

Real Estate Syndications: Navigating Minefields for the Unwary

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1

Part I Your Client is the Issuer



2

2

Under Section 2(a)(1) of the United States Securities Act of 1933, as amended (the “Securities Act”), the term “security” is defined as:

“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.”

3

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3

Under the Securities Act, every offer and/or sale of a security is required to be either:

- Registered with the Securities and Exchange Commission (“SEC”), or
- Qualify for an exemption from registration.

Private Placements under Section 4(a)(2) of the Securities Act are the solution.

4

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How does an issuer qualify for an exemption under Section 4(a)(2)?

- Rule 504 of Regulation D
- Rule 506(b) of Regulation D
- Rule 506(c) of Regulation D

5

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5

How do you qualify under Rule 506(b)?

- No general solicitation
- No limitations on offering size
- Securities can be sold to an unlimited number of accredited investors
- Making knowledgeable persons available to answer questions
- If you have a private placement memorandum or similar document, which sets forth substantially all of the information that would be required in a registration statement under the Securities Act, you can include up to 35 non-accredited investors

6

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Who qualifies as an accredited investor?

- Any individual that earned income that exceeded \$200,000 (or \$300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year
- Any individual who has a net worth over \$1 million, either alone or together with a spouse (excluding the value of the person's primary residence)
- The issuer's directors, executive officers, or general partners
- A financial professional holding a FINRA Series 7, 62, or 65

7

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What is the difference between Rule 506(b) and 506(c)?

- Rule 506(c) allows for general solicitation if and only if:
 - All of the other requirements of 506(b) are met,
 - All of the investors are accredited investors, and
 - The issuer has taken reasonable steps to verify that its investors are accredited investors.
- Trap for the unwary: A single unaccredited investor can disqualify an offering from qualifying for the Rule 506(c) safe harbor

8

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State Securities Regulation — "Blue Sky" Laws

- Issuers must consider state "blue sky" laws. These are state laws requiring issuers to register securities or find an exemption, make filings, and generally comply with state regulations even if the securities are exempt from federal regulation
- Federal pre-emption — Securities offerings under Rule 506 are "covered securities" under federal law, which pre-empts states from Regulating Rule 506 offerings under state blue sky laws but there may be other state compliance requirements

9

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Other Securities Issues — Funds

- If your client wishes to raise a fund to invest in a class of real estate assets, the Investment Company Act of 1940 (the "40 Act") or Investment Advisors Act may apply
- These laws generally apply to funds, and not to single asset LLC investments, and could require registration of the fund manager with regulators as an investment advisor
- There are exemptions to the registration requirements based on the number of investors or qualified purchasers, as well as a specific exemption for certain real estate funds (Section 3(c)(5)(C) under the 40 Act)

10

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10

Your client has decided on a Private Placement — How do you document it?

- Accredited Investor Questionnaire and/or Subscription Agreement
- Private Placement Memorandum or similar document
- Limited Liability Company Agreement (“LLC Agreement”)

11

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11

Are there any requirements after the sale?

- Form D — File with SEC:
 - A company is required to file a notice with the SEC on Form D within 15 days after the first sale of securities in the offering
 - A company must obtain EDGAR codes from the SEC to file electronically
 - Trap for the unwary: This takes a few days, so plan in advance
 - A Form D Filing is not a condition to qualify for the Regulation D exemption

12

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12

Are there any requirements after the sale? (cont'd)

- State filings may be required in each state the issuer has sold securities (i.e., where the purchasers are located):
 - Federal pre-emption may supersede state requirements
 - Blue sky requirements must be investigated in each state

13

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What if your client does not properly conduct the offer and/or sale of the securities?

- Investors have a rescission remedy — they can “put” the securities back to the issuer and require the company to repay the purchase price, as well as interest, attorneys’ fees and other costs
- In some cases, involving fraud or bad faith, culpable officers or directors may be required to repay
- The SEC may impose penalties and fines
- States may impose penalties and fines

14

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14

Part II

Your Client is the Buyer

Review of Issuer Documents – Accredited Investor Questionnaire and/or Subscription Agreement

- What are you looking for?

Review of Issuer Documents – Private Placement Memorandum

- What are you looking for?

17

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Review of Issuer Documents – LLC Agreements

- Taxes
 - Taxed and managed as partnership
 - How are tax gains and losses passed through to the investors?
 - Trap for the unwary: Investors should be entitled to minimum tax distributions

18

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Review of Issuer Documents – LLC Agreements (cont'd)

- Additional Capital Calls
 - Are the investors required to contribute additional capital?
 - If so and the investor fails to do so, what are the repercussions?
 - Trap for the unwary: Dilution provisions can be severe

19

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Review of Issuer Documents – LLC Agreements (cont'd)

- Voting Rights – Generally limited to “major decisions”, such as:
 - Issuing additional membership interests or creating an additional class of membership interests
 - Amending the formation document
 - Amending the LLC Agreement, except in limited circumstances
 - Filing for bankruptcy
 - Filing for dissolution

20

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20

Review of Issuer Documents – LLC Agreements (cont'd)

- Waterfall (i.e., how your client gets his/her money back) – Sample Provision:

4.3(a) Distributions of Available Cash. Subject to Section X [Distributions with Respect to Taxes], Available Cash shall be distributed to the Members by the Manager, as and when determined by the Manager, in the following order of priority:

(a) First, to the Members in proportion to their respective Percentage Interests, until each Member has received aggregate distributions pursuant to this Section 4.3(a) such that it has received its 7.0% Preferred Return;

(b) Second, to the Members in proportion to their respective Percentage Interests, until each Member has received aggregate distributions pursuant to Section 4.3(b) such that it has received a return of its Capital Contribution;

(c) Third, to the Members and the Manager, in the following proportion: (i) 75% to all Members in accordance with their respective Percentage Interests, and (ii) 25% to the Manager, until the Members receive an Internal Rate of Return of 12% on their Capital Contributions; and

(d) Thereafter, to the Members and the Manager, in the following proportion: (i) 50% to all Members in accordance with their respective Percentage Interests, and (ii) 50% to the Manager.

21

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21

Review of Issuer Documents – LLC Agreements (cont'd)

- Manager Fees
 - Paid prior to distributions of available cash
 - Trap for the unwary: Clients do not necessarily expect this although it is standard
 - Examples — Acquisition fee, asset management fee, loan origination fee, disposition fee, construction management fee, property management fee
 - What is market varies greatly depending on the type and size of the asset

22

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22

What if the issuer does not properly conduct the offer and/or sale of the securities that your client is buying?

- The purchaser's primary remedy is rescission, a right to "put" the security back to the issuer for a refund
- Under some circumstances, especially involving bad faith or fraud, the purchaser may recover costs and attorneys' fees

23

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23



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24

24