Real Estate Professional as Investor - Select Considerations

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A. PLATFORM .

1. If you are contemplating more than a "one-off," consider forming a dedicated platform company that would (i) enter into purchase contracts (if the offer is accepted and the property passes due diligence, the contract would be assigned to a special purpose vehicle to hold title to the property), (ii) be your "brand," (iii) establish payroll for employees and (iv) receive deal fees. The platform company would not own any property.
2. The platform company would generally be a limited liability company (LLC), but there are some benefits to being an S corporation. The S corporation benefits may, in the long run, be outweighed by S corporation disadvantages. Discuss with your tax advisor.

B. WHAT SPECIAL PURPOSES ENTITY TO USE TO OWN REAL ESTATE?

1. Almost always, the answer will be an LLC. If one owner, the LLC will be taxed as a sole proprietorship. No separate income tax return.If more than one owner, the LLC will be treated as a partnership - tax items flow through to the members (partners) who receive Schedules K-1 to report their shares of income, loss and other tax items."Series" LLC are generally to be avoided: mostly for the penny-wise and pound-foolish.
2. Limited partnerships may be used for larger real estate investment funds but generally not for individual deals.
3. S corporations (despite being a flow-through like a partnership) are almost always ill- suited for real estate. Exceptions include structuring for TIFs.
4. C corporations are always ill-suited due to double taxation. Exceptions for foreign ownership of US real estate.
5. REITS are for larger institutional transactions or funds and other special situations.

C. WHERE SHOULD THE LLC BE FORMED ?

1. In small to mid-size deals, the state in which the property is located.

2. Where there will be investors, Delaware is preferred for its better controlling member case-law.
3. With larger deals with insurance company, CMBS or agency financing, or with certain banks following CMBS and agency-like criteria, Delaware may be required (if not on acquisition financing, then possibly on a future financing).

D. PARTNERS OR INVESTORS - REGULATORY ISSUES ?

1. If you (the sponsor) will be supplementing your own capital with capital from others, a threshold question (that drives a number of regulatory considerations) is whether those other capital providers are " partners" who share control with you or whether they are more like " investors" who will look to you for expertise and pay fees and promotes to you for managing the asset. This distinction between partners and investors is an imprecise but often useful way of beginning to think about whether you have entered a complex and nuanced regulatory environment when it comes to raising or managing other people's money.There are easy cases:You and two of your colleagues pool your funds to buy and lease a building and share control. Probably no securities laws issues.You and one of

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your colleagues raise the bulk of funds from a handful of friends and family. The two of you control the deal, charge acquisition, disposition and other asset management fees and earn promotes if the deal is successful. Your offering to friends and family is likely subject to securities laws.There are harder cases - you raise money from two deep-pocket investors who you know well, one of whom is your brother-in-law. You control the deal subject to certain major decision rights. You charges fees and promotes. No easy answers, only practical judgements.

2. What are the regulatory issues?Offerings of privately placed "securities" are regulated by the Securities Act of 1933 and State laws.Disclosure (offering) documents (PPM) - intended to mitigate the risk that an investor can later seek reimbursement of investment losses on the basis that you did not disclose all material information in the sale of a security. Varied forms.Federal "Reg D" filings at the Federal level."Blue Sky" filings at the State level (based on residency of investor).Offerings should be limited to "accredited investors" (for whom disclosure can be on the lighter side). Accredited investors include individuals with annual net income over

$300,000 (married couple) and a net worth over $1 million (exclusive of primary residence).General Solicitation and Crowdfunding - growing rapidly but likely to remain an inconsequential part of the capital market. Benefits for small investors. Risks for unsuspecting sponsors.Investment Company Act (this is the Act that governs large mutual funds but it can also apply to larger privately placed investment funds). Exemptions for pools of fewer than 100 investors, pools of qualified purchasers ("super-accredited" investors) and still a fairly broad exemption for real estate.Investment Advisers Act (this is the Act that governs financial advisors who recommend and manage investment securities). Pre-Dodd Frank, a broad exemption for real estate investments. Now, distinctions must be made between actively and passively managed real estate (passive real estate interests may be viewed as securities), and equity versus debt (making or buying loans may be viewed as securities). Federal and State rules kick in at different levels of "assets under management."Broker-dealer considerations - cannot pay commissions or finder's fees to those who help you raise money unless they are registered broker-dealers. These rules also regulate how you compensate employees who assist in money-raising activities.

E. WHAT SHOULD AN LLC OPERATING AGREEMENT LOOK LIKE?

1. Design According to the Four Things that Matter. Focus on what is important (do not just follow the boilerplate): (a) contributions (initial and additional), (b) distributions (the "waterfall"), (c) governance (control) and (d) exits (buy-sells, drags, etc.).
2. Contributions - following the initial capital raise, what mechanisms are in place for bringing additional equity to the table if needed in the future? Who decides? What are investor expectations for putting in additional funds (mandatory versus optional calls)? What happens if additional capital does not come in proportionately (linear or punitive dilution, based on aggregate capital or fair market values)? Impact (if any) on promotes.
3. Distributions - "Waterfalls" come in all shapes and sizes and are mainly a function of market. Not only what other deals for similar assets look like, but what it takes to sell your deal to investors. How much promote you can charge is a function of deal profile (usually lower promotes on stabilized properties), your track record (usually

lower promotes if this is your first time out) and your investor base (usually higher promotes for friends and family or the "country club set" than for HNW and family office investors familiar with the institutional standard of 20%). A preferred return is not interest on capital; it is a hurdle to be cleared before the promote kicks in.The typical distribution waterfall can be "unified" or "bifurcated." The difference is whether capital is returned out of operating income. If not, the waterfall is bifurcated, meaning that a promote may kick in after a preferred return hurdle on operating income without having to return all capital first. Unified waterfalls are more common on development deals and deals with a short term time horizon. Bifurcated waterfalls are more common for mid to long term hold assets, stabilized assets, etc. The heavier the sponsor's fees, the more likely the waterfall is unified. Sample "bifurcated" waterfall:To investors until they have received a cumulative preferred return of 7%.On a capital event (sale or refi) only, to investors until they have received their capital back.20% to the sponsor (as a promote) and 80% to investors, until investors have realized a 12% IRR.35% to the sponsor (as a promote) and 65%

to investors.Sponsor capital should generally be treated the same as investor capital.

4. Governance - manager managed LLCs. Generally the sponsor is the "manager" and has sole control. Investors do not vote, they trust! In joint ventures or where there is a large lead investor and the sponsor has less of a track record, there may be major decision approval rights.
5. Exit Provisions.Where capital is sourced from investors, exit provisions are usually not relevant as the sponsor decides when to sell, refinance, recapitalize, etc.Where there are partners (including in joint ventures), two basic approaches to forced exit:"Drag to market," subject to right of first offer (ROFO). Usually kicks in after a "lock-up: period of three, five or seven years. This exit mechanism is preferred as the market should validate the exit price.Buy-sell (shoot-out). Similar lock-up period. Market does not validate the exit price and favors the partner with deeper pockets.Deadlock-driven exit mechanisms without a lock-up are effectively open for exercise at any time since deadlocks are readily "manufactured."

F. MISCELLANEOUS ISSUES .

1. Structuring for the 1031 investor who wants to provide you with capital, or pre-positioning for 1031 exchanges out.
2. Structuring for employees to share in promotes.
3. How to hold your interest - structuring for estate planning, creditor protection and spousal protection.
4. Double stacked ownership structures for flexibility and distress management.

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