# Access To Equity For Real Estate Projects: An Update On The Basics For Advising Your Clients

By: Alyson M. Harter

**09.01.2015**

*Note: This article was originally published in the Fall 2015 edition of The Fee Simple. Clickhere for the complete edition.*

If you are a real estate attorney assisting clients with commercial acquisitions and developments, you have probably had many a client approach you seeking advice on how to quickly and cost-effectively raise equity for such projects. Advising a client on these matters steps outside the confines of a real estate law practice and into the realm of securities laws. Raising capital from passive investors is generally considered to constitute the offer and sale of securities.

Securities can be sold three ways: (i) through a registered offering, (ii) pursuant to an exemption from registration, or (iii) illegally. Selling securities illegally is obviously not the desirable choice, so the only remaining options are by registration of the securities or pursuant to an exemption from registration. For most commercial real estate clients, a registered offering will be too cumbersome, time-consuming and expensive for their needs.

There are various methods for raising the requisite equity for commercial real estate projects; however, choosing the best vehicle for doing so can be very dependent on the facts of the deal, the particular needs of the client, and the current ?temperature? of the market. An attorney must be careful if he or she is not familiar with constantly changing federal and state securities laws, rules, and regulations that govern securities offerings. A lack of knowledge or familiarity could prove dangerous for the client and for the attorney providing the advice. In recent years, there have been significant changes in securities laws that have opened doors to more options for raising capital through private offerings--which is where a majority of commercial real estate clients will need to raise their equity. Such offerings are the focus of this article.

The Jumpstart Our Business Start-Ups Act (the ?JOBS Act?), signed into law by President Obama on April 5, 2012, is an attempt to increase the number of capital formation alternatives for companies and

ease the burdens and hurdles of raising capital for smaller companies that do not have the money and resources to raise capital through traditional public markets; however, the applicability of these alternatives is very limited.

Among other things, the JOBS Act (i) removed the prohibition against the general solicitation of an offering for the sale of interests in a company, (ii) created a new exemption under the Securities Act of 1933, as amended (the ?Securities Act?), for ?crowdfunding?, and (iii) amended the Securities Act to permit quasi-public offerings of up to $50 million. These changes were specifically encapsulated in Title II (general solicitation), Title III (crowdfunding) and Title IV (Regulation A+) of the JOBS Act, respectively.

**Title II and General Solicitation?Hello Internet.**

Title II of the JOBS Act permitted the U.S. Securities and Exchange Commission (the ?SEC?) to amend the rules governing the most traditional form of private offerings?private placements exempt from registration pursuant to Regulation D, as promulgated under the Securities Act (?Regulation D?). These updated rules took effect on September 23, 2013.

Most real estate attorneys may be familiar with Regulation D private placements. Although Regulation D establishes three different exemptions (under Rules 504, 505 and 506), approximately 90% of all Regulation D offerings are made pursuant to the exemption provided under Rule 506.  An advantage of the Rule 506 exemption is that no dollar limit exists on the amount of capital you can raise in the offering?it can be $1 million or $100 million. The issuer of the securities (the ?Issuer?) does not need to register the securities with either the SEC or with the states in which the securities are sold. This results in significantly lower offering costs compared to a public offering, as well as providing a quick and efficient entry to market because the Issuer does need SEC approval or qualification of the proposed offering. Filing a Form D with the SEC is the only requirement, and, subject to certain exceptions, in each state in which the securities are sold. Additionally, general solicitation of the offering is now permitted under subsection (c) of Rule 506, subject to compliance with certain requirements as set forth therein.

The Rule 506 exemption is not without its disadvantages. The securities sold under the exemption are deemed ?restricted securities? and cannot be resold without first registering with the SEC or pursuant to an exemption from registration. Thus, an investor cannot turn around and go sell its shares, units, or membership interests in the Issuer on a stock exchange. If an investor wishes to sell the shares in a private transaction, there are holding period limitations and restrictions on permissible purchasers of such securities, depending on the exemption being used. Additionally, if an Issuer seeks to use the Rule 506(c) exemption to sell the securities so that general solicitation may be utilized, each purchaser of the securities must be an ?accredited investor.? The new rules also include the prohibition of ?bad actors? (e.g., felons and others barred from securities transactions) from involvement in the offering, the failure with which to comply can result in serious consequences for the Issuer.

From a practical perspective, this type of offering works well for clients who can access accredited investors and need quick access to capital (this is often the case for commercial real estate clients beholden to due diligence and closing deadlines). The Issuer can also publicly advertise and market the offering if it complies with the requirements of Rule 506(c). Offerings can be for securities in one real estate asset or in the form of a ?fund,? meaning that a pool of capital can be raised to acquire or

develop two or more assets. Fund offerings can consist of identified assets, a partially blind pool (in which not all assets are identified, but some are), or a blind pool (in which no assets are identified). With a client which is always in the acquisition mode, a fund may allow them to take advantage of opportunities that will not wait for an offering process needing to start from zero each time equity is required.

The Delaware statutory trust (?DST?) is another offering vehicle available which can utilize the Rule 506 exemption. DSTs have gained in popularity in recent years. With a DST, an investor purchases a beneficial interest in the DST and, if certain restrictions are properly observed, such beneficial interest is considered for tax purposes to be a direct interest in the real property assets owned by the DST. As a result, investors who desire to defer capital gains using Internal Revenue Code §1031 can do so by using the proceeds from the sale of their relinquished property to purchase a beneficial interest in the DST. The popularity of the DST structure is also attributable to the decline of the tenancy-in-common (?TIC?) structure in the broker-dealer community, which was a common offering vehicle prior to the Great Recession. Community banks continue to be a source of debt for TICs with five or fewer investors, but since every TIC investor has a direct interest in the property, many lending institutions will not provide debt to TICs with a large number of investors due to the cumbersome nature of such a structure. The DST structure, where the lender is dealing with a single entity trust, is more widely accepted by many financial institutions. However, TICs may give your clients a vehicle to attract out of market money from investors desperately looking for a §1031 replacement property without the heavy front end load of DSTs available from broker-dealers. A fulsome discussion of the DST and TIC structures is beyond the scope of this article.

**Title III?Crowdfunding!**

?Crowdfunding? has been a common buzzword of late; however, a substantial number of people do not fully understand what it is. Generally speaking, crowdfunding is the pooling of money from a crowd to fund a project or venture, and utilizes a donation model, reward model, royalty model, debt model or equity model. Most of what is marketed as crowdfunding is essentially a platform for a charity or start-up firm where no equity interest is gained, but there may be an opportunity to be recognized for the contribution (Some firms using other offering vehicles discussed in this article (e.g., general solicitation Reg D or a Reg A+ offering) are incorrectly using the crowdfunding label).

Securities laws come into play when equity or debt securities are offered. Section 4(a)(6), added to the Securities Act by Title III of the JOBS Act, provides an exemption from the registration of such securities provided the issuer complies with certain rules and restrictions. Congress gave the SEC a deadline of December 31, 2012, to enact new rules providing for the exemption; however, that did not happen. Crowdfunding rules were proposed by the SEC in October, 2013, and were finally enacted on October 30, 2015 as Regulation Crowdfunding. The rules are not expected to become effective until May, 2016.

The federal rules provide that (i) the offering must be an ?all-or-none? offering (meaning that the entire amount offered must be raised or else the raise ?fails? and all subscriptions must be returned to investors); (ii) the aggregate amount sold by an Issuer to all investors in any 12-month period may not exceed $1,000,000.00; (iii) offering activities must occur through a registered broker-dealer or a new type of platform that must also be registered with the SEC and known as a ?funding portal;? and (iv) issuers may only communicate with investors through the funding portal or broker-dealer. Investors in

the offering do not have to be accredited investors; however, the maximum amount any one investor can invest in crowdfunding offerings in any 12-month period cannot exceed:

- the greater of $2,000 or 5% of the lesser of the annual income or net worth of the investor, if either the annual income or the net worth of such investor is less than $100,000;
- 10% of the lesser the annual income or net worth of the investor, but not to exceed $100,000, if both the annual income and net worth of the investor is equal to or greater than $100,000.

Additionally, the financial statements for an issuer choosing to sell its securities pursuant to the federal crowdfunding exemption would need to be: (i) for offerings of $100,000 or less, certified by the principal executive officer, unless financial statements of the issuer are available that have either been reviewed or audited by a public accountant independent of the issuer, then those must be provided instead; (ii) for offerings greater than $100,000 and up to $500,000, reviewed by a public accountant independent of the issuer, unless financial statements of the issuer are available that have been audited by a public accountant independent of the issuer, then those must be provided instead; and (iii) for offerings greater than $500,000, audited by a public accountant independent of the issuer, except that for issuers that are first-time issuers, financial statements of the issuer reviewed by a public accountant independent of the issuer are sufficient (nevertheless, if audited statements are available, those must be provided instead). All financial statements must be prepared in accordance with generally accepted accounting principles (?GAAP?).

In addition to the foregoing requirements and limitations on the actual offering, there are restrictions on the resale of the securities sold. Securities sold in an offering exempt under Regulation Crowdfunding cannot be transferred by an investor for one year from the date of purchase, except for transfers to the issuer of the securities, an accredited investor, a family member of the investor or in estate type transfers, and third parties in a registered offering.

The rules also provide for ongoing reporting obligations for Issuers. An Issuer would be required to file with the SEC and provide to investors certain annual and periodic reports, progress updates on the offering and a notice of termination of the issuer?s reporting obligations.

The alternative to interstate crowdfunding under Regulation Crowdfunding, intrastate crowdfunding, raises money through crowdfunding solely within one state. Pursuant to Section (a)(11) of the Securities Act, it is permissible to conduct an offering of securities that is not registered with the SEC so long as the securities are only offered to the residents of a single state by an Issuer that is registered and doing business in that state. All intrastate offerings must comply with the applicable state registration and offering requirements, which varies by state.

Many states have passed their own intrastate crowdfunding exemptions. In Virginia, SB 763 was signed into law by the Governor on March 19, 2015, as the ?Virginia Intrastate Crowdfunding Exemption.? In response, the Virginia State Corporation Commission proposed the adoption of Rule 21 VAC 5-40-190, which generally provides that:

- the issuer must be formed and authorized to do business and have its principal place of businessin

the Commonwealth of Virginia;

- the securities may only be sold to residents of the Commonwealth of Virginia;
- the exemption is only available for equity offerings and not debt offerings;
- no more than $10,000 can be invested in the offering by a single investor, unless the investor is an accredited investor as defined in Rule 501 under Regulation D;
- an issuer is limited to an aggregate offering amount of $2 million per 12-month period;
- the term of the offering cannot extend beyond the date which is 12 months after the date of thefirst offer of the securities;
- none of the proceeds raised may be released to the issuer until at least the targeted offering amount has been raised;
- certain financial statements must be provided depending on the amount of the offering;
- the issuer must make an exemption filing on Form ICE at least 20 days prior to an offering of the securities or the use of any publicly available website in connection with the offering;
- certain conditions apply to offers and sales made over the internet;
- certain reports must be provided to investors and the Virginia State Corporation Commission;
- the issuer must file a final sales report with the Virginia State Corporation Commission within 30 days after the last sale in the offering; and
- the crowdfunding exemption may not be used with other state exemptions.

Crowdfunding, whether intrastate or interstate, lacks the flexibility and speed available under the Regulation D exemptions. If an Issuer wishes to purchase a property valued at more than a few million dollars, crowdfunding is a viable option. The $1,000,000.00 federal offering limitation (which is $2,000,000.00 in a few states for intrastate offerings, including Virginia) significantly limits the assets that an Issuer can acquire. Many lenders will not permit a loan-to-value ratio in excess of 70% on a commercial property, meaning that an Issuer in Virginia wishing to use crowdfunding exclusively to raise capital for a transaction will be capped out at a purchase price of approximately $6.66 million. This may work for clients that typically acquire smaller assets, but for many Issuers, crowdfunding, unless utilized simultaneously with some other offering vehicle pursuant to a permitted exemption, will not be the answer. To ensure that concurrent offerings comply with securities laws, they would first need to be fully assessed by securities counsel.

Additionally, although the pool of potential investors may be greater since the offering is not limited to accredited investors, the amount each investor can invest in the offering is capped, meaning that the Issuer will need to reach a larger number of investors and process a greater number of subscriptions potentially resulting in increased marketing and administrative costs for the Issuer. The foregoing, combined with the ongoing reporting requirements, would likely limit the utility of this offering exemption for most Issuers.

**Title IV and Regulation A+, also known as ?IPO-Lite?.**

Another exciting development that came out of the JOBS Act, in addition to the removal of therestriction on general solicitation for certain Regulation D offerings, is Title IV, which provides for an expanded exemption under Section 3(b)(2) of the Securities Act, and is known as Regulation A+. Prior to the

enactment of Section 3(b)(2), an exemption from registration existed under Section 3(b), which has been retitled Section 3(b)(1). Section 3(b) provided a limited offering exemption for offerings of up to $5 million raised in any 12-month period, and sales could be made using general solicitation to investors who may or may not be accredited. These securities were not restricted and could be resold on the open market, but the Issuer of the offering had to complete and file Form 1-A with the SEC. The form is similar to Form S-1 (for public offerings), but more limited in scope and shorter in length. The offering then had to be prequalified with the SEC and the states in which the Issuer intended to sell the securities. From commencement of the structuring of the offering until SEC qualification, offerings made pursuant to the Section 3(b) exemption averaged almost one year. Under Section 3(b), now Section 3(b)(1), there are limits on investments, except those that may be imposed by the states in which the securities are sold. Nevertheless, many in the industry saw the Section 3(b) exemption as being umbersome and useless due to the limited offering amount permitted and lengthy time to get to market. Only twenty-six Section 3(b) filings were qualified by the SEC from 2012 to 2014. (The maximum amount was $5 million per offering, which if all were for the maximum permitted, would be only $130 million aggregate. Compare to the total amount of capital raised via Regulation D in 2014 alone, over $1.4 trillion.)

With the enactment of Title IV and the SEC?s adoption of final rules in March 2015, Regulation A+, sometimes referred to as ?IPO-Lite?, was born under Section 3(b)(2) of the Securities Act. The final SEC rules created a two-tiered exemption structure. The first tier (?Tier 1?) allows Issuers to raise up to $20 million in any 12-month period, while the second tier (?Tier 2?) allows Issuers to raise up to $50 million in any 12-month period. There are no investment limits for investors under Tier 1, or under Tier 2 for accredited investors. Under Tier 2, investors who are not accredited may not invest more than 10% of their annual income and net worth. Both tiers still require SEC qualification. The states are pre-empted from requiring the offering to be qualified in the states for Tier 2 offerings, but not Tier 1. This slightly shortens the time to market for Tier 2 offerings (which are likely to average between 2-4 months), but timing to market for Tier 1 offerings remains approximately the same as under the original Regulation A (Section 3(b)).

Issuers under both tiers must file balance sheets and certain other financial statements for their two most recently completed fiscal years (or since they have been in existence, if for less than two years). All financial statements for U.S. Issuers must be prepared in accordance with GAAP. Financial statements of Tier 1 Issuers are not required to be audited, but financial statements of Tier 2 Issuers must be audited in accordance with GAAP or the rules of Protecting Investors through Audit Oversight, a private-sector, nonprofit corporation, created by the Sarbanes-Oxley Act of 2002 (?PCAOB?).

In addition to the foregoing financial reporting requirements, both Tier 1 and Tier 2 offerings are subject to ongoing reporting requirements. A Tier 1 Issuer must file an exit report on Form 1-Z no later than 30 calendar days after the termination or completion of its Regulation A offering. The report must provide the number of securities sold, the names of underwriters and other service providers involved as well as the fees they received, and the net proceeds received by the Issuer. Reporting requirements for Tier 2 Issuers mimic those of Exchange Act reporting Issuers, but are more extensive, requiring annual reports, semi-annual reports, current reports disclosing material events, special financial reports, and the Form 1-Z exit report.

There is significant discussion over whether Regulation A+ will have the impact the industry had hoped. The limited advantages of Regulation A+ over its Regulation D counterpart underscore this sentiment. Although securities sold pursuant to the Regulation A+ exemption are not restricted and are freely transferable, this is more complicated than it sounds. Most commercial real estate clients will not have the need for an ongoing market for their shares. Instead, clients will often want a one-time equity raise for one project at a time, and once that project is sold or transferred, the Issuer will be dissolved. That equity can be raised from non-accredited investors would also seem to be a bonus. However, with the investment limitations on investors in Tier 2 offerings, there is more time involved in marketing the offering and smaller investments per investor, resulting in increased administrative costs. Equally important are the total costs to structure a Regulation A+ offering, for which the legal costs alone are about double that of a Regulation D private placement; this does not include the accounting costs and the costs of ongoing reporting compliance for Tier 2 offerings. Lastly, the timing for putting together a Regulation A+ offering and having it qualified by the SEC, anywhere from two months to one year or more, can be significantly longer than for a Regulation D offering, which typically takes about 4-6 weeks to get to market and does not require SEC review or qualification. Most commercial real estate clients have a window of approximately 60-180 days to close on a property, and for that reason Regulation A+ would not be palatable for single property capital raises. It may work, however, in a fund type structure (e.g., where $50 million is raised under Tier 2 to acquire a portfolio of assets; the portfolio may have some, all, or no assets identified during the capital raising stage).

Despite the increased options for raising capital attributable to the new Regulation A+ and Regulation Crowdfunding rules and intrastate crowdfunding in Virginia and other states, Rule 506 under Regulation D remains an attractive offering exemption for commercial real estate clients. Regulation A+ requires heavy lifting, including the time to market, the cost of getting there, and the costs after you arrive. Crowdfunding, whether intrastate or interstate, provides for a significantly limited offering amount, reporting requirements, and investment limitations on certain investors. In contrast, Rule 506 offerings provide for unlimited offering amounts, are quicker to market and do not require SEC qualification or any ongoing reporting requirements. Rule 506(c) also allows for general solicitation. In the near future, Regulation D offerings may be affected by changes in the definition of ?accredited investor?, which may include increased net worth or annual income requirements for individuals, but there is no certainty yet as to when those changes may take place. In the meantime, Issuers should continue to utilize all the benefits that the Regulation D exemptions have to offer and explore whether Regulation A+ or Regulation Crowdfunding may work for them. Please note: in most of the options discussed above, some level of premarketing is permitted. It may be advisable to survey the market first to determine what

features gain the most prospective investor support before finalizing the structure of their offerings.

## Related People