% overall annualized cash on cash return.
- The descriptions below show a 70/30 split. If the returns aren't sufficient to entice investors (the target is mid to high teens); try changing the split and adjusting the numbers to a 75/25 split.

Table Illustrating the Waterfall Models Described Below

If you don't want to wade through the text explanations below, you can access a table comparing the three waterfall models described in this chapter. The table illustrates how each model affects distributable cash for investors and the asset management team. To get your copy, please go to:

<https://RaiseCapitalForRealEstate.com/BookBonus>.

Straight Split Scenario

The waterfall below reflects a 70/30 split in a two-class company, otherwise known as a straight split.

Distributions From Operations (Cash Flow)

Cash derived from operations of the property (cash flow), will be disbursed in the following order until exhausted:

- Distributable cash will be split between all of the members, with 70% paid to Class A and 30% paid to Class B members.

Analysis

In the straight split scenario, from cash flow:

1. Class A would receive 70% of \$1M, or \$700k/year from cash flow;
and
2. Class B would receive 30%, or \$300k/year.

Distributions From Capital Transactions

On refinance or disposition of the property, or dissolution of the company (after payment of expenses and liabilities), cash will be disbursed in the following order until exhausted:

- First, the Class A members will receive all of the distributable cash as a return of capital until they have received a refund of 100% of their unreturned capital contributions;

Second, any remaining distributable cash will be split 70/30 between all of the members, with 70% paid to Class A and 30% paid to Class B members.

Analysis

In the straight split scenario, on sale:

1. Class A would receive 70% of \$5M, or \$3.5M, and
2. Class B would receive 30% of \$5M, or \$1.5M.

What was Class A's cash on cash return? Class A received distributions of \$700k/year for 5 years (\$3.5M) plus \$3.5M from sale for a total of \$7M. Thus, Class A earned an overall return of 70%; when divided by the 5 year hold period, this equals a 14% annualized return on investment.

What was Class B's total return in numbers? Class B received \$300k/year for 5 years (\$1.5M), plus \$1.5M on sale, equaling total distributions of \$3M. Divided over 5 years, that was an annualized distribution of \$600k.

Preferred Return With a 70/30 Split

The waterfall below reflects a 70/30 split, after payment of an 8% preferred return to Class A.

Distributions From Operations (Cash Flow)

Cash derived from operations of the property (cash flow), will be disbursed in the following order until exhausted:

- First, Class A members will be paid all of the distributable cash until they have received a non-compounded, cumulative annualized return of 8% (the preferred return), determined quarterly and calculated against the Class A unreturned capital contributions.

- Second, any remaining distributable cash will be split 70/30 between the members, with 70% paid to Class A and 30% paid to Class B members.

Analysis

In the preferred return scenario, from cash flow:

1. Class A would receive an annual return of \$800,000 (\$200,000/quarter); plus
2. Class A would also receive 70% of the remaining \$200,000, or \$140,000 (for a total of \$940,000/year); and
3. Class B would receive 30% of the remaining \$200,000, or \$60,000/year.

Any arrearages (deficiencies) in Class A preferred returns will be deferred and made up from future cash flow or proceeds from a capital transaction, at the asset manager's option. There is no catchup for Class B, so whatever they get in any given year is all they ever get.

Distributions From Capital Transactions

On refinance or disposition of the property, or dissolution of the company (after payment of expenses and liabilities), cash will be disbursed in the following order until exhausted:

- First, to repay the unreturned capital contributions of Class A members; then
- To make up arrearages in Class A preferred returns; then

- Any remaining cash will be split 70/30 between Class A and Class B.

Analysis

In the preferred return scenario, on sale,

1. Class A would receive 70% of \$5M, or \$3.5M, and
2. Class B would receive 30% of \$5M, or \$1.5M.

What was Class A's cash on cash return? Class A received distributions of \$700k/year for 5 years (\$3.5M) plus \$3.5M from sale for a total of \$7M. Thus, Class A earned an overall return of 70% ($\$7M \div \$10M = 0.7$; $0.7 \times 100 = 70\%$), or an annualized return of 14%.

What was Class B's total return in numbers? Class B received \$60k/year for 5 years for a total of \$300k, plus \$1.5M on sale, equaling total distributions of \$1.8M. Divided over 5 years, that was an annualized distribution of \$360k.

Any arrearages (deficiencies) in Class A preferred returns will be deferred and made up from future cash flow or proceeds from a capital transaction, at the asset manager's option. There is no catchup for Class B, so whatever Class B gets in any given year is all it ever gets.

We have clients who have used the Preferred Return Model above, and have since said they would never do it again because they did all the work and the investors got all the money. This can happen when there isn't sufficient cash flow for Class B to get a return during operations, and the projected sales price isn't realized, leaving only enough to pay back capital contributions of Class A, make up arrearages in their preferred returns, and

then Class B gets a meager 30% of whatever is left, if anything. The model below, with a Class B catchup, is the preferred model, for this reason.

Preferred Return With a 70/30 Split and a Class B Catchup

Below is a description of how the asset manager can preserve its rights to distributions from operations using a “Class B catchup” as an alternative to the straight split or preferred return scenario described above. This is the option that we recommend our clients use.

Distributions From Operations (Cash Flow)

Cash derived from operations of the property (cash flow), will be disbursed in the following order until exhausted:

- Distributable cash generated from property operations will generally be split 70/30 between Class A and Class B members, respectively, but it will be distributed in such a manner that the Class A members will be paid all of the distributable cash until they have received a non-compounded, cumulative annualized return of 8% (the preferred return), determined quarterly and calculated against the Class A unreturned capital contributions; then
- Class B will receive an annual, non-compounding, cumulative catchup distribution of 3.43% (the Class B catchup distribution), determined quarterly, calculated against the unreturned capital contributions of the Class A members; note that this is equivalent to a 70/30 split between Class A and Class B, as illustrated below:

$$70/30 = 8/x; 70x = 240; x = 3.43$$

- Any remaining distributable cash from company operations will be split 70/30, with 70% paid to Class A and 30% paid to Class B.

Analysis

In the preferred return with Class B catchup scenario, from cash flow:

1. Class A would receive an annual return of \$800,000 (\$200,000/quarter); plus
2. Class B would be entitled to \$343k, but since there isn't enough to pay it, Class B would receive the remaining \$200,000, with a deficiency of \$143,000.

Any arrearages (deficiencies) in either Class A preferred returns or Class B catchup distributions (meaning that either class didn't receive the annual return they were entitled to for the year) will be deferred and made up from future cash flow or a capital transaction, at the asset manager's option. Class B would be entitled to a look-back on a capital transaction, and could make up the \$143,000 deficiency from Year 1, plus any subsequent deficiencies from later years.

Distributions From Capital Transactions

On refinance or disposition of the property, or dissolution of the company (after payment of expenses and liabilities), cash will be disbursed in the following order until exhausted:

- First, to repay the unreturned capital contributions of Class A members; then
- To make up arrearages in Class A preferred returns; then

- To make up arrearages in Class B catchup distributions; then
- Any remaining cash will be split 70/30 between Class A and Class B.

Analysis

In the preferred return with Class B catchup scenario, on sale,

1. As there are no deficiencies in our example, with respect to Class A preferred returns, as soon as Class A's unreturned capital contributions were re-paid, the next step in the waterfall would be to make up deficiencies in Class B's catchup distributions. In this case, Class B would get \$143,000 as a catchup for every year it was deficient. Assuming it was deficient every year for 5 years, Class B would be entitled to a catchup distribution of \$143k/year ($\$143k \times 5 \text{ years} = \$715k$).
2. The remaining distributable cash would be split 70/30 between Class A and Class B. $\$5M$ minus $\$715k$ (arrearages paid to Class B) = $\$4,285,000$. Class A would receive $\$2,999,500$ (70%); and Class B would receive $\$1,285,500$ (30%).

What was Class A's cash on cash return? Class A received distributions of $\$800k/\text{year}$ for 5 years ($\$4M$) plus $\$2,999,500$ from sale for a total of $\$6,999,500$. Thus, Class A earned an overall return of 69.99% ($\$6,999,500 \div \$10M = 0.699$; $0.699 \times 100 = 69.99\%$). Class A's annualized return was $69.00\% \div 5 \text{ years} = 13.99\%$.

What was Class B's total return in numbers? Class B received $\$343k/\text{year}$ for 5 years for a total of $\$1,715,000$ plus $\$1,285,500$ on sale,

equaling total distributions of \$3M. Divided over 5 years, that was an annualized distribution of \$600k.

Final Word on Class B Catchups

As you can see, without the Class B catchup, you run the risk of paying all of the cash flow to investors both from property operations and from a capital transaction, leaving little (or none) to distribute to your asset management team. Further, you may even be creating a disconnect between your interests and those of your investors. For instance, if your investors are receiving cash flow from property operations but you aren't, they may want to keep the property long-term. However, because you aren't making any money for all of the work you are doing, the asset management team may have incentive to sell the property so you can get paid from your share of the equity realized on sale. Or alternatively, you may have to keep chasing acquisition fees from other deals to support your own financial needs, turning your attention away from this property to the detriment of your investors.

The best way to make sure that you and your investors' interests are aligned is to create a waterfall scenario where both you, as the asset manager, and your investors make money from all phases of property ownership.

I trust this explanation will help you understand the importance of this concept. I realize that not all deals will support this structure, but it should always be considered when underwriting your deals.

The scenario I painted above was probably rosier than what you will find in real life. You are much more likely to find deals that don't have 8% returns in the first 2-3 years, leaving deficiencies in Class A returns that must be made up on sale; and further diminishing the amounts available for distribution to Class B. This typically results in no distributions to Class B for the first 2-3 years, and if you don't have a Class B catchup, you will never be able to make up Class B distributions for those years.

Consider these models when you are doing your underwriting, and, if the property can support it, include the Class B catchups to protect yourselves and the members of the asset management entity. The asset manager can always elect to forego any management fee or any distribution to which Class B is entitled, if you wish to achieve your projected returns for Class A. It's better to give yourself the ability to collect the Class B catchup if you have sufficient funds, than to give away all of the proceeds to Class A and be sorry you didn't protect yourself. Most of our clients only make this mistake one time.

Variations to Consider

Change the Split to Match the Target Returns for Investors

The returns shown in the example waterfalls above (and in the bonus table) are based on a 70/30 split. The target for investors is an annualized return in the mid to high teens. If the returns based on a 70/30 split aren't sufficient to entice investors; try changing the split and adjusting the numbers to something like a 75/25 split.

Offer Lower Preferred Returns Until Stabilization

I once asked a representative from a large multi-family syndication company that has billions in assets under management whether they do 8% preferred returns, and their response was; “We don’t offer 8% returns in the first 2-3 years, during the stabilization process. During that time, we offer 5 or 6% returns, and then go to 8% after stabilization and refinance.” Something for you to consider. That way you don’t have to go back and make up arrearages.

Limit Preferred Returns to the First 1-2 Years

Another option is to consider a preferred return that only lasts for 1 or 2 years; after which it goes to a straight split.

Place Caps on Investor Returns

Another common option is to cap investor returns such that once all of Class A’s capital contributions have been repaid and they have received an annualized return of a pre-determined percentage, such as 18%, the split changes to 50/50 or even flips, so that from then on, it’s 30/70.

A Word on Buying Out Investors on Refinance

Investors don’t like this. Clients have tried this in the past, and come back to tell us, investors hated it and wouldn’t invest with them again. It’s better to cap investor returns, change the split and leave them in the deal, than it is to cash them out on refinance, while you get the windfall of owning the property that your syndicate or fund bought with their money.

Partial Payback of Investors on Refinance

When you do a cash-out refinance, you should always use the proceeds to return investor capital contributions. The very nature of a refinance results in higher leverage on the property, and if prices drop (due to interest rate increases, oversupply, lack of financing, etc.), you could be left short when it comes to paying back investor capital contributions on sale. Additionally, if there is a preferred return for investors, from that point forward, you only owe it on their “unreturned capital contributions”.

For example, it’s common for a syndicate or fund to pay back 50% of investor capital from a property refinance. From that point forward, you would only owe investors a preferred return on the 50% of their original capital contributions that remains invested, leaving more cash available to split between Class A and Class B; that is, more for the asset manager.

Forever-Hold Models

In the typical waterfall models described above, you would typically count all cash flow returns as a return on investment, and returns from capital transactions are usually always classified as a return of capital.

If you want to have a forever hold model, then you may need to classify all cash flow distributions as a return of capital until all capital contributions are repaid, after which any further returns are classified as a return on investment. The nice thing about this model for investors is that they don’t get taxed on returned capital, but they also don’t get their capital contributions back in chunks that they can then re-invest. The best way to

find out if your investors will like this model is to ask them if this model would work for them.

Distribution Models That Are Dangerous for Asset Managers

I have reviewed many offering documents drafted by other attorneys, and I commonly see several scenarios that I believe are dangerous for asset managers:

1. The first is to pay arrearages in preferred returns before returning capital contributions. I always tell my clients, remove your liabilities first. You won't get sued for not making your preferred returns, but you will get sued if you don't return capital. Pay back capital contributions first, and then make up arrearages in preferred returns.
2. The second is a model that some crowdfunding platforms and broker dealers tend to favor. This scenario requires that you pay back all of the investors' capital contributions plus their preferred returns before the asset manager can collect any distributions at all. This means you could be operating a property for 5 or more years and trying to live off asset management fees, with no distributions to the management class until sale. In my opinion, this mis-aligns your interests with investors. You can't wait to sell the property so that you can earn distributions from the sale, but investors are happily enjoying their cash flow returns, all while the asset management team starves. You may eventually have to turn your attention to paying deals or get a job to survive, leaving their investment to suffer. Any waterfall that doesn't

pay the asset manager along the way, or at least within a couple of years (and more than just asset management fees), is a recipe for a languishing investment. Investors shouldn't want this, and you shouldn't offer it. It's your job to educate them as to why it's in their best interests for you to earn distributions during ownership – and not just on sale.

3. A third model that often fails is trying to tailor your returns to individual investors – this is a rookie mistake; just don't do it. These are take-it-or-leave-it offerings. You've done the due diligence and the analysis; you know what will work for the long-term and for all investors, don't let a few bullish investors try to influence you or make you carve out special deals for them – unless they are bringing in a significant amount of money that you can't raise any other way; or if they want to provide an additional service, such as co-guaranteeing a loan, or introducing you to all of their wealthy friends.
4. A fourth model I have seen gives asset managers carte blanche abilities to unilaterally change the terms of an offering, and power of attorney over every investor to force them to go along. This is a dangerous position for investors, because there is nothing to stop a bad asset manager from completely changing the terms of the deal to which investors originally agreed. Investors should beware of offerings that have such provisions, and you shouldn't give yourself that much power. This too is a recipe for disaster as you may eventually succumb to the temptation to write yourself a bigger part of the deal, to the detriment of your investors, and your reputation.

Key Takeaways

For a table comparing the three waterfall models described in this chapter, that illustrates how each model affects distributable cash for investors and the asset management team, please go to:

<https://RaiseCapitalForRealEstate.com/BonusMaterials>

Figure out your split by determining overall cash on cash returns for a property. Once you know the overall projected return, you can decide how much you have to give investors and how much you need to keep for yourself. Try a couple of different splits until you land on one that gives your investors a return in the mid to high teens, without starving the management team during ownership of the property.

Keep a list of all of your assumptions, as you'll need to list them in your property package or investment summary. We can write disclaimers into the offering documents that all of your assumptions could be wrong, but if you use reasonable, conservative assumptions, you should end up close unless something outside of your control goes wrong (such as a pandemic, interest rate hikes, etc.). Just make your best estimates, use the right disclaimers, and forge ahead.

Chapter 23 – How to Name the Entities in Your Syndicate or Fund

If you are planning to syndicate multiple properties, you should pick a naming convention for all of the entities related to all of your syndicates or funds and stick to it. You may have as many as five entities in a syndicate or fund, but most commonly, you will only have two or three.

If you can figure out which one is which without having to resort to an organization chart, it will greatly simplify your life. A well-thought-out naming convention will prevent you from having to have a “key” on the wall in front of you to figure out which entity belongs to which property, and its role with respect to a property.

Naming Your Syndicate or Fund Entities

A syndicate or fund entity (that sells interests to investors) should include one of the following words in its name: Investors, Investments, or Partners. This way, you will always know this is the investment level entity, and more importantly for securities compliance purposes, this is the issuer of your securities.

The asset management entity should have one of the following words in its title: Manager, Asset Manager, Management, Mgr. or Mgt, or Fund Manager. This way, you will always know this is the manager of your syndicate or fund, and more importantly for securities compliance purposes, this is the asset manager of the issuer of your securities. If you are using a limited partnership, you could use “GP” or “General Partner” in the entity

name. The point is to use a word in the name that makes it obvious that this is the asset manager of your syndicate or fund.

You may need a separate title holding entity (SPV or single purpose venture). This will be required for multi-property offerings, funds, development projects, or if the loan balance is greater than \$10 million and you are getting “agency” debt, such as Fannie Mae- or Freddie Mac-based financing, or if you plan to do so in the future. If you need a title holding entity, it will be helpful if you use one of the following words in its name: Holdings (most common), or SPV. Other choices might include Hldgs, Owner, or Property Owner. Choose a word that makes it obvious that this is the title holding entity.

If you will create a joint venture with a private equity fund partner alongside your syndication a separate joint venture entity, you may want to use “JV” or “Joint Venture” or you could reserve the word “partners” for this entity and “investors” or “investments” for the investor-level entity; just choose a word in the name that makes it obvious that this is the joint venture entity.

The word or words that precede the suffix words suggested above should be related to either the name of the property, its street address, or your brand. The maximum number of words you should use in an entity name should be four. If you can’t use a name because it’s already in use by someone else, you can add some numbers (such as the numbers of a street address) or initials (such as a word from your brand or some initials related to the property), ahead of the name.

Naming Your Branded Entity

Many of our clients create a branded entity that they can use to generate a website, create business cards and other marketing materials. They often also use this entity to represent them in the asset management entity of a syndicate or fund, and to hold title to their Class B interests. Some even create a separate entity to represent them in management and a separate “asset protection entity” to hold their Class B interests.

How to name your branded entity is always a really good question. We’ve had some clients make some mis-steps when it comes to this; where they have had to re-brand after making a significant investment, so the point of this section is to help you avoid that.

Here are some guidelines:

- Start with a domain search. If the .com domain is available, good. But don’t buy it just yet.
- Next do an internet search to see if someone else is already using a name or domain that is confusingly similar to yours. I had a client that wanted to use a name and then found out that a \$5B hedge fund was using something very similar. My advice – don’t get in a fight with a giant hedge fund – find something else. If someone is using a very similar name, or if you find multiple companies using similar words in the real estate industry, find something else. The point is you don’t want your brand confused with someone else’s – you don’t want your investors calling them, or their investors calling you. Just adding a “the” in front of the name, or some different suffix at the end, like

“LLC,” is not going to be sufficient. If you do encroach on someone’s brand, they are likely to send you a cease and desist letter. If they’re already established and you’re not, they win. Just avoid the fight.

- Then check with the secretary of state where you plan to form your company to see if the name is available. The secretary of state generally won’t let you form a company if the first two words are the same as an existing company.
- If the internet search is clear, grab the domain. I also buy domains to keep people from encroaching on my space, I don’t worry so much about the .net, .co and other suffix domains, but if someone else could use my domain just by making a word plural or using a different tense, I buy that domain too. You can point other domains you own to yours. I usually buy domains for just 1 year to start (but set up auto-renew). If I’m not still using it in year, I can decide then whether to keep it.
- The name should be easy to pronounce and easy to spell. Avoid complicated Latin terms.
- The best brands use words that mean something to you, so if someone asks why you chose that name you have a good story behind it – one that you shouldn’t be embarrassed to tell.

Chapter 24 – Where to Form Your Entities

Where to Form the Entity That Represents Your Brand

Where to form your branded entities is always a valid question. Here are some considerations:

Single-Member of Spousal LLCs

If you need to form a single-member limited liability company, or one for you and your spouse, Wyoming may be your best choice, although the state where you live may also be an acceptable choice.

Here's why Wyoming may be preferable:

1. A charging order is the sole remedy that a creditor has against a Wyoming limited liability company. This means a creditor can attach the distributions of the limited liability company, but they can't force it to make distributions, liquidate or sell assets, nor can they remove you or insert themselves into the structure of your limited liability company.
2. Wyoming allows anonymity. They don't require disclosure of the names of the manager or members of the limited liability company. If we file your limited liability company, the name of the organizer (us) is the only name that appears in the public record connected with your limited liability company.

3. Wyoming has no personal income tax or business taxes that apply to members of a Wyoming limited liability company.
4. You can use your out-of-state business address with a Wyoming LLC, although you do have to appoint and maintain a “registered agent” in Wyoming and pay its annual dues for the life of your Wyoming LLC. We have an agreement with a registered agent that has nationwide offices, and who can provide this service for our clients for <\$100 annual fee. If you don’t have a business address, there are registered agents in Wyoming that can also provide you with a business address and mail forwarding for an additional annual fee. If you fail to pay the registered agent’s annual fee, they will notify the state that they are no longer your registered agent, and unless you (or a new registered agent) have filed paperwork with the state appointing a new registered agent, your entity could be suspended or dissolved by the state.
5. You do have to pay an annual registration fee to the State of Wyoming until you dissolve your Wyoming LLC. If you fail to pay this fee, your entity could be suspended or dissolved by the state.
6. Wyoming LLCs can be formed nearly instantaneously online.
7. But here’s the real reason: unlike all of the other states, Wyoming offers the same protection to single-member limited liability companies that other states offer only to multi-member limited liability companies. To my knowledge, it’s the only state that has a statute that does this. More about this below:

Wyoming Single-Member LLC Protections

Wyoming Statutes, Title 17, Chapter 29, Articles 1-11; Section 17-29-304(D), says: “In any analysis [relating to personal liability under Section 17-29-304], a court shall not consider factors intrinsic to the character and operation of a limited liability company, whether a single or multiple member limited liability company.”

Factors that this Wyoming statute considers intrinsic to the character and operation of a limited liability company include, but are not limited to:

1. The ability to elect treatment as a disregarded or pass-through entity for tax purposes;
2. Flexible operation or organization including the failure to observe any particular formality relating to the exercise of the company’s powers or management of its activities;
3. The exercise of ownership, influence and governance by a member or manager;
4. The protection of members’ and managers’ personal assets from the obligations and acts of the limited liability company.

However, per Section 17-29- 304(c), the sole member of a single-member limited liability company can be held personally liable if they commit fraud, or for any combination of the following:

- Inadequate capitalization of the company,
 - Failure to observe certain company formalities where required by law;
- or

- Commingling of company and personal finances with personal assets.

Thus, if you are considering forming a single-member limited liability company to participate as your “branded entity” in a syndicate or fund, whether you want it to participate in management of one or more syndicates or funds or to hold your profit interests, Wyoming clearly offers advantages that other states don’t.

Multi-Member Branded LLCs

Multi-member limited liability companies, where you and some team members from the same state are working together to find and syndicate properties, can be formed in the state where all of the members live. However, if some of the members live in other states, you may again, wish to form this entity in Wyoming.

Where to Form Entities for Your Securities Offerings

Syndicate LLCs — For Specified Offerings

Syndicates that acquire specific properties are usually formed in the state where the property is located. If you form them in another state, you will also have to register them in the property state, so that they can legally conduct business there (contracting services, banking, etc.).

Fund LLCs — For Blind Pool Funds

Funds are most often formed in Delaware, as it has a Court of Chancery that only hears business disputes. The benefit of this is that the judges should

be well-versed in Delaware's LP and limited liability company Acts. Additionally, your dispute won't get put on the docket alongside other civil and criminal matters that could cause it to take much longer to litigate. Finally, the limited liability company and limited partnership Acts in the state of Delaware generally favor business owners over individual investor rights, which can often stop a syndicate or fund dead in its tracks.

Title-Holding LLCs — For Loan Balances Over \$10M

If your loan balance will be over \$10M, any agency (government backed) debt, such as Fannie Mae and Freddie Mac loans, will require that the title holding entity (SPV) be formed in Delaware, because their loan documents are drafted in conformance with Delaware law. They will additionally require that you obtain an opinion of Delaware-licensed counsel that the entity is validly and duly formed in Delaware; that the members have the authority and right to enter into the loan agreement; and that the loan documents are enforceable in the state of Delaware. This Delaware opinion will generally cost \$3,500-\$5,000.

Once the title-holding entity is formed in Delaware, you will also need to register it as a foreign entity in the state where the property is located so that it can legally conduct business there. You will need to maintain a registered agent and pay annual dues to both states for the duration of property ownership.

Title-Holding LLCs—For Development Projects or Multi-Property Offerings

Title-holding entities for development projects and multi-property syndicates or funds will generally be formed in the state where the property is located (assuming the loan balance is less than \$10M). If the loan balance is >\$10M, they should be formed in Delaware and registered as a foreign entity in the state where the property is located.

SECTION 5 — HOW TO LEGALLY SOLICIT INVESTORS

Chapter 25 – Soliciting Investors for a Rule 506(b) Offering

What is Considered ‘General Solicitation’ or ‘Advertising’?

Rule 506(b), as you recall from Chapter 8, contains an absolute prohibition on general solicitation or advertising, both of which are broadly defined. The prohibition precludes general announcements regarding an offering using the Regulation D, Rule 506(b) exemption in any group setting where the asset manager has not already established a substantive pre-existing relationship with each person receiving the solicitation or announcement.

Examples of improper solicitation include providing details about a specific offering or property such as:

- Announcements in front of a real estate investment club or during a teleconference with multiple participants;
- Posts on an electronic or physical bulletin board, social media forum, blog, search-engine optimized website, or other electronic forum;
- Mailings to lists of accredited investors obtained from list brokers;
- Email blasts that include recipients whom you have not specifically pre-vetted;
- Seminars whose sole function is to talk about a specific offering or past deals by a syndicator or fund manager.

When trying to decide if your proposed activity complies with the rules, it might be helpful to ask yourself, “What would a regulator or a jury think?” as they may be the people you have to convince if you do it wrong. A decision regarding whether you have violated securities laws will likely hinge on a preponderance of evidence as to whether you have made effective, consistent and documented attempts to comply with the rules of the claimed exemption.

What is a ‘Substantive, Pre-Existing Relationship’?

The way to prove that you didn’t engage in general solicitation or advertising is to demonstrate that you have a pre-existing substantive relationship with every prospective investor to whom you made an offer to invest, regardless of whether they were accredited or unaccredited, or whether they invested or not.

Citizen VC No-Action Letter

I mentioned before that the SEC issues interpretive letters in response to questions from issuers in the form of “no-action letters.” These no-action letters provide guidance to the securities legal community and issuers as to whether a specific proposed program would be in compliance with applicable securities laws. The end result is that issuers use the no-action letters to model their own policies.

In response to a no-action letter requested by Citizen VC, Inc. in August 2015, the SEC confirmed its position regarding pre-existing, substantive

relationships, in the wake of the JOBS Act, for a Rule 506(b) exempt offering as follows:

1. There must be a pre-existing relationship between the issuer and investor that is not built solely through a specific duration of time or a short-form accreditation questionnaire;
2. Rather, it can be established by adhering to specific policies and procedures both online and offline (where appropriate), which enable the issuer to evaluate the prospective investor's financial sophistication, circumstances, suitability, and their ability to understand the nature and risks of the interests to be offered (i.e., a "suitability conversation"); and that the issuer actually followed this process to make such an evaluation;
3. The relationship must pre-date the offer, and
4. The issuer must have a recordkeeping system to prove that "investor suitability" was determined between the date on which the asset manager first met the investor and when the offer of securities was made.

Note that the SEC makes no distinction between whether the investors are accredited or unaccredited in its response. As long as the issuer is relying on Rule 506(b), the rules are the same for both.

How to Determine Investor Suitability

An asset manager has the obligation to determine whether an investor is suitable for the offering; specifically, if the investment opportunity being offered matches the investor's investment goals, and

1. Whether the investor is accredited or non-accredited, but sophisticated, and
2. Whether the investor can afford to lose the money.

If the answer to (1) is "No," the investor is not qualified to invest in the offering, and if the answer to (2) is "No," the asset manager should not allow that investor to subscribe to its offering.

Every issuer should have a written procedure for pre-qualifying investors to which it strictly adheres with every prospective investor and further, the issuer must have a record-keeping system to document compliance for every investor who subsequently participates in a Rule 506(b) offering.

Example Questions to Determine Suitability

The following list includes example questions you may want to ask prospective investors to determine whether they meet the investor suitability requirements for a Rule 506(b) offering:

- What is your current net worth, excluding equity in your primary residence?
- Has your last two years' income exceeded \$200,000/year if single or \$300,000/year if married or co-habiting?

- Do you expect your current income to continue indefinitely into the future?
- What types of investments do you currently have?
- What is the estimated value of your other investments?
- What kind of returns are you getting from your other investments?
- What experience do you have in private placements?
- What are your investment objectives (returns, etc.)?
- What is your investment time horizon (how long would you be willing to stay in a deal)?
- Would it cause a hardship if you weren't able to withdraw your cash for 5-7 years while we are holding a property?
- How would you rate your risk tolerance?
- If you were to invest \$50,000 in a property and something went wrong, could you withstand a total loss of your investment?

How to Maintain the Relationship

Once the relationship is established, best practice is to further cement the relationship with additional contacts, such as webinars, a drip system, further conversations, or education, before you start making offers. After all, if you have a suitability conversation with someone this month, but don't have a deal to offer for 6 months, are they even going to remember you?

Maybe not, unless you have established a system for ongoing communication.

What If You Don't Know Enough Suitable Investors and Have a Deal Now?

Look for a co-management team member who has experience and pre-established, substantive relationships with investors and invite that person or entity to become a member of your asset management entity in exchange for a portion of the management earnings (fees and profits).

Chapter 26 – How to Legally Compensate Capital Raisers or Finders

Since passage of the National Securities Markets Improvement Act of 1996 (NSMIA), in a Regulation D, Rule 506 securities offering, the issuer may sell its own securities in any state without: a) registering the securities offering, or b) being registered with the SEC or state as a broker or dealer.

Under the Securities Exchange Act of 1934, Section 3(a)(4)(A), a “broker” is broadly defined as “any person engaged in the business of effecting transactions in securities for the account of others.” Third parties or even internal officers, directors, or employees who sell securities for a fee based on the amount they have sold generally fall within this definition. Thus, anyone who is paid “transaction-based compensation” for selling securities on behalf of the issuer is not exempt from registration as a securities broker or dealer.

Think of this like a real estate transaction. Most people understand that a person can sell their own real estate without a license (the proverbial “FSBO”—for sale by owner), but they cannot legally be compensated for selling someone else’s real estate unless they have a real estate broker or sales agent license. The issuer exemption for securities offerings operates in much the same way.

You can sell your own securities without a license, as long as you follow the rules for an exemption, but you can’t be paid “transaction-based

compensation” for selling securities for someone else’s offering (or even your own) without a securities broker-dealer’s license. It doesn’t matter whether you are part of the issuer (such as an officer, director, manager, general partner, member, or employee) or an external capital raiser/promoter, you cannot be paid “transaction-based compensation” based on the amount invested by people you solicited, unless you hold the proper license.

Not only is it illegal for you to receive such compensation, it’s also illegal for the issuer to compensate unlicensed securities broker-dealers. The issuer can lose its exemption and be charged with hiring unlicensed brokers to sell their securities.

Who is the Issuer?

Persons who claim the issuer exemption must have substantial responsibilities associated with management of the company other than referring investors, that forms the basis for their compensation. The Texas State Securities Board’s website contains the following illustrative explanation:

“... Since a business can act only through natural persons, such as its owners, officers or directors, the exemption from dealer registration will extend to these persons acting on behalf of the issuer, but only if they meet three important criteria:

1. The person cannot have been hired for the purpose of offering or selling the securities;

2. Any securities activities of the person must be incidental to their bona fide primary non-securities-related work duties; and
3. The person's compensation must be based entirely on that person's non-securities-related duties.

If these criteria are not met, the person offering the securities must be registered with the State Securities Board as a dealer or agent. Similarly, any person who is not an owner, director, officer, or employee of the issuer who offers or sells the issuers securities is subject to the dealer registration provisions of the Act.”

In summary, everyone in management has the responsibility to raise money and everyone has to have a job in management other than raising money, and that's what they get compensated for. No-one gets compensated solely for raising money, and no-one in management (or otherwise) gets compensated based on the amount they raise, period. Got it? Give everyone a non-securities related job and make sure they do it.

Paying Unlicensed Securities Brokers May Blow Your Exemption

States generally recognize the Regulation D, Rule 506 exemption, provided you file a Blue Sky notice within 15 days of the sale and/or offer of a security within the state (see Chapter 10 regarding Blue Sky Filings), and no compensation is paid to unregistered persons for selling the securities.

Securities broker-dealer licenses can be obtained at the federal level through FINRA (the Financial Industry Regulatory Authority), a quasi-governmental agency that regulates securities licensing in the U.S. Securities broker or dealer licenses may also be available at the state level through a state securities department, but such state's license would only be applicable to investors from that state.

Below is another example from the Texas State Securities Board, which identifies one of Texas' requirements for recognition of a Regulation D, Rule 506 exempt offering:

“No commissions, fees or other form of remuneration may be paid to any person who solicits investors in Texas under this exemption unless that person is licensed in Texas as a securities dealer or agent.”

I use Texas as an example as they have well-developed directives regarding their position on these matters that appear to be echoed by other state securities agencies. Many state securities laws contain similar provisions.

OK, But What About Finder's Fees?

Although there is a purported “finder's exception”, it is not codified in any federal law or rule. It allows introductions only, but requires disclosure of compensation at the time the solicitation is made.

The sum of SEC guidance and relevant case law with respect to finder's fees have indicated the greater the person's involvement in such things as: 1) structuring the offering, 2) soliciting investors (which may include advertising), and 3) participating in the sale transaction (taking orders or

routing them), and 4) previous involvement in the sale of securities, the more likely they are to be construed as a broker.

This unwritten rule has evolved over a series of court cases and SEC interpretive guidance and no-action letters, and charges filed against high profile individuals. Some of the relevant cases around which this unwritten rule has evolved are discussed below:

Paul Anka No-Action Letter Re Finder's Fees

The SEC has a process where it will provide an advance opinion on whether a proposed activity would violate securities laws. The process is that the proponent's counsel would submit a detailed request to the SEC, outlining the proposed activities, and ask whether they would consider such activities as a violation of securities laws, and take action against the proponent. If the SEC says they wouldn't consider it a violation, they will cite the very specific facts the proponent proposed, and issue a "no-action letter." Issuers and securities legal practitioners rely on these no-action letters to guide their clients' activities.

There is one such SEC no-action letter called the "Paul Anka No-Action Letter" from 1991 related to finder's fees that is still considered the seminal guidance on what's allowed when it comes to payment of finder's fees. In case you don't know, Paul Anka is a famous American-Canadian singer whose more popular songs include "Put Your Head On My Shoulder"

(1959)²³ and “Puppy Love” (1960)²⁴. He was asked to use reasonable efforts “to introduce potential accredited investors to The Ottawa Senators Hockey Club Limited, a Canadian limited partnership (Senators)”.

Mr. Anka was to be compensated a fee of 10% of the interests sold to the investors he introduced, and a 1% fee for all other interests sold.

Mr. Anka’s activities were to:

- Describe to the potential accredited investors the name of the issuer and the price per Unit.
- Disclosure to potential investors of his percentage ownership interest in the Senators and his right to receive a finder's fee in the event such investor purchased units.
- If an investor expresses interest, Mr. Anka would forward the investor's name, address and telephone number to the Senators.

In its no-action letter, the SEC noted:

1. Mr. Anka reasonably believed that all potential investors were accredited;

²³ To listen to Paul Anka’s 1959 recording of “Put Your Head On My Shoulder” on YouTube, use this link: <https://www.youtube.com/watch?v=kvazBqAlx58>.

²⁴ To listen to Paul Anka’s 1960 recording of “Puppy Love” on YouTube, use this link: <https://www.youtube.com/watch?v=gyshrihhv3E>.

2. Mr. Anka was not previously involved in any securities offerings,
3. He didn't handle or distribute offering materials,
4. He did not handle investor funds,
5. Nor did he provide any independent analysis of the performance of the company or securities, and
6. He didn't participate in distribution of the securities post-sale.

Thus, this is a very narrow exception, and in order for you to rely on it as a finder (or as an issuer that pays finders), you would have to meet identical conditions. This is still considered the “on-point” no action letter, when it comes to determining whether the finder's exception applies.

Rainieri Partners Cease-and-Desist Proceedings

Below is a more recent case in which a finder claimed to rely on the Paul Anka no action letter, but in fact, did not meet these exact conditions and was found to have acted as an unlicensed broker:

On March 8, 2013, The SEC issued administrative and cease-and-desist proceedings against Rainieri Partners, LLC (Rainieri), William M. Stephens, an independent consultant who raised the money, and Donald W. Phillips, one of its managers, alleging that they were acting as an unlicensed securities broker in connection with the sale of interests in a fund offered by Rainieri. The charge against Rainieri, Stephens and Phillips, included allegations that:

1. Stephens sent offering materials (including, private placement memorandums, due diligence materials and subscription documents) to potential investors;
2. Stephens suggested that investors diversify their investment portfolios to accommodate an investment in Ranieri Partners; and
3. Stephens provided an analysis of Ranieri's fund strategy and performance track record; and
4. Stephens disclosed confidential identities and capital commitments of other members.

In exchange for his efforts, Stephens earned a fee of 1% of all investments he generated. Rainieri and Phillips collectively paid a \$450k fine (Rainieri and Phillips were cited for failure to supervise an unlicensed broker), and Stephens was barred from the securities industry.

Kim Kardashian Anti-Touting Rule Violation

An even more recent example was the settlement between the SEC and Kim Kardashian in 2022. The SEC filed charges against Kim Kardashian for promoting a crypto-currency offering for EMAX tokens offered by EthereumMax on her Instagram account, but failing to disclose the \$250k payment she received for doing it.

Gurbir S. Grewal, Director of the SEC's Division of Enforcement stated, "The federal securities laws are clear that any celebrity or other individual who promotes a crypto asset security [or any other security] must

disclose the nature, source, and amount of compensation they received in exchange for the promotion.”

The SEC found no issue with the fact that Kim was being paid for merely posting on social media. She got in trouble for not disclosing her compensation under the SEC’s “anti-touting” rule. Why does the anti-touting rule exist? Because the SEC believes that followers might view a paid advertisement by a celebrity as biased, versus an uncompensated endorsement of an offering, which devoted followers might blindly follow.

Kim Kardashian ultimately settled with the SEC and paid \$1.26 million, which included \$260,000 in disgorgement of her gain plus prejudgment interest, and a \$1,000,000 penalty, along with an agreement that she wouldn’t promote any crypto asset securities for three years.

Bottom line, if you have someone who will advertise your offering (assuming it’s a Rule 506(c), Regulation A+ or Regulation CF offering that can be advertised), and you agree to compensate them; the amount of compensation, who pays it and when it will be paid must be disclosed in the advertisement.

Consultant Finders

In the course of my career, I have encountered professional finders that will ask for a flat fee (as much as \$25k) – we’ve had clients pay this where the person failed to make suitable introductions. Others want you to pay them \$15k or more per month while they make introductions, some of which may not be suitable for your investments, either because you don’t have the

right experience their contacts are looking for, or your business model doesn't fit theirs. I have yet to have a client be successful with this model.

A better model would be to pay the consultant when someone invests – but if you follow this model with a consultant, make sure their introductions conform to the finder's limitations discussed in this Chapter, such as the Paul Anka No-Action Letter.

Penalties for Violations

Regulatory Prosecution

Acting as an unlicensed broker may result in possible civil or criminal charges filed by the SEC or state securities regulators. The charge would be for violation of Section 15(a) of the Securities Exchange Act of 1934 (Exchange Act).

The risk for a finder or capital raiser is: 1) prosecution by the SEC, 2) prosecution by one or more state securities regulators, 3) a civil suit initiated by one or more investors seeking rescission of the offering on grounds of securities violations, 4) irreparable and immediate damage to the finder's reputation, even if they are deemed innocent years later after the matter is settled. The risk applies also to the issuer who hires an unlicensed broker, who may be charged with "aiding and abetting" violations of the 1934 Act.

If a state regulator determines that an issuer improperly compensated an unregistered person for selling its securities, the state could deny the federal securities exemption and apply its own registration or exemption criteria to the securities offering. If the state determined the offering didn't comply

with its intra-state rules (which it likely would not), or that someone acted as an unlicensed broker, it could deny the intra-state exemption, make a determination that the offering violated intrastate state and/or federal rules, and prosecute.

Civil Lawsuits

Section 29 of the Exchange Act provides that “a contract made in violation of the 1934 Act is void as regards the rights of any person who entered into or performed the contract in violation of the 1934 Act” - meaning that if the finder’s activities were in violation of the 1934 Act, the issuer could avoid paying the finder. Further, this provision gives an investor the right to file a civil action to render the contract void (i.e., seek rescission). Many state securities acts also specifically authorize rescission in such cases.

The statute of limitation for securities violations (i.e., the time period in which an action must be brought) doesn’t begin to run until the violation is discovered, which could be many years after the securities were originally sold, and years into a deal. Where a right of rescission is upheld, the company may be required to return all of the investors’ original investment plus interest within a specific time frame (which could be as little as 30 days), and doing so may still not be sufficient to preclude further prosecution.

How Are Violations Discovered?

Private securities offerings are generally self-policing, in that there is little likelihood that anyone will audit your offering for securities violations

– until something goes wrong. Violations are usually discovered when the investment fails, a manager flakes out and stops performing or responding to inquiries, or an investor wants out of a deal because of something that happened in their life (lost job, illness, legal issues, etc.). In that case, the investor either hires an attorney or complains to a securities regulator in an effort to get their money back.

Securities violations will usually be discovered during a securities investigation by the SEC or a state securities regulator, or during pre-litigation discovery in a civil lawsuit filed by one or more investors. Once securities violations are discovered, all disgruntled investors may exert their right of rescission or use it as leverage against the issuer to force a settlement.

Think this only applies to external finders? Think again. The SEC has applied these same arguments to in-house employees, officers or directors, who received “transaction-based compensation” and who were not licensed securities brokers.

Key Takeaways

So, How Can You Legally Compensate Capital Raisers?

1. Transaction-based compensation is illegal for anyone except licensed brokers – all capital raisers who will be raising capital for an issuer must have a role in management other than raising money, and their compensation must be based on the non-sales role. This rule also applies to officers, directors, managers, Co-GPs, and employees. No

one in management can be paid a fee based on the amount of capital they raise.

2. The common law finder's exception allows mere introductions - but nothing more, and it is questionable whether it would apply to referrals of non-accredited investors. All such compensation must be disclosed to investors (when, how much, and who pays it) at the time the solicitation is made.
3. The burden is on the finder or capital raiser to prove to the SEC that it didn't act as an unlicensed broker, and the more frequently a finder engages in these activities (such as raising capital or serving as a finder for multiple issuers), the less likely they are to prevail. Further, even if a finder prevails in its arguments to the SEC, it may fail when scrutinized by state securities regulators.

Still want to pay capital raisers or finders? Run your proposed compensation model past your corporate securities counsel before you commit. You may want to pay them to obtain a no action letter, draft an opinion letter or written memorandum, just to make sure your proposed compensation model is not going to get you, the capital raiser, or finder in trouble.

What Other Jobs Can You Do?

Below is a list of 12 jobs required to manage a successful syndicate. Some of these are jobs that "capital raisers" can do in addition to raising capital, and thus, justify their compensation, but word to the wise, don't

promise someone a commission and try to somehow fit it in reverse to one of these other jobs. If you are being examined by securities regulators, they will see through it and dig deep enough to find that it is transaction-based compensation. It's your job to make sure all members of the management team actually perform their job(s) and the compensation is commensurate with the tasks they perform.

What Other Jobs Can You Do?

- Find Deals
- Conduct Due Diligence
- Analyze Deals
- Guarantee Loans
- Put Up At-Risk \$\$\$
- Oversee Property Manager
- Work With Bookkeeper / CPA
- Create Investor Status Reports
- Coordinate Investor Meetings
- Follow Up With Investor Leads
- Prepare Property Package
- Liaison With Attorneys



Chapter 27 – How to Create an Effective Pitch Deck or Presentation

The purpose of a Pitch Deck or slide presentation is to explain your investment opportunity to investors, usually in a Microsoft PowerPoint presentation. The purpose of a Pitch Deck is to give your investors a compelling slide presentation that illustrates relevant information about your investment opportunity, or to educate your audience about something they need to know to invest with you (like how group investments and syndicates work and what's in it for them). The person delivering the presentation should use the PowerPoint slides as a prompt to remind them what to say, and to deliver the presentation in an organized, step-by-step format.

Types of Presentations

Deal Pitch Deck

The purpose of a deal pitch deck is to pitch a specific offering. When you do this type of pitch, you are making an offer to the audience to invest in a current fund or syndicate that is currently accepting investors. This is considered an offer and a general solicitation.

- If this is a Rule 506(c) offering, you can show a deal pitch deck to an invited audience that hasn't been pre-vetted.

- If you are doing Rule 506(b) offerings, you would only be able to use this type of pitch deck with a pre-vetted audience. Pre-vetted means persons with whom you have already established a pre-existing, substantive relationship, as described in Chapter 25. This requires that you have had a suitability conversation with every attendee prior to making the offer. If someone is in the room that you have not previously pre-vetted and wants to invest, you would specifically have to exclude them from this offering. But you could develop a substantive relationship and invite them to future offerings.
- The best deal pitch deck is one you prepare after you complete a property information package or investment summary for a specific property. Think of the pitch deck as a condensed version of the property package. If someone wants more detail after you do your pitch, send them the property package so they can read the details themselves. That's where they will make their buying decision.

Educational Presentations

Educational presentations are designed to educate the audience on how the syndication process works. This could be part of a multi-course series of presentations designed to make your investors sophisticated enough to invest with you, or it could be to show non-real estate investors how group investments and syndicates work in general – so they can understand how they might participate. Another purpose may be to introduce prospective investors to your company and what you do, while you are in between offerings.

Below are some presentation tips, many of which I learned from one of my mentors, David Lindahl, and others I have learned at several “how to be a public speaker” workshops that I have attended. And some tips I have learned from doing hundreds of presentations to real estate investors who want to learn and understand securities laws, deal structures, and legal methods of investor solicitation.

Presentation Tips

Tailor Your Presentation to Your Audience

I once agonizingly sat through an hour-long presentation about a deal – for the first 15 minutes, the speaker went through 15-20 slides telling a group of real estate investors why they should invest in real estate! That audience didn’t need convincing. There’s 15 minutes of our lives we can’t get back.

By the time the presentation got to 45 minutes, I was ready to fake an emergency, set a wastebasket on fire; pull a fire alarm, or anything just to get it over with! Had I been an actual investor, I probably would have lost my desire to invest because I was bored to death and by then, I was simply annoyed. Now, if you ask my spouse, he will say that’s because I’m impatient, but don’t you think high net worth investors have a lot of other things to do than listen to you drone on an on ad nauseum about a project that could have been explained in ½ the time? The pitch deck is meant to pique their interest so they ask for additional information – not to give them all of the information whether they want it or not!

You should have also prepared a Property Information Package (for a specified offering) or an Investment Summary (for a fund), that goes into all of the details, and that you can send to those who are interested and want more information so they can read it at their leisure, and share it with their significant other.

Preparing the Presentation

1. Use headings on each slide; each heading should be 3-7 words; one-line headings are preferred.
2. Fonts:
 - a. Don't use a font size of less than 28 points. This prevents you from having too many words on a slide and can be read by attendees in any size room.
 - b. Don't use green fonts as they are hard to read. Make sure your fonts and background are in sharp contrast so the words can be easily discerned.
 - c. Don't use skinny fonts (be bold) or white fonts on light backgrounds.
 - d. Don't use anything except for the most basic fonts. If you ever have to give a host your presentation on a thumb drive and they don't have your font on their computer, your presentation will get completely messed up. If you have someone design your presentation, make this a hard rule. I've had words show up ½ capitalized and ½ not, or phrases get cut off because the app substitutes a different, bigger font. I once had to stop a

presentation to 125 people while the tech installed my font on his computer! Resist the urge to be creative with fonts and keep them simple. Calibri, Cambria, Times, Helvetica, work on all Macs and PCs. Other fonts may not. Don't try to be fancy.

3. Use bullet points, with a maximum of 3-5 bullet points per slide. Each bullet should be a short phrase of 3-7 words; just enough to remind you what you want to say – not to fully inform the audience about every aspect of your opportunity. That's what the property package or investment summary is for. After you prepare it, go back through it at least 2x and eliminate extra words.
4. Make sure each slide covers a single subject. Each slide with content should take 1 to 1.5 minutes to explain. If you are spending longer than that on a slide, it has too much information; break it up.
5. Don't include whole sentences or paragraphs on our slides. The most boring presentation is one that the audience can read for themselves, or that you actually read to them!
6. Don't use detailed graphs and tables with fonts smaller than 28 points, or that require you to explain them for more than 60-90 seconds. You'll get lost in the explanation and so will your audience.
7. Limit your deal slide presentation to no more than 15-20 slides (including section header slides). Educational slide presentations can be longer if you have a longer presentation period. I find that the number of slides I have generally matches the number of minutes I have to give it, but I tend to talk fast to keep the presentation lively.

Make sure to confirm in advance with the host how long you have to speak so that you can tailor your slide presentation to the time you have.

8. If you have hired someone to design your slides, make sure they don't convert your words into images that are pasted into Powerpoint as you won't be able to edit or tailor your slides and you'll likely want to do that at some point. Tell them you need the slides created in PowerPoint in an editable format. And make sure they read these guidelines.
9. Tailor your presentation in advance to suit the type of audience. If you are talking to real estate investors, you don't have to convince them why they should invest in real estate so skip those slides; but if you are talking to physicians, "why invest in real estate" might be a central part of your message. I customize or update slides for almost every presentation.
10. Always bring your presentation to someone else's hosted event on your computer and on a thumb drive. You never know until you get there if the host is providing a dedicated computer that's already connected to the projector; or if your computer won't connect, you can use someone else's.

Giving the Presentation

1. You should be able to deliver a deal presentation in approximately 20 minutes with 10 minutes left for questions and answers. If your entire presentation plus Q&A is longer than 30 minutes, you will lose the attention of your audience, and you'll probably start repeating

yourself. Honestly – is your property that unique that it requires 45 minutes to explain it? Trust me, it's not. And if it is, your deal is probably not viable (See Chapter 17) because it's too complicated. You'll know your presentation is too long when people start leaving the room, fiddling with their phones, squirming in their seats – or worse yet, sleeping!

2. Show up early. If you are asked to give a presentation, whether live or virtual, show up 10 to 15 minutes early so that you are ready when the host starts the show. It's disrespectful to show up right on time, and then have to spend 10 minutes getting everything to work. If you do this, you won't be invited back.
3. Make sure you've gone to the restroom and that you have a glass of water standing by.
4. Don't eat nuts before your presentation. They tend to come back up and cause you to choke on your words. I've had this happen, and it's embarrassing.
5. Get plenty of rest the night before, or take a nap before the presentation if needed. It's easy to lose words or your train of thought when you're tired.
6. When you first get in front of the audience, and before you start your presentation, stop and take a deep breath; look around and see the entire room. Then start your presentation, using a slow and measured pace. My team is constantly gesturing to me to slow down. Take a breath and carry on.

7. If you are standing while you make your presentation, don't pace, but don't stand rigidly still. Some animation and hand gesturing is good. And don't forget to smile!
8. Don't rely on the host to provide a slide clicker. You can buy your own at Best Buy or online for less than \$100. Always bring your own. If you don't, you may end up stuck in front of a podium hitting forward keys on your computer.
9. Make sure your presentation ends on time or you won't be invited back and you may alienate the audience. If they are late for lunch, or miss a break because of you, they'll be resentful. If you run short on time, skip unimportant slides. Just because you wrote it, doesn't mean you have to cover it. Just click on through until you get to your end slide. No-one will notice what you didn't cover.
10. If you are doing a virtual presentation, include a free giveaway such as a free ebook, report, one-on-one consultation, etc. – something of value to this specific audience. Set up a bar code on your last slide that attendees can scan from their seat. You want the bar code scan to open a form where they have to provide contact information (first and last name, email, and phone), and it should be set up to automatically deliver the thing you promised, and to deliver their contact information to your database.
11. Don't allow people to ask questions during the presentation, your presentation should answer most of their questions. Ask them to write

down their questions and assure them that you will answer any remaining questions either in Q&A or individually after the event.

12. Don't answer complicated questions that are unique to an individual during a group presentation. Tell them that's a question that requires more time than you have but you are happy to answer it after the presentation.
13. Thank the audience for listening and complement them on their attentiveness and smart questions. They'll love you for it.

Post-Presentation Tips

1. Look around before leaving a live stage. If you leave something, like your phone, purse, computer charger, thumb drive or clicker (I've done all of them at least once) you won't be able to get to them until the next speaker ends their presentation.
2. Be prepared to hand out business cards after your presentation, so make sure you have them with you when you go to the stage. If people like your presentation, you may have a crowd that wants to speak to you right then. If you have to go get business cards, some will disperse. Make sure you are collecting cards as you are giving them out. Your goal is to collect contact information that can be added to your database – not the other way around. You want to be in control of future contact, not them.

3. Figure out in advance how you will follow up with everyone who expresses interest and gives you contact information. Follow up is key to conversion.
 - a. Will you call them?
 - b. Will you schedule an appointment via email?
 - c. Will you hold a more in-depth follow up presentation for those that raise their hand?

Common Mistakes

We offer reviews of our clients' self-prepared pitch decks, educational presentations, investment summaries, and websites – or we can create them for you. Each time I review self-drafted decks, my common comments are:

- Fix your fonts so they stand out and are readable, etc.
- Strike extra words (usually sentences or paragraphs).
- Turn this into 3-7 word bullets.
- You have too many bullets on a slide, or it covers too many topics. The rule is one topic per slide. If in doubt, make it two slides.
- Eliminate that slide – it's too complicated and no-one can read it.
- Cut your presentation to 20 slides, 30 or 40 is way too many, unless its an educational presentation. I often do 1 hour presentations that have 45 slides and 15 minutes for Q&A. If I am asked to do a 90 minute presentation, I spend more time on each slide, giving examples or discussing things that have happened to our clients.

My pitch deck reviews are almost always a slash and burn meeting, and sometimes I actually feel sorry for the client afterward, but most of our

clients are grateful to get the feedback – and they leave with a slide presentation they can confidently deliver, and that they feel much more confident about.

You get the idea. Now go work on your own pitch deck, or better yet, hire us to do one for you!

Have Syndication Attorneys' Present to Your Group

In case you're wondering, I give a lot of presentations on people's podcasts, coaching programs, virtual and live events. And we have two other attorneys who can also present at your events. Yes, we can present at your educational event or on your podcast too! See Syndication Attorneys speaker biography page at: <https://syndicationattorneys.com/request-a-speaker/>.

SECTION 6 – HOW TO RUN YOUR INVESTMENT COMPANY

Chapter 28 – How to Run Your Company

What happens after you raise the money? You must comply with state laws, securities laws, tax laws and general business practices while you run your company. This chapter provides some of the basics you need to follow.

First and foremost, you must operate the company in compliance with your governing documents. Failing to abide by your documents is one of the biggest mistakes issuers make, and the biggest reason managers get removed or lawsuits get filed.

If you need to deviate from your operating agreement, you need permission from your investors so you'd better have a good reason, and you need to call a meeting and explain it.

Obtain Your Federal Employer Identification Number

After your company is formed, you will need to obtain your federal Employer Identification Number (EIN). This nine-digit number is assigned by the IRS to establish your tax account. You will need this number in order to open a U.S. bank account in the name of your company and to submit your annual tax filings to the IRS. You can only obtain one EIN per day per responsible party.

If you live in the United States and your business has a responsible party with a Social Security number, you may instantaneously obtain your EIN

for free at the IRS website: www.irs.gov. You may also apply via mail, but the IRS often has processing times of several weeks for EIN requests submitted by mail.

If you have no legal residence, principal place of business, or principal office or agency in the U.S. or U.S. possessions, you can't use the online application to obtain an EIN. Instead, you should go to the IRS website at www.irs.gov and obtain form SS4; complete it for reference, then call the IRS at (267) 941-1099 to give them the information and obtain your EIN.

The responsible party must be a principal for a corporation or limited liability company, a general partner if the company is a limited partnership, or the sole member for a single-member limited liability company, such as the tax identification number of the person in control of paying the company's taxes.

Don't worry about giving the IRS your social security number. Don't you think they already know it? They just want to know who the live taxpayer is that they need to contact regarding your business for tax reporting and auditing purposes.

Open Your Company Bank Account

You will need your EIN and your company's articles of organization in order to open a company bank account. Some banks may require additional proof of your authorization to do this on behalf of your company. This could be a corporate resolution from the entity authorizing you to do this, or a copy of the governing agreement for the company. We attach a corporate

resolution at the end of our operating agreements. Just show the bank this form and you should be ok.

Some banks may require a “resignation of organizer” letter if your company was formed by an attorney. We provide this letter, handing over authority to conduct business to certain members of the asset management team, for the entities we create for our clients.

Maintain Your Company

Your company has certain annual obligations, such as filing annual reports with the secretary of state’s office and paying annual state filing fees. You must also maintain a registered agent with a physical address in the formation state at all times. Failure to comply with these requirements will cause the state to suspend or dissolve your company. Your company will lose many of its rights if this occurs, such as the right to file a lawsuit, evict tenants, collect rents, contract with third parties, etc.

Information Requests

Your company may receive informational requests from the formation state(s) that will require responses and additional information. You are required to respond to these requests. In some states there are companies that mimic state agencies who will attempt to charge you unnecessary fees to prepare and submit these filings.

Examine closely any seal on any correspondence you receive to ensure that it is the official seal of the state before responding. If you are unsure, call your attorney to help you make this determination. Always go directly

to the secretary of state's website to do these filings so you know your company information is not being hijacked. Corporate identity theft happens.

Registered Agent Requirements

As a condition of forming a company, you are required to maintain a registered agent who will accept legal service on your company's behalf in the formation state. You must pay an annual fee to the registered agent until your company has been dissolved. We recommend you pay a professional registered agent to provide this service. They will generally charge from \$99 to \$199 per year. We have an agreement with a registered agent service called Cogency Global that provides this service in every state for our clients for \$99/year.

In exchange for the fee, the registered agent will promptly forward any legal notices it receives on the company's behalf within 24 to 48 hours, remind you of annual filings, and inform the state of its continuing status as your company's registered agent. This is far preferable to using a relative who lives in the state of formation, or one of your asset management team members who travels a lot or doesn't go to the PO box very often, as the company's registered agent.

Your registered agent will be listed on the company's formation document. The registered agent will bill you directly for their services every year, so please don't ignore their invoices. If you wish to change registered agents, you may do so at any time, but the new registered agent will need to file a change of registered agent form with the state in order to do so. Several

states require that you have advance written consent of your registered agent before designating a third party other than yourself to fill that role.

Annual Tax Filings

You are required to file annual tax returns (Form 1065) with the IRS, send K-1 forms to your investors, and 1099s to any contractors. For multi-member limited liability companies, the filing deadline is March 15th.

You should obtain an IRS form W-9 or a Social Security number from all investors with their subscriptions to your offering. This information will be needed to send out investor 1099s and K-1 forms.

The financial bookkeeping requirements associated with maintaining a real estate syndication are generally beyond the abilities of most laymen, and beyond the capabilities of personal income tax preparers. We get many calls around the first of March from personal income tax preparers that are confused about this. We recommend you hire a CPA that works with real estate investors as soon as possible after closing on a property or setting up a fund to assist you with setup and maintenance of your bookkeeping system, and to do your annual tax filings. The time to meet a new CPA for your company is before the end of the year, not March 1st.

If you attempt to do this in March, it is unlikely that you will be able to file your annual tax returns and issue K-1s and 1099s in a timely fashion. Your investors will be waiting for you to produce their K-1s so they can file their own income tax returns. If you file extensions and their K-1's are issued late, your investors may have to file extensions. If they get penalized

or owe interest on account of your late filings, they will not appreciate you, and may ask you to compensate them.

Initial Meeting of Your Members

To kick off your new company, we recommend that you hold an initial meeting for your new company while the manager is still the only member. This happens after we form your company but before you close on a property or start admitting members.

The meeting can be held by phone or in person if there are other members of the managing entity who should be included, but you should follow the meeting protocol described in your company's agreement for calling and conducting the meeting and any votes or resolutions taken. At the initial meeting, you should:

1. Accept the managing entity; and
2. Adopt any other resolutions as necessary to authorize the manager to conduct business and raise money for the company.

Maintain Company Books and Records

You must maintain separate books and records for the company and must not allow the funds of the company to be commingled with the funds of any other company you own or control; or any other bank account owned or controlled by the manager or any of its individual members, officers, partners or employees, or another member of the company.

We recommend you start a filing system or three-ring binder notebook to house the company's operating agreement, meeting minutes, resolutions,

and current list of members along with their contact information. You should also include any other information you deem relevant to the company. It will be necessary to do this for your managing entity as well.

You may want to ask every member to provide you with an alternate contact. We've had clients whose members have died and they didn't know who to contact about distributions, etc.

Wind Up and Dissolve the Company

When you have sold the property, you will need to wind up the affairs of the company and dissolve the investment company. An entity that previously owned a syndicate or fund asset should not be re-used. This is to ensure that you don't carry any unknown liabilities forward into a new offering.

Before you can dissolve the company, however, you must ensure that:

- All debts and outstanding bills for the company have been paid. If there are outstanding debts at the time the company is dissolved, members of the asset management team and/or investors could become personally liable for them.
- If your company is involved in a lawsuit, you cannot disburse all of the cash or dissolve it until the lawsuit has been resolved.
- All real or personal property owned by the company, including cash, has been disbursed to you and your investors, as described in your operating agreement.
- Once the above steps have been taken, you may close your bank accounts and dissolve your company by filing the required documents

with the appropriate government agency in the state where the company was formed. You should ask your registered agent or an attorney licensed in the formation state to help you do this if you are unsure about it.

- Some states may require public notification by running an ad in a newspaper or other publication notifying potential creditors of the company's pending dissolution. Failure to take this step, if required in your formation state, could keep the door open for future creditor claims, for which officers and directors of the company and possibly investors could become personally liable. You should ask your registered agent or an attorney licensed in the formation state to help you do this if you are unsure about it.

You should consult a business attorney licensed in the state where your company was formed prior to dissolution to ensure that the correct dissolution procedures are followed.

Chapter 29 – How Cash Flows in a Syndicate or Fund

What Bank Accounts Do You Need?

First, you need to set up bank accounts for every entity in our syndicate, including both a checking and savings account for the syndicate or fund entity, a checking account for the asset management entity, and a checking account for any SPVs in your organization chart.

Where to Collect Investor Funds

The Issuer's Bank Account

You want investors to deposit their funds directly into the issuer's bank account or a "securities escrow account." When the time comes to close on the property, you will wire exactly the funds needed for closing to the property escrow.

You should have raised extra funds for acquisition fees, working capital and reserves, capital improvements, etc. that will remain in your company's bank account; some of which you will disburse post-closing (to reimburse the asset manager for pre-closing expenses or acquisitions fees), and some of which you will hold while making capital improvements or operating the property.

The last thing you want is to have excess funds you have collected from investors show up on your closing statement as income to your company.

What is a Securities Escrow Account?

This is an account set up at a bank or through a securities broker-dealer, that will hold investor funds until you achieve a stated milestone in your offering documents; such as raising your minimum offering amount. Your escrow agreement with the institution won't allow them to release the funds to you until this milestone is achieved. In the event you don't achieve it, they will wire the funds back to the depositors. You will be responsible for the costs associated with the wires (incoming and outgoing) and any escrow agent fees, which could be as much as \$1,000.

Using a securities escrow account can greatly enhance your credibility with investors, who may be nervous about sending funds directly to your syndicate or fund before you have achieved your minimum offering amount. This gives them assurance that if you never achieve the minimum, you can't use their funds and they will get them back without deduction. So, even though it can be costly to set up a securities escrow account, it may be worth it, especially for a fund that will hold investor deposits until they find a suitable property.

Don't Let Investors Wire Their Funds to a Property Escrow Account!

Can investors wire their funds directly to the property escrow account?
No!

Don't ever put a third party (the seller) in control of your investor funds by having investors wire them to the property escrow account directly. If something goes wrong with the deal, and there's a dispute over the escrowed

funds, your investors funds could be tied up for a very long time while it gets sorted out with the seller, who may be able to claim some of the funds as damages.

Property Management Accounts

You may also need a separate property management account. This will be spelled out in the property management contract that will be executed between your title holding entity and the property manager. Note, although we have mentioned this before, it bears repeating: the asset management entity that manages your fund or syndicate is not the same as the property manager.

The property manager is a third party entity that deals directly with tenants, property management staff and property contractors, and has the correct liability insurance for property management services (evictions, employee/HR liabilities, etc.). Even if the same members of the asset management team are acting as the property manager, you will do this through a separate entity that has the correct licenses (if required) and property management insurance.

Be careful of allowing a property manager to commingle your property's funds with those of other property owners. Some property managers will want to do this. If your property is large enough, you can insist that your funds be kept in a separate bank account in your company's name – that you AT ALL TIMES have both access and signing authority. If something goes wrong with your property manager and you need to fire

them you need to be able to cut off the property manager from your bank account – not the other way around.

Don't leave excess funds in an account your property manager can access. Leave them just enough to pay the property expenses. Any excess cash needs to be swept out of the property management account into your syndicate or fund's bank account. If the property needs additional funds later, you can always transfer money back.

Disbursing Cash on Acquisition

Once you have all of the bank accounts set up, you need to understand how you will use them. Below is a summary of how cash flows in the syndicates or funds we create:

Investor funds are collected in the syndicate or fund's (for this discussion, we'll call this the "Investor LLC") operating account. DO NOT collect them in the asset manager's bank account or any individual's bank account. Do not allow your co-GPs to collect funds in their own accounts – unless they are investing via their own fund of funds (see Chapter 15).

When it's time to close on the property, the asset manager wires only the funds needed for closing from the Investor limited liability company's operating account to the property escrow account.

If you have completed your target raise, there should be excess cash remaining in the Investor limited liability company's operating account. This cash will be used to pay the asset manager for its acquisition fees and to reimburse the asset manager (or its members individually) for any pre-closing expenses they may have contributed. Additional cash remaining in

the Investor LLC's bank account should be used for operating capital, reserves and capital improvements. You may want to hold the reserves and capital improvement funds in the Investor LLC's savings account.

If there are any lender-required reserves, the lender may require that you hold them in a separate escrow account.

Disbursing Cash From Operations

- The property earns money,
- Either the property manager or the asset manager writes checks for property operating expenses and debt service, as agreed in the property management agreement.
- Excess cash is swept into to the Investor LLC's operating account.
- The asset manager writes checks from the Investor LLC's account to itself for any fees that are due at that time. Asset manager's fees are described in your operating agreement.
- The asset manager distributes its earnings to its members as described in its own operating agreement.
- The asset manager decides how much to retain in the Investor LLC's operating account as working capital or reserves and how much, if any, is distributable cash that can be split among the Investor LLC's members.
- If there is to be a distribution, the manager follows the waterfall in the Investor LLC's operating agreement, depending on the phase of the company (operations, or a capital transaction).

- The manager references its list of members from the Investor LLC’s operating agreement to determine who will receive checks, and how much each member is entitled to receive from the distribution, based on their respective percentage interests.
- The checks are written from the Investor LLC to the Class A & Class B members listed– using the exact member names listed in those tables (which should match their subscription agreements).

Caveat Regarding Bank Accounts

If you are forming a limited liability company in a state where you don’t live, you may also want to set up the company’s bank account in the state where the entity is formed, versus setting up a bank account for an out-of-state entity in your home state. Your home state could take the position that since your company has a bank account (and is thus, conducting business there), your entity should also be registered as a foreign entity in your home state. Additionally, your bank could require proof of registration in the state where the branch is located.

As an example, because the minimum franchise tax for a California registered company is \$800/year, California has a vested interest in requiring out-of-state companies to register there as a revenue generating measure, whenever they can find a nexus between California and the entity. A nexus is a relationship – for instance this could apply if you live in California, but operate an out-of-state company; or if your out of state company has California members. In either case, California may try to assert dominion and require you to register the out-of-state entity in California.

California regularly checks the lists of registered companies against companies with bank accounts in its state. If there is a disconnect, they will send a letter informing you that you must register in California, perhaps charging you a fine of up to \$5,000 for not registering voluntarily, and requesting that you pay past franchise taxes for all of the years your out-of-state company has been in operation. Note, however, if you are buying property in California, you can't avoid forming or registering your entity in California.

To set up a bank account in a state other than where you live, you will need to speak directly to a branch in the state where your entity is formed. If you use a national bank, you may be able to set up the account online, but have your identification verified and sign signature cards at your local branch. Or you may be able to use an online bank for this purpose. Read Chapter 24 on Where to Form Your Entities before you make this decision.

Chapter 30 – Complying With the Corporate Transparency Act

Starting January 1, 2024, Section 6403 of the Corporate Transparency Act (CTA)²⁵ will take effect. This means that all “beneficial owners” of any corporate entity you own (Corporations, LLCs, LPs, LLPs, and business trusts) must be disclosed to the U.S. Financial Crimes Enforcement Network (FinCen). Additionally, financial institutions will be required to verify the identity of any individual owning $\geq 25\%$ of a legal entity, as well as all individuals who control such legal entity.

The term “beneficial owner” generally means an individual who, directly or indirectly, exercises substantial control over the entity; or owns or controls ≥ 25 percent of the ownership interests of the entity.

This means asset managers who have existing companies (or are forming new companies) must gather and report identifying information from every investor and each member of your asset management team and any investor who owns (or could come to own) 25% or more of the interests in either the syndicate, your fund or your management entity. Additionally,

²⁵ ₃₁ See U.S. Code 2021, Title 31, Subtitle IV, Chapter 53, Subchapter II, Section 5336, available at FinCen’s website at: <https://www.fincen.gov/boi>.

lenders and banking institutions may also be required to collect this information – and they will be asking you for it.

The final rule, called “Beneficial Ownership Information Reporting Requirements” (BOI) was published in the Federal Register on September 30, 2022. To read the final rule (which is 184 pages long), go to our Book Bonus page:

<https://RaiseCapitalForRealEstate.com/BookBonus>

Purpose

According to FinCen, "The rule will help to stop criminal actors, including oligarchs, kleptocrats, drug traffickers, human traffickers, and those who would use anonymous shell companies to hide their illicit proceeds." This information will help “protect U.S. national security and the U.S. financial system from illicit use and provide essential information to national security, intelligence, and law enforcement agencies.”

There are 23 exemptions to the rule, none of which appear to apply to real estate syndicates, small businesses or blind pool funds, so an issuer should expect that the rule will apply to all of your real estate syndicates or funds and each of their related entities.

When Reports Must be Filed

The “effective date” of the rule is January 1, 2024. Every entity an issuer owns or controls prior to the effective date will have one year to file an initial report. Entities formed after the effective date will have 30 days after formation to file their initial report, and any changes in membership must

be reported within 30 days. This includes changes in the address of a member who is subject to reporting. You will need to file amendments as soon as you become aware of such a change.

I expect that initial filings and amendments will eventually be something your registered agent can do for you – which is another reason you will need to hire and maintain a professional registered agent for every entity you control.

What Does This Mean for Syndicators and Fund Managers?

1. You may have to file your initial report before you know who your members are, as some of your entities may be formed more than 30 days prior to admitting investors, and
2. You will have to file an amendment within 30 days of admitting members, which generally happens when you close on the property. In operating agreements our firm drafts, we specify that admission occurs on the day you close on the property, break impounds and use investor funds (although sending back a receipt or certificate of ownership earlier could trigger an earlier deadline). But, be careful with offerings drafted by others, who may consider an investor admitted on receipt of their capital contribution and subscription agreement.
3. You will have to file amendments within 30 days of admitting new members. For example, this would include late-coming investors or members added to the asset manager post-closing.

4. You will have to file amendments if you become aware of address changes for any members whom you were required to report, including members of the asset management entity and any owner of 25% or more of the interests in your fund or syndicate.

So as not to miss these deadlines, issuers should admit new members in “tranches” (versus one-by-one), with each tranche coinciding with a “closing date” (i.e., when new members are admitted), with the tranche closing date becoming the 30-day trigger for filing updates. This will be especially important for funds whose closing dates are not tied to acquisition of a specific property.

What Information Must be Provided

Information that must be reported for each of your entities will include:

1. The entity’s full name,
2. Any trade name or “dba” name for the company,
3. Its business street address,
4. The state where it was formed, and
5. The entity’s IRS taxpayer identification number (e.g., the Federal Employer Identification Number or “EIN”).

Information to be reported for each “beneficial owner” (i.e., member) includes:

1. Their full legal name,
2. Their date of birth,

3. Their current residential or business street address,
4. A unique identifying number from one of four types of “acceptable identification documents”:
5. An image of the identifying document.

Acceptable identification documents include:

1. A nonexpired U.S. passport;
2. A nonexpired state, local, or Tribal identification document;
3. A nonexpired state-issued driver's license; or,
4. If an individual lacks one of those other documents, a nonexpired foreign passport.

It will be the issuer’s responsibility to gather and provide the information and sign the report to be filed with FinCen.

Who Can Access the Information

FinCen plans to issue additional rules regarding who will be able to access the information and how such information will be safeguarded.

Penalties for Non-Compliance

The BOI was enacted to implement Section 6403 of the Corporate Transparency Act (CTA), that is part of the National Defense Authorization Act for Fiscal Year 2021 (NDAA). The CTA has established that it is unlawful for any person to willfully provide false information. The final rule includes a “certification” requirement that states that “each person filing a

report under that section must certify that the report is accurate and complete.”

Commenters on the final rule expressed concern that “the certification requirement could expand a person's liability for providing inaccurate information even if the information was provided in good faith.” Nonetheless, the rule squarely places the burden of providing accurate and complete information on the reporting company; the individual who signs the form does so in their capacity as a member or manager of the reporting company. FinCen, during the rulemaking process, indicated that it was doubtful that an inadvertent mistake would be considered “willfully false or [a] fraudulent violation.”

Key Takeaways

Issuers should share or direct their investors to this book, and specifically, this Chapter, so they understand their obligations, as some of them also are using entities to invest that will be required to do their own reporting. You may be the only person to explain these reporting obligations to them, and they will appreciate you for informing them.

Doing so can also help them understand their obligation to provide complete and accurate information to you, so that you can make your required FinCen filings.

Chapter 31 – Avoiding Fraud in Your Syndicate or Fund

Fraud is a constant risk in any kind of transaction but even more so in a real estate syndication, which involves pooling funds from multiple investors, many of whom are senior citizens. The SEC and state securities regulators are acutely aware that unscrupulous issuers can quickly strip unsuspecting investors of their retirement funds. Thus, the sale of securities is strictly regulated with stiff penalties for non-compliance.

Penalties for fraud and securities violations can include jail, fines, civil lawsuits, damages, disgorgement of gains, and becoming labeled as a “bad actor.” This could preclude you from ever participating as a manager in another syndicate or dealing with investor funds again.

As a member of an asset management team, you have the responsibility to your investors to constantly be on the lookout for illegal dealings relating to your syndicate or fund that can threaten your investors, your livelihood, and your reputation.

Some of the most common forms of illegalities to beware are:

- Violations of securities laws by “co-GPs”, capital raisers or finders (See Chapter 26);
- Embezzlement where members of the asset management entity misappropriate investors’ money and transfer money to personal accounts, write checks to themselves, or withdraw company funds for personal purposes;

- Ponzi schemes, where new investor funds need to be raised to pay back previous investors.

Violating Securities Laws

It's best to steer clear of anyone whom you know or suspect is violating securities laws, regardless of whether you are participating as a passive investor or actively involved in management of a syndicate or fund where securities violations are occurring. Issuers who get in trouble with securities regulators are likely to use investor funds for their defense.

Following are some of the most common securities violations that asset managers must guard against:

Admitting Bad Actors to Management

It's also essential for asset managers to run background checks on all of the people they admit to the asset management entity. Certain "bad actors" who have been in trouble with securities regulators in the past are prohibited from participating in management of a company engaging in Regulation D, Rule 506 or other securities offerings. It's the issuer's (i.e., the asset manager's) responsibility to police this. We do bad actor and background checks on all members of the asset management entity as a courtesy for our clients, but if they admit someone to the asset manager and don't tell us, we can't help them.

Embezzlement

It's a well-known fact among forensic CPAs and attorneys who prosecute fraud that three things lead to monetary fraud or embezzlement in nearly all cases (known as the "Triangle of Fraud"):

1. Opportunity or access to funds — Investor funds, funds in the Company's bank account, company books, etc.
2. An un-sharable need — For example, "I need this money to buy a new car, to buy a new boat, to pay medical bills, to cover a vacation, to show investors I'm successful, etc. Often, this starts with good intentions: "I'll pay it back, I'm just borrowing the money."
3. Justification — When they can't pay it back, they justify why they deserve it: "I worked harder than everyone else; I should have been paid more," etc.

By the time this process plays out, the funds have usually been spent and are irretrievable.

You need to pay careful attention to the bank accounts for your syndicate or fund and the people with access to them. When people experience financial stress, embezzlement increases. It's important that syndicate managers closely control who has access to the bank and also closely monitor bank transactions within the syndicate on a weekly basis.

Here are some protective measures you should be taking:

- Make sure there are at least two unrelated people keeping an eye on your bank accounts, with no single person in charge;

- Watch for unauthorized transfers or large expenditures, frequent ATM withdrawals, personal credit cards paid with company funds, advances on future pay, or reselling interests in the company.
- Watch for people living above their means – buying fancy toys, taking extravagant vacations, holding lavish parties, etc.

Knowing someone else is watching is the best prevention. If you discover embezzlement, you will need to remove that person from the asset manager; your documents should allow this, but you might have to hire an attorney to do so. Make sure your manager’s operating agreement has clear removal provisions, for both members and managers, that can be executed by a majority of members of the asset management entity.

Ponzi Schemes

Ponzi schemes occur when new investors are recruited to pay previous investors. This is often done to cover up embezzlement by someone in management, or mismanagement of the investment. Before investing in an existing syndicate or fund, or agree to a “capital call” in an existing investment, make sure you have a clear picture of how the funds will be spent, and that the explanation makes sense.

Descriptions of additional types of investor fraud can be found on the SEC’s website at:

<https://www.investor.gov/protect-your-investments/fraud/types-fraud>

Key Takeaways

If you are tempted to engage in fraud, remember that it never ends well. You will eventually get caught, and when you do, relationships will be burned, your reputation will be ruined, and you could be labeled a “bad actor” and prevented from ever raising money from investors again. Remember that previous job you hated? You’ll be lucky if you can get it back, assuming you’re not in jail.

If you suspect that a member of the asset management entity is embezzling funds, you must stop them immediately, and if funds can’t be recovered, you will need to also contact a litigation attorney.

If you are a passive investor and you suspect fraud by the asset manager of a syndicate or fund, contact a securities litigation attorney or your state securities agency. The securities agency may stop them, but won’t get your money back. A securities litigator may be able to stop them and get your money back, but it might cost you money to prosecute the case.

Chapter 32 – 10 Things to Ask Before Investing in a Syndicate or Fund

If you have a self-directed IRA or substantial investment funds, you may have considered investing in real estate. You may lack the funds to invest on your own or the desire to deal with the hassles of property management. A viable option for you may be to invest in a syndicate or fund as a passive investor.

What Information Should You Get From the Syndicator?

Prior to accepting any investor funds, the issuer is required by securities laws to provide a set of offering documents that explains the terms and discloses the risks of the offering to prospective investors. Issuers typically answer to their investors by means of periodic newsletters, financial reports, and/or teleconferences.

Unlike a stock investment, investors may also have some limited voting rights regarding major decisions affecting the company or their investment.

You should always ask hard questions about the asset manager's track record and what kind of returns they have had on past deals that they have sponsored by themselves, and whether they have met investor expectations, or if they have had any deals that failed or didn't meet their projections.

They are required to be truthful with you. You may also want to ask for some investor references from past deals.

Below is a summary of the questions you should ask.

Checklist: 10 Questions You Should Ask

1. What is the issuer's background, education and experience with similar investments, if any?
2. Who are the team members involved in acquisition and operation of the property, including other members of the asset management entity, attorneys, CPAs, property managers, and affiliates that may receive fees?
3. When are cash distributions paid to investors, including the proposed timing and anticipated percentage returns?
4. What fees and distributions will be paid to the issuer?
5. What is the anticipated duration of the investment?
6. Ask for information about the property, including the type and condition, purchase price, financial history, proposed added value, exit strategies, and financial projections.
7. What has to happen for you to get your money back and what if you need to get out early?
8. What are the voting rights of investors?
9. What are the provisions for removal of the issuer?

10. What law firm structured the offering and drafted the offering documents, and is the firm experienced with securities offerings?

When to Seek Professional Advice

In addition to satisfying yourself with respect to all of the items listed above, you should seek the advice of your own attorney, financial adviser or accountant regarding the investment.

Your attorney should determine whether the offering complies with applicable securities laws. An issuer who disregards the applicable laws, or who drafts their own documents, may expose the entire investment to unnecessary civil or criminal liability. They may be unaware of its fiduciary obligations to investors. Your CPA or financial adviser should evaluate the financial merits of the investment based on past financial statements for the property, projections provided by the issuer, and its suitability for your investment portfolio. We may be able to help if we didn't draft the offering and don't otherwise have a conflict.

Where Can You Meet Syndicators?

Become a member of your local real estate investment clubs and attend their meetings on a regular basis, and attend the informational seminars offered by your self-directed IRA administrator. Attend networking and training events offered by real estate trainers who teach investors how to syndicate in order to meet asset managers with whom you might want to invest. Check out crowdfunding portals and platforms for investing

opportunities. Make sure you are qualified for the investments offered. If you're unsure, talk to the issuers or platform operators.

Precautions

Investing in a syndicate or fund incurs an obligation on the investor to conduct their own due diligence about the issuer and the investment opportunity. Failure to do so can have dire effects. You should not invest money you can't afford to lose. You should never invest in a syndicate or fund if you are depending on the returns as a steady source of income to pay your bills. Investing is not without risks. Markets are subject to periodic up and down cycles, where investors can win or lose big. Although it rarely occurs, environmental hazards or insurance disputes can cause properties to go into disrepair and ultimately foreclosure. Sometimes these events (like hurricanes, sinkholes, tornadoes, fires, ice storms, etc.) are beyond the ability of the asset manager to control.

Get to know the issuers before investing. Ask for references and talk to previous investors, and look closely at the investment opportunity and the offering documents. If you don't understand what you will be getting in return for your hard-earned dollars, seek another opportunity. There are plenty out there now that you know where to look.

APPENDIX A – GLOSSARY

1031 Exchange

A section of the Internal Revenue Code that allows the owner of real estate to exchange one real estate asset for another similar real estate asset for the purpose of reinvestment, without paying capital gains taxes. Capital gains taxes will be deferred until the asset is sold without the intent to reinvest the proceeds of the sale.

Anti-Touting

The Securities Act of 1933, Section 17(b) says, in summary, that it is unlawful for any person... to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer..., without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

Asset Manager

This is the legal entity, comprised of individuals or other entities, that manages a syndicate or fund.

Assets

Real property or other personal property owned by a syndicate or fund. This term is sometimes used interchangeably with the word “properties” when appropriate for the context in which it appears.

At-Risk Capital

This is the capital contributed by members of the asset manager to cover pre-closing expenses, such as property deposits, third party reports, legal fees, lender fees, and travel during due diligence, for a real estate acquisition.

Balloon Payment

A large payment due at the end of a loan period, after the payment of a series of smaller payments on the principal amount of the loan. Balloon payments are usually applied to short-term loans, where only a small portion of the principal amount of the loan is amortized over the term of the loan.

Beneficial Owners

Owners of an entity or Delaware Statutory Trust who contribute capital for property acquisition and operations in exchange for a share of profits.

Blue Sky Laws

State securities regulations or laws adopted by a state regulatory agency to protect investors from securities fraud.

Brand

A unique name and image for a product or service, which differentiates the product or service from others which compete with it.

Branded Entity

A company whose name you can put on our business card, create a website to act as your storefront (i.e., to establish credibility with sellers, brokers, lenders and investors), and use to make offers on properties.

Break Impounds

This occurs when the stated minimum dollar amount of a securities offering has been raised, allowing the issuer to spend funds. See definition of Irretrievably Committed for purposes of filing federal and state securities notices below. See also the definition of Securities Offering below.

Capital Call

The process of requesting capital from current members of a company (such as members of a limited liability company or limited partners) for additional, usually unanticipated expenses during the course of real estate ownership.

Capital Contribution

Any contribution to the capital of a company in cash, property, or services by an investor whenever made.

Capital Raisers

Persons who purport to raise capital from private investors for syndicators or funds in exchange for compensation, generally in the form of interests in the syndicate, fund and/or asset management entity.

Capital Transaction

The refinance, sale, or other disposition of the assets of a business.

Carried Interest or Carry

A method of compensating asset managers for their work in providing a return on investment. Tax rules allow those asset managers to pay taxes on carried interest realized at sale at the capital gains tax rate rather than the higher tax rate that normally applies to ordinary income.

Cash On Cash Return

The rate of return, expressed as a percentage, that calculates the pre-tax income (from cash flow and equity on sale) against the total cash invested in a property, and divided by the number of years the property has been held.

Compounded Interest

Interest calculated on both the principal amount of a loan, and on accumulated interest on the loan. It is essentially interest on interest.

Covered Person

According to the SEC, "A Small Entity Compliance Guide, September 19, 2013, Disqualification of Felons and Other "Bad Actors" from Rule 506

Offerings and Related Disclosure Requirements”; ‘covered persons’ include:

- the issuer, its predecessors and affiliated issuers,
- directors, general partners, and managing members of the issuer
- executive officers of the issuer, and other officers of the issuers that participate in the offering
- 20 percent beneficial owners of the issuer, calculated on the basis of total voting power
- promoters connected to the issuer
- for pooled investment fund issuers, the fund’s investment manager and its principals
- persons compensated for soliciting investors, including their directors, general partners and managing members

Crowdfunding

The use of small amounts of funds from a large number of investors to finance a business, usually using social media and websites to bring investors together.

Crowdfunding Platform

An organization or website that brings together investors to pool funds.

Crowdfunding Portal

A mechanism on a website used by a crowdfunding platform to allow investors to directly make capital contributions to a securities offering.

Debt Investor

A person or legal entity that loans money to a company, in return for receiving interest as well as the return of the principal amount of the loan. The debt investor does not have an ownership interest in the company. Usually any involvement with the company will cease upon repayment of the loan by the company.

Distributions

The disbursement of cash or other property to the asset manager or the investors, usually as stated and defined in the operating agreement or other governing document of a company.

Distributable Cash

Also known as “available cash,” all cash of a company derived from all sources of income, reduced by the amount necessary for the payment of the company’s debts, liabilities and reserves.

Equity

On a company’s balance sheet, equity equals the amount of needed funds contributed by investors plus retained earnings (or losses). <https://www.investopedia.com/terms/e/equity.asp>.

Equity Investor

A person or entity that invests money in a company in return for an ownership interest in the company. Equity investors generally recover their investment amount after the company liquidates its assets, but will expect

to receive cash distributions or another type of return on their investment from the company during the operation of the company's business.

Fix-and-Flip

A type of real estate investment strategy in which the asset manager purchases properties with the intent to renovate them and sell them for profit.

Fund or Blind Pool Fund

A group investment formed to acquire multiple properties based on an investment summary (business plan). This model allows the fund manager to raise capital prior to getting deals under contract but is the hardest way to raise money.

Fund of Funds

This is an entity created for the purpose of investing in securities offered by other syndicators or fund managers.

Hard Money Lender

An individual or entity that provides short-term loans to a person or entity for the purpose of acquiring real estate, until the borrower can obtain more conventional financing. Use of hard money lenders can assist asset managers in acquiring investment properties relatively quickly.

A hard money lender is a private lender that generally uses more lenient standards than financial institutions for extending credit to borrowers.

Howey Test

A test created by the Supreme Court to determine whether certain transactions constitute investment contracts (U.S. v. Howey, 328 U.S. 293 (1946)). If a transaction constitutes an investment contract, then the transaction is considered to involve the creation of a security. It will be subject to certain disclosure and/or registration requirements under The Securities Act of 1933 and the Securities Exchange Act of 1934.

Informed Consent

This is what an investor gives when they decide to invest, but only after they have been provided with all information related to a property or an issuer that would be relevant to their decision to invest (i.e, all “material facts”), including (but not limited to) such things as what is being acquired; where it’s located; what management plans to improve performance, resale value and investment returns; who is involved in management (including disclosure of any negative events in their personal histories) and their past track record with other similar real estate projects (whether lacking, good or bad); what risks are associated with an investment in this type of property, including risks related to real estate and financial markets, taxes, regulatory concerns, and environmental risks.

Investment Contract

The legal definition is “an investment of money in a common enterprise, with an expectation of profits based solely on the efforts of the promoter” (Securities and Exchange Commission v. W.J. Howey Co., 328 U.S. 293—

1946); typically this encompasses any passive investment in an entity that will be managed by an asset manager and will have passive investors who are not involved in generating their own profits or making day-to-day decisions about the property.

Investment Summary

A document developed to give investors pertinent information regarding a securities offering and the issuer's business and objectives.

Irretrievably Contractually Committed

When determining when securities notices must be filed with state and/or federal securities agencies, an irretrievable commitment occurs both at: 1) the date of impounds, and 2) the date of acceptance, for any investors accepted after impounds are broken. The issuer must cause applicable federal and/or state securities notices to be filed, generally within 15 days of the date investor funds become irretrievably committed.

Issuer

A legal entity such as a corporation, limited liability company or a limited partnership that sells securities to finance its business objectives. The term 'issuer' encompasses the asset manager, but the 'issuer' entity is the actual entity that is issuing the securities to investors. The issuer is your syndicate, fund, or Investor LLC.

Leverage

The use of debt to finance the acquisition of properties.

Limited Partner

In the real estate context, this is the name applied to passive investors in a limited partnership managed by a general partner (asset manager).

Manager-Managed Limited Liability Company

A manager-managed limited liability company mirrors the structure of a limited partnership, where the “manager” has the same role as a general partner, and the “members” have the same role as the limited partners. The investors are passive investors, although some portion of the membership interests (i.e., Class B) may be reserved for management. The manager of a manager-managed limited liability company usually earns certain fees and a share of profits for its role as the asset manager of the company.

Member-Managed Limited Liability Company

This is the structure typically used for joint ventures; every member is considered by law to be a “managing member.” Where members make cash investments, every investor must be actively involved in generating their own profits – which means they must have more than just a right to participate in voting; they need an actual role in management, thus, this is not the structure to use if one or more of the members desires to earn an extra share of profits or fees for “managing” the company.

Managing Members

The members of a member-managed limited liability company.

Material Facts

Information that must be disclosed to investors in order for them to make “informed consent.”

Mortgage

A loan evidenced by a written legal agreement used to finance the purchase of real estate, in which the borrower (the mortgagor) gives the lender (the mortgagee) a lien on the property as collateral for the loan.

Offering Materials

The documents an asset manager shares with prospective investors to tell them about an investment opportunity; also called “securities offering documents.” Typical offering materials include a private placement memorandum, a subscription agreement, the operating agreement for your syndicate or fund, and an investment summary describing what is being purchased by your syndicate or fund.

Organizational Documents

These documents include the formation documents for your entities, and the operating agreements or limited partnership agreements that identify the members, the asset manager, and their respective rights and duties. Your lender will need these documents, and an accompanying organization chart, showing every entity and/or individual associated with the entity, and their respective percentage interests.

Passive Investors

These are investors who make capital contributions in exchange for interests (i.e., “investment contracts”) in a syndicate or fund, with the expectation that their investment will generate a return on their investment plus a return of their capital contributions based on the asset manager’s efforts in finding, operating, and ultimately disposing of real property on the investors’ behalf.

Ponzi Scheme

An investment scam that involves using funds acquired from new investors to generate income for older investors, instead of operating a legitimate business. Ponzi schemes are similar to pyramid schemes.

Pre-Existing Relationship

This is a relationship that pre-dates an issuer making an offer to invest, and must be “substantive” in nature; see the definition of “substantive relationship.”

Private Placement

An offering of unregistered securities to a pool of investors that must meet certain qualifications.

Promissory Note

A signed agreement between a borrower and lender that contains a written promise by the borrower to pay stated sums to the lender (or its assignee) on or before a specified date, after which all payable sums become

due and payable (i.e., “mature”). Promissory notes may be secured (recorded against real property) or unsecured (backed by a personal guarantee of the borrower). Required payments may be periodic or lump sum, and there are typically remedies that the lender may exercise if the payment terms aren’t met, such as foreclosure against the security, or a lawsuit to enforce a personal guarantee.

Preferred Class

A class of investors who are given distributions by the company before other classes of investors are paid.

Private Equity Fund

An investment strategy that involves forming a company with investors, which invests in other people’s investment opportunities rather than directly owning the investment property. Private equity funds can take a preferred equity position as a single investor in a specified offering or as a joint venture partner in a specific property.

Private Placement Offering

The sale of securities to a relatively small numbers of investors who must meet certain criteria. These types of securities offerings are exempt from the registration and regulation requirements of the Securities and Exchange Commission, under various sections of Regulation D of The Securities Act of 1933, but are generally subject to notice filings at the federal and state level.

Property Manager

An entity, which may be an unrelated third party or an affiliate of the asset manager, whose role is to take care of the day-to-day activities related to a property's physical structure and operations.

Properties

This term refers to real property owned by a syndicate or fund, and is sometimes used interchangeably with the word “assets” when appropriate for the context in which it appears.

Purchaser Representative

A person designated by an investor to advise them regarding the purchase of securities in a private placement. A purchaser representative should be someone who is NOT connected with the asset manager as an affiliate, director, officer or employee, and does not own more than 10% of any class of equity interests (unless related to the purchaser by blood, marriage or adoption and a familial relationship).

Real Estate Syndicate or Fund

A group formed to pool resources to purchase, rehabilitate, operate, and eventually sell real estate. The word “syndicate” typically refers to a specified offering for one or more pre-identified properties, while the word “fund” typically refers to a multi-property offering where the properties have not yet been identified, but will be acquired based on a business plan (investment summary).

Real Estate Securities

Securities issued by a company that owns real estate, allowing the investor to invest in real estate without having to buy land or buildings. This provides the investor the opportunity to invest in real estate without having to become involved with real estate management, while giving the investor limited liability. The investor owns interests in the company, but does not have direct ownership in the real estate owned by the issuer's company.

Registered Agent

A person or legal entity that may be served any process, notice, or demand required or permitted by law to be served on the company.

Registered Investment Adviser

An adviser or firm participating in the investment advisory business and registered with the SEC or with state securities regulatory agencies. Registered investment advisers have a fiduciary duty to their clients.

Resignation of Organizer

A letter generated by the person hired to form an entity on behalf of someone else. The resignation transfers the authority for operation of the company from the person who filed the paperwork with the secretary of state to the persons who will actually be involved in managing the entity.

Safe Harbor

A "safe harbor" exemption from registration is granted to the issuer of securities when an offer and sale of securities complies with the specific

requirements of Regulation D, Rules 504, 505, or 506 under the federal Securities Act of 1933. The safe harbor exempts an issuer from both registration requirements under the Securities Act of 1933, and licensing requirements for securities brokers and dealers under the Securities and Exchange Act of 1934.

Securities Escrow Account

A bank account where investor deposits will be held by a designated escrow agent pending achievement of a milestone in a syndicate or fund. The securities escrow agent will review the issuer's offering materials and enter into an escrow agreement to hold the funds until the milestone (such as a minimum offering amount) has been achieved, and only then will the escrow agent release the funds. If the milestone is not achieved, the escrow agent will return the funds to the original depositors without deduction, except for its own escrow fees.

Securities Offering

The sale of securities by a company, commonly a corporation, limited liability company or a limited partnership.

Securities Offering Documents

The legal documents necessary for an issuer to offer securities to investors. Typically, these documents consist of a disclosure document, a governing document for the company issuing securities, and a subscription agreement between the issuer, with the investor documenting the terms under which the investor buys interests or shares in the issuer's company.

Security

An investment contract between an issuer and at least one other party, which includes the expectation that parties other than the issuer will receive income or a profit. Whether or not an agreement is an investment contract depends on whether it meets the following standards, based upon the Howey Test, which are: 1) an investment of money; 2) in a common enterprise; 3) with an expectation of profits; and 4) generated solely by the efforts of the promoter.

Sophisticated Investor

An investor who either alone or together with his, her or its purchaser representative, has sufficient knowledge and experience with financial and business matters that the investor can evaluate the risks and merits of a contemplated investment.

SPV

A single purpose venture. This is an entity that has been formed for a single purpose; typically to acquire or invest in a single property.

Substantive Relationship

This relationship begins after you have actual knowledge about every investor's financial qualifications (such as whether they are accredited or sophisticated) and "suitability" before you make offers to invest; which the SEC believes cannot be done solely by an electronic exchange of information.

Syndicate

A group of people who pool resources to achieve a common goal or for a common purpose. In a typical real estate syndicate, investors contribute cash and the asset management team contributes at-risk capital, time and knowledge in order to acquire, operate, improve, and ultimately dispose of real estate.

Syndicator, Fund Manager, Asset Manager, Asset Management Entity or Asset Management Team

These terms all refer to the active group of investors who form, organize, and run a syndicate or fund on behalf of passive investors. Real estate asset managers focus on maximizing a property's value for investment purposes. Asset management team refers to the members of the asset management entity. Asset manager is the entity itself.

The term ‘asset manager,’ ‘asset management team’ or ‘asset management entity’ refers to the entity formed specifically to be the manager of the issuer of securities (your syndicate or fund), and includes the members of the asset management entity who are actively involved in managing the issuer on behalf of investors.

Track Record

This is a written, tabular, or graphic description of your (or your management team’s) prior experience with similar properties and investors, and to be complete, must include both good and bad experiences.

Tranche

The process of raising funds in a series of closings, versus trying to raise all of the money at once; this is typically used in a fund versus a syndicate setting. Syndicates typically need a finite amount to close on a property within a specific period of time so they raise what they need as quickly as possible; whereas funds generally raise funds as they are able to deploy it.

Transaction Based Compensation

Compensation to someone associated with, or employed by, an issuer that is related to the amount of capital they raised for an offering. Only licensed securities broker-dealers may earn transaction based compensation; all others may only earn compensation for their role in management other than raising money; see Chapter 26.

ABOUT THE AUTHOR

About Attorney Kim Lisa Taylor

Kim Lisa Taylor is the founder of Syndication Attorneys, PLLC, a law firm that provides corporate securities and commercial real estate transactional services nationwide. She is a nationally recognized corporate securities attorney, licensed in California and Florida. She routinely teaches securities compliance and real estate deal structuring at live and virtual real estate events in front of crowds of 20-1,000 attendees.

Kim is also the host of the popular podcast “Raise Private Money *Legally*,” which has published over 70 episodes and is rated in the top 25% of BuzzSprout podcasts. Kim additionally holds a Certified Capital Raising Specialist designation from the Investment Certification Institute.

Her first book, “How To *Legally* Raise Private Money” has over 5,000 copies in circulation, and has received many, many positive reviews. This second book expands on the content provided in the first book, going into greater depth and covering topics that Kim and her legal team field from potential clients every single day.

About Syndication Attorneys, PLLC

Syndication Attorneys, PLLC is a growing Florida corporate securities law practice that currently employs both long-term contractors and service providers. The firm’s law practice is focused on helping clients structure their corporate entities and securities offerings under federal and state securities laws. Additionally, the firm’s staff provides commercial real

estate transactional services and professional investor marketing materials for clients who wish to legally raise capital from private investors.

Syndication Attorneys, PLLC's legal team includes:

- Mola Bosland, Attorney and Operations Director, and patient client shepherd;
- Michael Fugler, Attorney, who has over 25 years of securities experience in private and public offerings with both real estate and small business clients;
- Bishoy Habib, Attorney, the lead attorney in our commercial real estate transaction division.
- Charlene Standridge, Law Clerk and Business Development Director
- Ruth Remenar, Head Paralegal
- Susan Rathbone, Paralegal and Admin Support
- Sandra Bryant, Law Firm Administrator and Paralegal
- Melissa Salcedo, Administrative Assistant

Our marketing team includes:

- Cassia Watts, Marketing Director, who handles our website, automations, and oversees all other marketing personnel
- Linda Wienandt, our in-house Professional Editor and Graphic Designer, who prepares our newsletters, and also creates client investor marketing materials including investment summaries, pitch decks, one-pagers, and websites
- Dana Bisbee, our Social Media and Podcast Team Leader who creates and manages all of our social media and podcast posts

- The Hatchery, our Website SEO and Google Ad Consultants
- Successwise, the best marketing consulting firm we ever hired!

For more information about our firm, go to:

<https://www.SyndicationAttorneys.com>

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 - a. Comparison of Financial Implications of 3 Common Waterfalls
 - b. Crowdfunding and Investor Management Platforms
 - c. Crowdfunding Categories
 - d. Federal Securities Exemptions
 - e. Federal v. State Securities Exemptions
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