

## Obtaining development financing by way of securities

### Developers who conduct private placements usually sell interests in new LLCs

One of the most challenging elements of a real estate transaction or development is finding the money.

We all know about financing a real estate "project" through conventional methods; however, more and more, financing is occurring through private sources. Venture capitalists, angels and other investors are looking to make an investment that's secured by collateral and is therefore less risky than the stock market, but provides for a higher return than government bonds or other secure investments.

In many instances, raising capital from such investors is accomplished through private placement of securities. Real estate securities typically qualify as such under the investment contract definition, which in most states is defined as, "an investment of money, in a common enterprise, with the expectation of profit, based solely or primarily on the efforts of others."

There are three primary reasons to care whether this investment vehicle is a security: registration, disclosure, distribution.

#### Registration

To avoid the significant time and expense of a public offering, the offering of real estate securities must qualify for an exemption from registration. Most issuers seek exemption under Regulation D of the Securities Act of 1933. The Regulation D exemptions each have different rules with respect to the dollar amounts raised, and the number and type of investors that can be included; however they all prohibit advertising and general solicitation.

#### Disclosure

With respect to disclosure, the goal of the Securities Act of 1933 is to protect investors and ensure they have the information necessary to make a rational decision. The amount and type of disclosure that is required depends on the qualifications of the investors who will be participating in the offering.

"Accredited investors," as defined under



GUEST  
COLUMN

Coni  
Rathbone

and therefore, specific disclosure is required. Severe penalties, both criminal and civil, may result from failing to comply with the securities disclosure provisions, which essentially require the issuer to tell about the deal; tell about the owners and their experience; tell about the risks; and tell about the finances and returns.

#### Distribution

Distribution defines who can sell the security that is being offered. It is safe to assume that in most instances you should be a licensed security salesperson in order to sell any security. Of course, there are exceptions, and these rules vary from state to state. However, the consequences for failing to be licensed include significant civil penalties and potential felony criminal charges.

#### Raising funds

There are three primary ways to raise funds through real estate securities offerings:

- Sell entity interests, such as corporate stock, limited partnership interests, and member or manager managed LLC interests.
- Sell promissory notes.
- Sell tenant-in-common real property interests.

The most common structure for a real estate private placement is for the issuer to create a limited liability company to own the project. The issuer obtains the maximum debt financing available for the project and typically personally guarantees the debt. Then they raise the required equity through the sale of LLC interests to investors who will own a proportionate amount of the company. This LLC interest is personal property to the investor.

In this structure the investors typically

receive priority returns from the LLC and the issuer maintains management control over the entity and project. The issuer will often take a fee for its management efforts and will typically reserve for itself a percentage of the equity as a reward for structuring the transaction and for guaranteeing the loan.

It is also common for an issuer to form the same LLC to own the project as just described, and then raise funds by issuing secured promissory notes from investors. The collateral for the loans is often a proportionate participation interest in a deed of trust that encumbers the project. Each note holder is secured by a piece of the trust deed. The note and trust deed are personal property to the investor. As you might imagine, the complicating factor is that a group of beneficiaries own the same trust deed and must take all actions in concert. An agent of the beneficiaries must act on behalf of all of the beneficiaries for any action taken under the trust deed.

Finally, quickly gaining prominence as a way to finance a real estate project is the creation of a tenant-in-common structure. This is where the same issuer creates the same LLC and obtains and guarantees the same loan as above. The distinction is that to raise the required equity, the issuer sells undivided TIC interests in the real property as opposed to the personal property the investors own under the other structures.

Because the investors own land and improvements, if properly structured, this type of investment can qualify as a "like kind" 1031 exchange for the sale of other real property. This is significant because an investor that relinquishes real property cannot do a 1031 exchange into an investment that produces personal property.

Each of the structures discussed here has strengths and weaknesses, and each can be used with many variations to create the proper funding vehicle for your real estate acquisition or development. However, the creation and sale of securities is not advisable for the inexperienced, so proceed cautiously with the appropriate real estate professionals.

Each of the structures discussed here has strengths and weaknesses, and each can be used with many variations to create the proper funding vehicle for your real estate acquisition or development. However, the creation and sale of securities is not advisable for the inexperienced, so proceed cautiously with the appropriate real estate professionals.

**Coni Rathbone** is a partner in the Portland office of Davis Wright Tremaine LLP where she practices in real estate development, transactions, corporate and securities. She can be reached at 503-241-2300 and at [conirathbone@dwt.com](mailto:conirathbone@dwt.com).