Deal Syndication

Video 1

Rules Governing Syndications

Video Overview

Video 1: What's covered?

- What is a syndication?
- Who may participate?
- Rules governing syndications

Disclaimer

I am an attorney, but I am not YOUR attorney.

I am NOT a securities lawyer.

You may not rely on any of this as legal advice.

You must obtain your own securities lawyer if you are contemplating doing a syndication.

What Is A Syndication?

A syndication = a pooling together of money and expertise to invest in real estate

It's the coming together of people with money who don't want to manage real estate actively (i.e., "passive investors") with people who want to actively manage real estate and seek to bring passive investment funds into the deal to help close it.

What Is A Syndication?

- The person or group contributing the real estate expertise is the "sponsor" or "promoter"

- The people contributing the money are "investors"

What Is A Syndication?

Sponsor's Role

- Find a deal and put it under contract
- Perform due diligence
- Set up ownership structure
- Arrange financing
- Sign on mortgage debt
- Oversee property manager
- Deal with lender
- Communicate with investors
- Make distributions of profits
- Oversee preparation of financial statements and tax returns
- Oversee sale of property at end of holding period

What Is A Syndication?

Investor's Role:

- Write a check at closing
- Receive checks during distributions
- Respond to capital calls, if any

What Is A Syndication?

Basic syndication structure:

- Sponsor forms an entity (LLC)
- LLC purchases a property
- Sponsor sells membership interests to the investors
- Investors get priority on returns from property
- Sponsor earns fees and has a secondary claim on returns from property

Rules Governing Syndications

A syndication = a sale of securities

- Income is "passive" when one person earns money solely through the efforts of another person
- A right to collect a stream of passive income from another person is known as a "security"
- When you sell a membership unit in an LLC, you are selling a security
- The sale of securities is governed by the Securities and Exchange Commission (SEC)
- **The SEC imposes civil and criminal penalties for violation of its rules on the sale of securities**
- **You need an <u>experienced securities lawyer</u> if you do a syndication**

Rules Governing Syndications

Sale of Securities:

- Requires registration with SEC = IPO
- Unless your offering falls within an exemption to the registration requirements

Rules Governing Syndications

Two primary exemptions to the registration requirement

- Regulation D, Section 506B
- Regulation D, Section 506C
- Colloquially, these are known as "Reg D" offerings
- They are also called "private placements" of securities
- Under 506B or C your offering is also exempt from state Blue-Sky securities regulations

Who May Participate In Private Placements?

Two types of investors:

- “Accredited” Investors
- “Sophisticated” Investors

Who May Participate In Private Placements?

Accredited Investors =

- $200,000 in individual income last year and anticipated this year, or
- $300,000 in joint spousal income last year and anticipated this year, or
- $1,000,000 in net worth, excluding the primary residence
- Various corporate/entity definitions as well, but not relevant here.

Who May Participate In Private Placements?

Sophisticated Investor =

- "a type of investor who is deemed to have sufficient investing experience and knowledge to weigh the risks and merits of an investment opportunity."
- Extremely vague
- Recommended that you establish a definition of "sophisticated" (ex: only attorneys, CPAs, financial advisors, investment advisors, etc., or have invested $X in prior deals), document it, and stick to it every single time you bring "sophisticated" investors into a deal
- No income or net worth requirements for sophisticated investors

Rule 506B Offering

- The traditional and easiest way to do a private offering and the most common type of private offering in real estate
- Forbids "general solicitations" to investors
- Requires a "pre-existing substantive relationship" with all investors
- No limit on amount raised in total
- No limit on amount raised per investor
- Unlimited number of accredited investors
- Up to 35 sophisticated investors

Rule 506B Offering

What's a "general solicitation"?

- It's a solicitation to buy securities to any person with whom you do not have a "pre-existing substantive relationship"
- Forbidden under Rule 506B
- If you generally solicit, your private offering becomes a public offering (IPO), subject to the registration requirements

Rule 506B Offering

What's a "pre-existing relationship"?

- "Pre-existing" = "you" knew the investor before you contemplated the deal you're offering them
- "You" includes your partners, your attorneys and any registered broker-dealer you hire to raise capital
- Best practice is never to offer someone you just met the chance to participate in an active deal. Offer them the next deal.

Rule 506B Offering

What's a "substantive relationship"?

- "Substantive" = you've talked to them enough to feel reasonably confident that they're not lying to you when they say they are accredited
- Ex. They say they are accredited and they are an investment banker = okay!
- Ex. They say they are accredited and they work at Starbucks = probably not okay!
- Judgment call, no bright lines -> be careful

Rule 506B Offering

Advantages of Rule 506B Offering:

- You are entitled to rely on an investor's representation that he/she is accredited
- No obligation to verify accredited status
- Can have up to 35 sophisticated investors in the deal
- "You" covers your attorney and broker-dealer for purposes of pre-existing relationship

Rule 506B Offering

Important Notes about Rule 506B Offerings:

- If you have only accredited investors, you do not legally need to do a private placement memorandum (PPM)
- However, you ABSOLUTELY SHOULD from a legal liability standpoint
- Proper PPM protects you from all claims by investors except fraud and gross negligence
- If you have even ONE sophisticated investor, you must do a very detailed PPM, which is much more expensive than the PPM you would do with only accredited investors.

Rule 506C Offering

- A relatively recent addition to the private placement rules as part of the JOBS Act.
- A partial relaxation of rules governing Rule 506B offerings

Rule 506C Offering

Differences with Rule 506B Offering

- You may engage in general solicitation
- You do not need a pre-existing substantive relationship with investors
- Only accredited investors may participate
- Sponsor must verify actual accreditation status of every investor who participates

Rule 506C Offering

Verification:

- Tax returns to verify income
- Analysis of net worth through viewing their bank accounts or other assets minus their liabilities
- Certification of net worth by licensed attorney, broker-dealer, investment advisor or accountant

Differences Between 506B and 506C

	506B Offering	506C Offering
Pre-existing substantive relationship	Required	Not required
General solicitation	Forbidden	Permitted
Sophisticated investors	Up to 35 permitted	Forbidden
Verification of accredited status	Sponsor can rely on investor's self-verification	Sponsor must verify actual accredited status

What If You Screw Up?

Consequences for getting this wrong are high

- SEC can bring an "enforcement action" against the sponsor
- Investors get rescission rights (they can demand their money back)
- Possible criminal charges against the sponsor
- So the lesson here is hire an <u>experienced</u> syndication lawyer if you plan to syndicate a deal

Next Up

Video 2: Structuring a Syndication

- Structure of the LLC
- Suggestions for structuring your business entities
- Distribution “waterfall”
- Sponsor fees
- Who signs the debt