

Syndicated Real Estate Investments: Raising Capital in the Post-JOBS Act Environment

Navigating Investment Entity Structures, Securities Law Compliance and Private Equity Considerations

Wednesday, February 4, 2015

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Stafford Publications, Inc.
February 4, 2015

Set the Stage

- In 2013, real estate ownership, development, leasing and related activities accounted for an estimated 5 to 7% of the gross economic activity in the United States, according to the U.S. Bureau of Labor Statistics.
- At its core, a syndicated real estate transaction involves bringing a group of individual investors together to pool capital for investment in real estate.
 - » For the investor, syndication offers an opportunity to gain access to large-scale property investment opportunities that he, she or it otherwise may not be able to access.
 - » For the sponsor of the syndication, it offers an alternative source of capital for capitalizing on deals and for facilitating diversification of the sponsor's own capital.

Legal Structure

- At the outset, a syndicated real estate transaction involves the sale and distribution of a security within the meaning of the Securities Act of 1933, as amended, and the various other applicable federal and state securities laws.
- There are four basic legal structures used in syndicated real estate transactions: a corporation; a general partnership; a limited partnership; or a limited liability company. Selecting the appropriate form involves practical as well as legal and tax considerations.
- The most common legal structures used today in syndicated real estate transactions, however, are the limited partnership and limited liability company.
- Issues such as limitation of liability, management, the method selected to raise the necessary capital (debt and equity), investor make-up; regulatory considerations, and federal, state and local tax implications typically drive the selection of the legal structure for a syndicated real estate transaction.

Securities Compliance & JOBS Act

- **What is the JOBS Act?** – The Jumpstart Our Business Startups Act (JOBS Act) was signed into law on April 5, 2012. The Act's purpose is to stimulate economic growth by loosening regulatory restrictions that apply to the capital raising activities of small private and emerging market companies. Additionally, the JOBS Act added innovative methods to the regulatory regime for capital raising activities.
- **What does the JOBS Act do?** – The JOBS Act significantly altered the state of capital raising activities by (a) allowing sponsors to raise up to \$1 million from a large group of both accredited and non-accredited investors, (b) loosening regulations for small private and emerging market companies to go public, and (c) requiring the U.S. Securities & Exchange Commission (SEC) to amend Rule 502(c) of Regulation D to lift the restriction on general solicitation and advertising to investors in private placements.

General Solicitation v. Crowdfunding

- The JOBS Act impacted syndicated real estate transactions in two principal manners.
 - » First, as a result of Title II of the JOBS Act, the SEC created Rule 506(c), which rule is effective today. Rule 506(c) amends Regulation D to permit the general solicitation and advertising of private placements to non-accredited investors so long as the sponsor takes reasonable steps to ensure that any actual sales are made only to accredited investors.
 - » Second, as a result of Title III of the JOBS Act, a new exemption from registration under Section 4 of the Securities Act of 1933 is to be created that will allow sponsors to raise up to \$1 million in capital from accredited and non-accredited investors by selling the underlying securities through a broker or an approved SEC funding portal. This is what is commonly referred to as “Crowdfunding”. The SEC has stated its intent to finalize the Crowdfunding rules by October 2015, with an expected effective date in early 2016.

General Solicitation – The Basics

- Rule 506(c) allows sponsors to raise *an unlimited amount* of money from *accredited investors* (subject to other conditions of the rule). Under this new rule, sponsors can generally solicit their offerings (subject to conditions and requirements). This is a significant departure from existing Regulation D and similar rules previously issued by the SEC.
- The SEC's repeal of the ban on general solicitation relates to accredited investor-only offerings under Rule 506(c). Accredited investors are generally individuals with a greater than \$1 million net worth, excluding their primary residence, taking into account debt on that residence in excess of its fair market value. This includes individuals with incomes in excess of \$200,000 in the last two years, with the expectation of the same in the current year, or \$300,000 with a spouse.

Crowdfunding – The Basics

- The current Crowdfunding rules proposed by the SEC provide the following framework:
 - » **The Investors** – An investor with an annual income or net worth above \$100,000 is capped at an annual crowd funded investment of 10% of the investor’s annual income or net worth. Whereas, an investor with an annual income or net worth below \$100,000 are capped at an annual crowd funded investment of the greater of \$2,000 or 5% of the investor’s annual income or net worth.
 - » **The Sponsors** – The sponsors are required to make an initial filing with the SEC to disclose operational structure and financial wellbeing of the sponsor, as well as information pertaining to the securities offered, including but not limited to the offering amount and the price of the securities. Additionally, the sponsor is required to file an annual report with the SEC, and provide a copy of such filing to the investors.

Title II vs. Title III – Key Differences

- The key differences between Rule 506(c) and Crowdfunding offerings are:
 - » Rule 506(c) offerings are legal now; an unlimited fund raise is possible, but only from accredited investors. There is no cap on the amount an individual investor may invest or the total all investors may invest collectively. General solicitation is allowed. Other conditions apply, such as an obligation to take reasonable steps to verify the accredited investor status of the investors, including reviewing Form W-2s , etc. Sponsors engaged in a Rule 506(c) offering are not required to use an intermediary, like a broker-dealer or SEC registered portal.
 - » Crowdfunding under Title III of the JOBS Act is not yet legal; it will not be until the SEC issues the associated regulations – which is currently expected to be October 2015, with an effective date in early 2016. Once legal, sponsors will be able to raise capital from both accredited and non-accredited investors, but there will be limits on the amount each investor can invest and a cap on the overall amount all investors can invest during any 12 month period. Sponsors that crowd fund will be required to use a registered broker-dealer or a registered funding portal.

The JOBS Act in Short

	Rule 506(c)	Crowdfunding
Permitted under existing laws?	Yes	No
Individual Investor Limits?	No	Yes
Aggregate Fund Raise Limits?	No	Yes
Advertising Allowed?	Yes	No*
Investors Eligible?	Accredited Investors Only	Both Accredited & Non-accredited Investors
Broker or Intermediary Required?	No	Yes

* Once legal, it is expected that sponsors will be able to advertise notices which direct investors to the funding portal or broker.

Equity Syndication – Overview

- Syndicated real estate transactions provide an investment vehicle for passive investors who are not in a position to spend significant portions of their time searching for, and then managing, appropriate investment properties.
- Sponsors of syndicated equity real estate transactions, often individuals or companies experienced in sourcing and managing real estate opportunities, desire to access this type of passive investment capital so as to allow such sponsor to diversify his, her or its own capital over several different projects.
- There are several possible legal structures for syndicated equity real estate investments but the most common is the limited liability company because it allows both the sponsor and investors to limit their liability to the value of their investment in the venture. While the considerations are numerous when deciding which legal structure to use, a common driving factor is the answer to the question of “who gets what – and how much”?
- In most syndicated equity real estate transactions, the sponsor provides a relatively small portion of the capital for the investment, but offers the investment opportunity and the time and expertise to make the investment successful.

Syndication Basics

- The basic types of syndicated equity real estate offerings are as follows:
 - » **Specific Offering:** The sponsor identifies one or more specific assets to be acquired and raises the amount of capital necessary to acquire such assets. This allows the investors to examine each property and to make a decision regarding the investment potential of each asset before they invest. This is the most often used structure for syndicated equity real estate transactions.
 - » **Semi-specific Offering:** The sponsor identifies one or more specific properties to acquire and presents a business plan to investors to raise capital to purchase additional properties that have not yet been identified. This offering is popular for sponsors who want to provide diversification to their investors and raise larger amounts of capital without multiple offerings.
 - » **Blind Pools:** The sponsor presents a business plan to investors explaining how the sponsor will go about acquiring properties but does not identify specific properties. The investors must understand the business plan, see its value, and be convinced that the sponsor can succeed with the plan. Generally the sponsor must have a track record of doing specific or semi-specific offerings to be successful in raising capital for a blind pool.

The Investor's Risks v. Benefits

Risks	Benefits
<ul style="list-style-type: none">• Property type/class, operational concerns, market conditions	<ul style="list-style-type: none">• Sponsor can bring expertise that investors may leverage
<ul style="list-style-type: none">• Sponsor experience and commitments to other projects	<ul style="list-style-type: none">• Sponsor's with enough "skin in the game" will work hard towards success
<ul style="list-style-type: none">• Sponsor may be motivated to move on and thus sell the property too cheaply	<ul style="list-style-type: none">• Sponsor's with significant share in the upside will try to maximize a sales price
<ul style="list-style-type: none">• Sponsor's interests may not otherwise be fully aligned with those of the investors	<ul style="list-style-type: none">• Structured with proper incentives, a project can represent an attractive opportunity

Investor Considerations

- Resolving the risk/benefit paradigm will depend largely on the risks and benefits involved in the particular project. However, certain customary questions and issues include the following:
 - » How much capital will the parties provide?
 - » Will there be a “preferred return” before sharing any additional profits?
 - » How will those remaining profits be split?
 - » Will the Sponsor be entitled to a management fee or other payments?
 - » Who will get any available tax benefits?

Common Resolutions

Limited Members	Sponsor
<ul style="list-style-type: none">• Provide the vast majority of the capital (often 80 to 95%)	<ul style="list-style-type: none">• Provide a small portion of the capital (often 5 to 20%)
<ul style="list-style-type: none">• Receive a “preferred return” on their invested capital (often 5 to 10%)	<ul style="list-style-type: none">• Receive the same preferred return as investors on its own invested capital
<ul style="list-style-type: none">• Receive a share of the remaining cash flow and profits (often 50 to 80%)	<ul style="list-style-type: none">• Receives a “promote” share of the remaining cash flow and profits (often 20% +)
<ul style="list-style-type: none">• Receive the bulk of the tax benefits, such as depreciation and interest deductions	<ul style="list-style-type: none">• Receives some share of the tax benefits
	<ul style="list-style-type: none">• Receives a fee relating to property acquisition, loan financing and management

Real Estate Syndication Stats, 2012

Source: RealtyShares.com

Average Syndication Size:	\$2.3 million
Investor Commitment:	80 to 95% of Required Capital
Sponsor Commitment:	5 to 20% of Required Capital
Average Preferred Return:	8%
Average Sponsor Acquisition Fee:	1%
Sponsor Property Management Fee:	2 to 9% of Gross Revenue

Entity Considerations

- **Corporation:** This form insures centralized management as well as limited liability for the sponsor and investors. However it is seldom utilized in syndicated equity real estate transactions because of its negative tax implications. Usually a consideration where one or more investors are foreign or “off-shore” investors.
- **General Partnership:** This avoids the double taxation usually involved in a corporate entity, but the unlimited liability provision and lack of centralized management inhibit its use. Usually a consideration in tenant-in-common syndicated transactions.
- **Limited Partnership & Limited Liability Company:** This combines nearly all of the advantages of the corporate and partnership forms. It has the corporate advantages of limited liability for the sponsor and investors, and centralized management. It also offers the tax advantages of a partnership.

Debt Syndication – Overview

- Syndicated Real Estate transactions are not limited to the equity in the underlying project. Lenders closed approximately \$244.2 billion of commercial/multifamily mortgage loans in 2012. With this rapid growth in volume, the escalating size and complexity of such loans and the projects securing them, lenders have increasingly turned to the syndicated real estate markets as a means to diversify their risk.
- The changes in the law facilitated by the JOBS Act are also not limited in any way to equity products only. In fact, many Rule 506(c) offerings today involve investor participation in the debt secured by a particular real estate project rather than the project itself.
- Important differentiating factors in debt versus equity syndicated transactions include: what is the investor ultimately investing in; the source of repayment of the investment; the risks associated with such investment instrument; and the ultimate yield on the investment payable to the investor.
- The primary incentive for syndicating loans in today's market is risk diversification, leveraging income, and maintaining relationships with clients.

The Lending Syndication

- In any syndicated loan transaction, it is vital that the primary and syndication loan documents clearly define the role of each party, and set forth the relative rights, obligations and priorities among the parties.
- While many provisions are standard, some may be heavily negotiated or modified by side letters between the lead lender and co-lenders/participants. These issues include the following:
 - » **Assignment & Assumption Agreement:** The sale of the interest in the loan is documented by this agreement. While not usually heavily negotiated, one important issue in this document is the detailed true-sale language to support favorable treatment under tax and bankruptcy laws.
 - » **Information Rights of Co-Lenders and Notice Provisions:** The loan's primary documents will govern when third parties and the borrower are required to give notices and to whom. The syndication documents will address the types of notices and other information the lead lender is obligated to give to its and co-lenders/participants. Co-lenders/participants typically want to negotiate as broad a right as possible.

The Lending Syndication – Cont'd

- » **Liability & Reliance on Lead Lender:** The lead lender usually limit its liability to its co-lenders/participants to willful misconduct or gross negligence resulting in actual damages. The lead lender is usually held to the standard that it would use in its own transactions.
- » **Decision Making:** The lead lender customarily wants the maximum amount of freedom possible with respect to administering the loan, including avoiding interference or delay due to co-lender/participant involvement. However, co-lenders/participants will want some degree of control over key issues such as material amendments to the loan documents (such as changes in the interest rate, maturity date or increase in the loan amount). Co-lenders/participants also want control over the management of the collateral, decisions regarding acceleration of the loan after an Event of Default, release of any collateral, actions that affect the value of the collateral, and appointment of any successor lead lender.

The Lending Syndication – Cont'd

- » **Intercreditor Agreements:** Some syndicated real estate loans involve senior and subordinate tranches within a facility that are secured by (a) the same mortgage (e.g., an A/B Loan Structure), or (b) the ownership interests of successive layers of entities that ultimately own the collateral owning entity (e.g., mezzanine borrower structure). Because of this senior-subordinate relationship in the same ultimate collateral, the rights and priorities of the respective parties must be set forth in a written agreement. Key elements of negotiation often include: (a) limitations on the rights of the subordinate lenders to take enforcement actions; (b) agreements by the subordinate lenders not to challenge the enforcement or foreclosure actions taken by the senior lenders; and (c) limitations on other secured creditor rights of the subordinated lenders (e.g., bankruptcy rights).
- » **Defaults & Payment Priorities:** They syndication documents typically specify both the pre-default and post-default waterfall. For an A/B loan or other senior/subordinate note structure, the senior group will typically be paid first. In exchange for this waterfall, the subordinate lender has typically received a higher interest rate to compensate it for this subordination risk. Issues that are negotiated include reimbursement of the lead lender for expenses, including any protective type advances.

Financing Considerations

- Sponsors of syndicated equity real estate transactions generally face the same issues as any other buyer of real estate when it comes to the availability of debt financing.
- However, such sponsors also face additional hurdles in the underwriting process because in many cases a lender may also underwrite the syndication group to determine creditworthiness, net worth, liquidity and property management expertise.
- It is not uncommon for lenders to seek to underwrite individual members of a syndication group whom have more than a 15% interest in the venture.
- Depending on a particular transaction, it is not unusual for a lender to require that the sponsor have an unencumbered net worth in an amount equal to or larger than the amount of the requested loan, and to require the venture to have liquid cash equal to six to 12 months of projected debt service.
- In some cases, a lender may look to involve the sponsor or investors as credit enhancers to the loan transaction, which usually increases the cost of the underlying equity syndication.

Financing Considerations – cont'd

- Two often overlooked issues that should be given consideration include:
 - » **Guaranty Back Stop:** If, as and when an investor is asked to become a credit enhancer to any underlying loan, a carefully drafted guaranty backstop from the sponsor or other investors should be negotiated. This should provide for an equal allocation of liability to the other venture participants in the event the guaranty is ever called upon by the lender.
 - » **Recourse Care-Outs:** Even in a non-recourse loan situation, investors will want to pay particular attention to the situation under which the “bad boy” guarantor (typically the sponsor) may be called upon to satisfy lender losses (or the loan). Consideration should be given to whether the occurrence of these events should be outside the scope of any indemnification or exculpation provisions under the venture documents.

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