

# THE REAL ESTATE SYNDICATION AND FUND HANDBOOK

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*A Guide to Structuring, Raising Capital, and Operating  
Real Estate Investment Vehicles*

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# Disclaimer

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This book is written for educational purposes. The information in these pages is intended to provide a working overview of the legal, structural, and regulatory concepts that arise in the context of real estate syndications and private real estate funds. It is not legal advice, and it is not a substitute for legal advice.

Real estate syndications and private fund offerings involve a complex web of federal and state laws, including the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Company Act of 1940, together with the securities laws of every state in which interests are offered or sold. The law in these areas is not static. Rules change. Exemptions are amended. Enforcement priorities shift. What is accurate today may require revision tomorrow.

More importantly, the analysis that governs any particular transaction depends entirely on the specific facts of that transaction. Two deals that look nearly identical on the surface can require completely different legal approaches depending on the investor composition, the offering structure, the sponsor's prior offerings, the states involved, and a dozen other variables that no general-purpose book can anticipate.

Nothing in this book creates an attorney-client relationship between the author and any reader. If you are considering forming or investing in a real estate syndication or fund, please retain qualified legal, tax, and accounting professionals before you act. The cost of getting the structure right on the front end is a fraction of the cost of unwinding a compliance failure on the back end. Experience teaches that lesson repeatedly and expensively.

The examples used throughout this book are illustrative only. Names, figures, and deal structures are used to clarify concepts, not to describe actual transactions or predict actual outcomes.



## FRONT MATTER

# About the Author

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I came to this area of practice the way most attorneys come to a specialty: through a combination of where I started, what problems kept showing up on my desk, and, frankly, a genuine fascination with how the pieces fit together.

My background before law school was in finance and economics. I was drawn to understanding how capital moves, how deals get done, and what makes the difference between a transaction that closes cleanly and one that falls apart at the table. That instinct carried through law school and into practice, where I gravitated toward transactional work. Specifically, the intersection of corporate law, securities compliance, and real estate.

Over time, that intersection became a practice. I now advise real estate sponsors, developers, investment managers, and fund managers on structuring and executing real estate syndications, private funds, and joint ventures across the United States. I structure and negotiate private securities offerings under Regulation D, Regulation A, Regulation CF, and related exemptions. I draft offering documents, governance documents, and subscription agreements. I advise sponsors through every stage of the investment lifecycle, from formation and capital raising through acquisitions, asset management, recapitalizations, and exits.

Before returning to private practice, I served as general counsel to two corporations. That experience changed how I approach legal advice. Sitting on the client side of the table, watching deals stall, watching compliance problems surface at the worst possible moments, watching the difference between well-structured transactions and poorly structured ones play out in real time, gave me a perspective that I do not think you can fully develop without living it. I try to bring that perspective to every matter I work on.

I am a corporate and securities attorney in the Austin office of Dickinson Wright, where my practice focuses on real estate private equity, capital formation, joint ventures, mergers and acquisitions, corporate governance, and strategic financings. I also write about these topics regularly at [crowdfundlawyer.com](http://crowdfundlawyer.com), which covers real estate syndication and fund formation, and at [retokenlawyer.com](http://retokenlawyer.com), which covers the emerging area of real estate tokenization. I am a co-author of *"The Lawyer's Guide to Raising Capital for Business People: With Offering Document Samples"*.

Outside the office, I am an active triathlete, running, cycling, and occasionally questioning my own judgment during long training blocks. I live in Austin with my family and have embraced the city's food, music, and culture more thoroughly than I expected when I first moved here.

If the questions this book raises lead you to want a conversation, I would welcome it. You can reach me through [crowdfundlawyer.com](http://crowdfundlawyer.com).

## FRONT MATTER

# Preface

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Every year, real estate sponsors make expensive legal mistakes that were entirely avoidable. Not because they are careless, and not because they lack sophistication in their core business. They make them because the legal and regulatory framework that governs private real estate capital raising is genuinely complex, genuinely counterintuitive in places, and genuinely unforgiving when things go wrong.

I have spent a significant part of my career on the back side of those mistakes, helping sponsors understand what happened, what their exposure is, and what can be done about it. That work is interesting and often salvageable. But the problems are almost always preventable. And they are almost always more-expensive to fix than they would have been to avoid.

That observation is the reason this book exists.

The real estate syndication has evolved into one of the most widely used private investment structures in the United States. Sponsors use it to acquire apartment communities, industrial properties, office buildings, self-storage facilities, development sites, and virtually every other category of commercial real estate. Investors use it to access institutional-quality real estate without the burden of direct ownership. The structure, when properly executed, genuinely serves both sides of that equation.

Those two words, properly executed, are carrying a lot of weight in that sentence. Most real estate syndications are securities offerings. Securities offerings are governed by federal law and by the law of every state in which investors are solicited. The structure of the offering entity matters. The way capital is raised matters. What is said to investors, and what is left unsaid, matters. The documents that govern the investment matter. The filings that must be made after closing matter. Getting any of these things wrong creates legal exposure that can follow a sponsor for years.

Real estate funds add another layer. A sponsor who moves from deal-by-deal syndications to a blind pool fund is stepping into a different regulatory environment. One that raises questions about investment adviser registration, fiduciary obligations, fund governance, and institutional investor expectations that do not arise in the same way in a single-asset deal. Many sponsors make that transition without fully appreciating the shift.

This book is my attempt to give real estate sponsors, and the professionals who work alongside them, a practical working understanding of how this world actually functions. Not a treatise. Not a compliance manual. A working understanding that helps you ask the right questions, avoid the

most common traps, and structure your investment programs in a way that serves your investors well and protects your business over the long term.

I have tried to write this book the way I talk to clients: directly, practically, and without unnecessary abstraction. The law matters, but the law in the abstract is not especially useful to someone trying to close a deal. What is useful is understanding how the law applies to the decisions in front of you, how to structure your offering, how to select the right exemption, what your documents actually need to say, and what happens if something goes wrong.

A few things I want you to understand as you read this.

First, this book does not replace a lawyer. I know that sounds like the kind of thing an attorney has to say, but I mean it specifically. The framework I describe here is the framework. Every transaction applies that framework to a specific set of facts, and the specific facts always matter. I have seen sponsors read a chapter on Regulation D and conclude that their situation is covered when it is not. Please use this book to become a more informed client, not to represent yourself.

Second, this book covers a lot of ground. I have organized it deliberately, starting with foundational concepts and building toward more complex topics. If you are new to real estate syndication, I recommend working through it sequentially. If you are experienced but looking for depth on a specific topic, such as fund structures, securities exemptions, waterfall mechanics, or the Investment Advisers Act, the structure allows you to use it as a reference.

Third, the law changes. I have made every effort to accurately describe the legal landscape as it exists at the time of writing. But tax rules evolve, the SEC amends its regulations, states update their filing requirements, and enforcement priorities shift. Treat this book as a reliable map of the terrain, but check the current conditions before you act.

Finally, this is a book written by someone who has spent years on both sides of these transactions, as an advisor and, briefly, as an operator. The perspective I bring is shaped by what I have seen work, what I have seen fail, and what I wish more sponsors understood before they started raising capital. I hope it is useful.

## INTRODUCTION

# Who This Book Is For

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This book was written primarily for real estate operators and entrepreneurs who are building, or thinking about building, an investment platform that raises capital from outside investors.

That category is broader than it might first appear. It includes the experienced real estate investor who has always used his own capital and is now considering his first syndication. It includes the established syndicator who has closed a dozen deals but has never fully understood the legal infrastructure underlying what he does. It includes the developer who has relied on institutional equity partners and is now thinking about raising capital directly from high-net-worth individuals. And it includes the operator who has been successfully running single-asset syndications and is now evaluating whether to move to a fund structure.

The practical reality is that most real estate operators understand their market, their asset class, and their business plan far better than they understand the legal and regulatory framework that governs how they raise money. That is not a criticism. Real estate is a highly specialized discipline, and most operators got into it because of their expertise in real estate, not because they were interested in securities law. But the legal framework is not optional, and misunderstanding it, or ignoring it, creates real and sometimes severe consequences.

Beyond sponsors, this book should be useful for the following readers.

- Real estate developers who are considering raising outside equity for the first time and need to understand what that decision involves legally and structurally.
- Real estate fund managers who are building or have built investment vehicles and want a deeper understanding of the regulatory environment in which they operate.
- Investment managers, financial advisors, and wealth managers who work with clients who invest in real estate syndications or funds, and who want a working understanding of how these structures are built and governed.
- Real estate brokers, lenders, and consultants who work alongside sponsors and want to better understand the legal context of the transactions they support.
- Entrepreneurs who are building technology platforms, crowdfunding portals, or other infrastructure for the private real estate market.

- Investors who want to understand what they are actually investing in when they participate in a real estate syndication or fund: what the documents mean, how the economics work, and what the sponsor's obligations are.
- Law students and newer attorneys who are interested in this practice area and want a practical introduction to how these transactions actually work.

One audience this book is not specifically designed for: institutional investors evaluating whether to make a commitment to a large private equity real estate fund manager. That world has its own vocabulary, its own due diligence processes, and its own set of concerns that goes well beyond the scope of what I am covering here. Elements of this book will be relevant to that audience, but it is not the primary focus.

## What This Book Is Not

Given the subject matter, I want to be direct about what you will and will not find in these pages.

This is not a legal treatise. The Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Company Act of 1940 have each generated decades of case law, rulemaking, no-action letters, and scholarly commentary. Attempting to cover any of those bodies of law comprehensively in a single volume, let alone all of them together, would produce a reference work that is technically exhaustive but practically useless for most of the people who need to understand this material. That is not this book.

This is not a tax guide. Tax considerations are woven throughout real estate syndication and fund practice. Depreciation, carried interest taxation, FIRPTA, the passive activity rules, 1031 exchanges, Opportunity Zone structures, and cost segregation all have significant implications for how these deals are structured and how investors experience them. I discuss these topics because you cannot properly understand the deals without them. But the analysis is practical and introductory, not comprehensive. Tax law is highly technical and highly fact-specific. Do not make tax decisions based on a chapter in this book.

This is not a substitute for transaction-specific legal advice. I recognize that this point appears in the disclaimer and in the preface, and I am repeating it here deliberately, because it is the point that matters most. No book can account for the specific facts of your transaction. The legal analysis that applies to a 506(b) offering of equity interests in a value-add apartment deal is materially different from the analysis that applies to a 506(c) offering of preferred equity in a ground-up development project, even though both are real estate syndications in the colloquial sense. The framework in this book is accurate and important. The application of that framework to your specific situation requires legal judgment that a book cannot provide.

This is not a guide to running a real estate business. I am not going to tell you how to underwrite a deal, how to evaluate a market, how to manage a renovation, or how to negotiate a purchase agreement. Those topics are covered in depth elsewhere by people with far more hands-on operational experience than I have. My focus is on the legal and structural framework: how the investment is formed, how capital is raised, what the documents need to say, and how the regulatory obligations work.

What this book is, I hope, is something more useful for most readers than any of the above. A clear, honest, practical explanation of how real estate syndications and funds actually work from a legal and structural standpoint, written by a lawyer who has been doing this work for a long time, in a form that gives you enough working knowledge to participate in these structures intelligently, avoid the most costly mistakes, and know when you need help.

## How to Use This Book

The book is organized into six parts, each addressing a distinct dimension of the real estate syndication and fund practice.

### **PART I**

#### **Foundations**

*The essential conceptual and legal groundwork.*

What is a syndication? What is a fund, and how does it differ? When does a real estate investment become a security? What types of syndications and funds exist, who makes up the sponsor team, and what advisors are needed? If you are new to this area, spend time here. The foundational concepts in Part I inform everything that follows.

### **PART II**

#### **Structuring the Deal**

*How real estate syndications and funds are actually built.*

Entity structures, the capital stack, investment terms and waterfall mechanics, sponsor compensation, and tax considerations. This is where the structural decisions get made, and where many of the most consequential mistakes also get made. The choices a sponsor makes at the structuring stage shape the entire investment lifecycle.

### **PART III**

## **Securities Law and Regulatory Compliance**

*The legal framework governing how these investments are offered to investors.*

Securities exemptions. General solicitation rules. Investor qualification. Offering documents. Disclosure obligations. The regulatory filings that must be made. The consequences of getting it wrong. This is dense material, and I have tried to present it as practically as possible. It is also arguably the most important part of the book for sponsors who are new to raising capital.

### **PART IV**

## **Capital Raising**

*The operational side of getting a deal funded.*

Marketing compliance, understanding different investor profiles, building a capital raise plan, and managing the closing process. The legal rules from Part III apply throughout this section, so Part IV assumes familiarity with that framework.

### **PART V**

## **Fund Administration, Operations, and the Investment Lifecycle**

*What happens after the deal closes.*

Asset management, distributions, fund administration, refinancing and recapitalization events, disposition, and what to do when things go wrong. Many books on this subject treat closing as the finish line. It is not. The ongoing obligations that arise after closing are significant, and failing to manage them properly creates real legal and investor relations exposure.

### **PART VI**

## **Avoiding Mistakes and Building a Scalable Platform**

*The most strategic section of the book.*

This part catalogs the most common and costly mistakes sponsors make in capital raising and deal structuring, provides a framework for deciding whether and when to syndicate or form a fund, addresses the path to institutional capital, and closes with a forward-looking look at where



real estate syndication and fund practice is heading. The appendices are designed to be working references. The glossary, exemption comparison tables, waterfall calculation examples, document checklist, state blue sky guide, and bad actor disqualification reference are materials you will likely return to repeatedly.

### **A Note on Reading Order**

If you are new to real estate syndication, read the book sequentially. The concepts build on one another, and skipping ahead will occasionally leave you without context that earlier chapters establish. If you are experienced and using this book as a reference, the chapter structure allows that. Each chapter is reasonably self-contained. If you are deep into a 506(c) offering and want a quick refresher on verification requirements, you can go directly to the relevant chapter without working through the rest.

If you are a sponsor who is right now in the middle of structuring a deal or launching a capital raise, I have two pieces of advice. Read the relevant chapters carefully, and then call a securities lawyer. The framework this book provides is valuable, and informed clients make better clients. But the specific application of that framework to your deal requires professional judgment that this book cannot substitute for.

### **A Final Note**

I have tried throughout this book to be genuinely educational, to explain concepts clearly and honestly, including the concepts that are most likely to generate legal fees when they go wrong. I did not write this book primarily as a marketing tool, and I have made no effort to make the subject seem more complicated than it is in order to make your need for legal help seem greater.

That said, I am a practicing attorney, and I built a practice in this space because I find the work genuinely interesting. If you have questions that this book raises but does not fully answer, or if you are working on a transaction and want to talk through the structure, I welcome the conversation.

By the time you finish it, you should understand how real estate syndications and funds are built, how they are governed, how they are funded, and how the law shapes every step of that process. You should be a better-informed operator, a more credible sponsor, and a more effective advocate for your own business. Let us get started.

***Jason Powell, Esq.***

*Austin, Texas*

## CHAPTER ONE

# What Is a Real Estate Syndication?

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Real estate has always required more capital than most individuals can supply on their own. The apartment community, the industrial portfolio, the mixed-use development: these are not assets that a single investor typically acquires with personal funds. They require a mechanism for assembling capital from multiple sources, directing it toward a common purpose, and organizing the rights and obligations of everyone involved.

That mechanism is the real estate syndication.

At its core, a real estate syndication is a structure through which multiple investors pool capital to acquire, develop, or operate a real estate asset. A sponsor, sometimes called a syndicator, managing member, or general partner, identifies the opportunity, organizes the investment vehicle, arranges the capital stack, and manages the execution of the business plan. Investors contribute equity capital and hold ownership interests in the entity that owns the property. When the investment performs well, both sides share in the returns.

The model is straightforward. The legal infrastructure around it is not.

Real estate syndications are securities offerings under federal law in virtually every case. The framework of federal securities regulation, including registration or exemption from registration, disclosure obligations, anti-fraud rules, investor qualification requirements, and ongoing compliance obligations, applies to the process of raising capital, to the documents that govern the investment, and to virtually every communication between sponsors and investors. Understanding that framework is not ancillary to understanding real estate syndication. It is central to it.

This chapter builds the foundation for everything that follows. Before exploring entity structures, offering documents, securities exemptions, investor onboarding, capital raising mechanics, or tax treatment, we need a clear understanding of the model itself: what a real estate syndication is, why it exists, how it functions, and where the legal framework attaches.

## **The Basic Structure: Sponsor, Investors, and the Project Entity**

A real estate syndication has three primary components: the sponsor, the investors, and the project-owning entity. Each plays a defined role, and the legal relationships among them are the subject of every major document in the syndication.

### **The Sponsor**

The sponsor is the active party. This is the individual or team responsible for sourcing the deal, structuring the investment, arranging the financing, raising the equity capital, and managing the execution of the business plan from acquisition through disposition. The sponsor contributes expertise, relationships, operational capacity, and management bandwidth. In return, the sponsor earns fees for specific services and a disproportionate share of investment profits, the promoted interest or carry, once investors have achieved a specified minimum return.

In the legal documents, the sponsor typically controls the project-owning entity as its managing member in an LLC or as its general partner in a limited partnership. That control is not unlimited. The governing documents define the boundaries of the sponsor's authority, identify decisions that require investor consent, and establish the sponsor's obligations to the investors whose capital it is managing. Within those boundaries, the sponsor has broad discretion to manage the investment without convening investor votes for every operational decision.

### **The Investors**

Investors contribute equity capital to the project-owning entity in exchange for ownership interests: membership interests in an LLC or limited partnership interests in an LP. Those interests carry economic rights, including distributions of cash flow and sale proceeds, and, depending on the governing documents, certain governance rights such as approval of major decisions or the ability to remove the sponsor for cause.

What investors in a real estate syndication typically do not have is operational control. They are passive participants. They do not manage the property, direct contractors, negotiate leases, or make day-to-day decisions about the investment. That passivity is the defining feature of the investor relationship in a syndication, and it is precisely what brings the investment within the scope of federal securities law.

## The Project-Owning Entity

The project-owning entity, typically a limited liability company formed specifically for the transaction, holds title to the real estate, is the borrower under the mortgage, and is the party to the management agreement, the purchase contract, and the leases. It is the legal vehicle through which the sponsor manages the investment and through which investors hold their ownership stakes.

The governing documents of this entity, the operating agreement in the case of an LLC, define every material aspect of the investor relationship: economic rights, governance rights, transfer restrictions, fee structures, the mechanics of distributions, and the procedures for winding down the investment at exit. The operating agreement is the most important legal document in a real estate syndication, and its drafting deserves the most careful attention.

### The Basic Syndication Structure

**Sponsor Entity (Managing Member or General Partner)**

Controls and manages the project-owning entity. Earns management fees and promoted interest.

**Project LLC or LP (the SPV)**

Holds title to the real estate asset. Is the borrower under the mortgage.

**Investors (Members or Limited Partners)**

Contribute equity capital. Receive ownership interests representing passive economic stakes.

**Lender**

Provides debt financing secured by a first mortgage on the property.

The Project LLC owns the property. Investors own interests in the LLC. The Sponsor controls the LLC as its managing member or general partner.

The governing documents for this structure include an operating agreement or limited partnership agreement, a private placement memorandum (PPM), and a subscription agreement. Together, they form the legal backbone of the syndication: the documents that define investor rights, disclose material information, and establish the regulatory compliance foundation for the offering.

## Why Real Estate Syndications Exist

The real estate syndication exists because it solves two distinct problems simultaneously, and neither problem has an obvious alternative solution.

### **The Capital Problem**

Commercial real estate is expensive. That observation is obvious, but its implications bear examination.

A modestly sized apartment acquisition in a growing market, say 150 units with standard financing, might require \$7 million to \$10 million in equity capital after debt is placed. A value-add office repositioning might require more. A ground-up development project in a primary market might require multiples of either figure. Very few individuals possess the liquidity to deploy that kind of equity in a single transaction, and those who do generally have sound reasons not to concentrate it that way.

Syndication solves the capital problem by aggregating equity from multiple investors. Rather than requiring a single investor to write an \$8 million check, the sponsor raises that capital from a pool of investors, perhaps twenty or thirty of them, each contributing \$250,000 to \$400,000. The aggregate capital is assembled. The deal closes. Each investor participates in an asset that would have been inaccessible to them individually.

This mechanism also enables a degree of diversification that individual investing cannot match. A sponsor who raises equity from investors across multiple deals allows those investors to spread their real estate exposure across different assets, markets, property types, and business plans. The concentration risk of direct property ownership, where all of an investor's real estate exposure sits in a single building in a single market, is substantially reduced.

### **The Expertise Problem**

Capital by itself does not generate returns. It requires informed deployment and active management.

Acquiring, managing, and ultimately monetizing a commercial real estate asset requires a specific set of capabilities: market knowledge and deal-sourcing relationships to identify the opportunity; underwriting and capital markets expertise to structure the financing; construction management experience to execute a renovation; property management competency to maintain occupancy and income; lender relationship management to navigate covenant compliance; and transaction expertise to execute an

exit at the right time and on the right terms. Most investors, even sophisticated ones with substantial real estate experience, do not possess all of these capabilities simultaneously.

Syndication solves the expertise problem by interposing a professional manager between the capital and the asset. Investors provide the capital. The sponsor provides the expertise. Neither party can fully replicate what the other brings. The structure allows transactions to be executed that neither party could achieve alone.

### **The Alignment Mechanism**

The economic structure of a real estate syndication is designed to ensure that the sponsor and investors are pursuing the same outcome. The standard mechanism is a distribution waterfall that first returns investor capital, then provides investors with a preferred return on that capital, commonly 8% per year, and then splits additional profits between investors and the sponsor through the promoted interest.

The promote, typically 20% to 30% of profits above the preferred return threshold, is the sponsor's primary economic incentive, and it is earned only after investors have achieved their minimum required return. This structure means that the sponsor does not participate disproportionately in the investment's upside until investors have first been made whole and provided a baseline return on their capital. It is an imperfect alignment mechanism: fees and other compensation can create incentives that diverge from investors' interests. When properly structured and disclosed, however, the promote provides a genuine foundation for aligned incentives.

## **How Syndications Differ from Other Real Estate Investment Structures**

The real estate syndication occupies a specific position in a landscape of investment structures. Understanding what distinguishes it from other mechanisms for pooling capital in real estate helps clarify both its utility and its regulatory position.

### **Direct Ownership**

In a direct ownership arrangement, a single investor, or a small group of investors who all play active roles, acquires and operates a property. There is no passive investor class, no offering document, and typically no securities law analysis required. Direct

ownership is the simplest form of real estate investment and the baseline from which syndication is a meaningful departure.

The departure matters because of scale. Direct ownership is limited by the individual investor's capital and operational capacity. Syndication breaks those constraints by pooling capital from multiple sources and concentrating management responsibility in a professional operator. The trade-off is legal complexity. The introduction of passive investors immediately brings the investment within the scope of securities regulation.

## **Joint Ventures**

A joint venture typically involves two or more parties who each play an active role in the investment, or who are each sufficiently sophisticated that the passive investor analysis does not apply in the same way. A joint venture between an operating sponsor and an institutional equity partner, such as a family office or pension fund, involves a very different legal and commercial relationship than a traditional syndication with individual investors. Governance rights are more negotiated, documentation is more-extensive, and the investor's role is more active.

The distinction matters because the legal framework applicable to joint ventures and traditional syndications differs in important respects. Joint ventures are addressed in Chapter 7 in the context of entity structures and institutional co-investment mechanics.

## **Real Estate Funds**

A real estate fund pools capital not for a single identified asset but for a portfolio of assets to be identified and acquired over time. The fund structure introduces a different regulatory profile, a different investor relationship, and a different set of ongoing obligations than a single-asset syndication. Chapter 2 addresses the fund structure in depth.

## **REITs**

Real Estate Investment Trusts are a statutory investment structure governed by specific provisions of the Internal Revenue Code. Public REITs trade on national securities exchanges. Non-traded REITs raise capital through broker-dealer networks. Private REITs combine elements of the fund structure with a REIT tax election. Each REIT structure carries its own regulatory framework, and the compliance obligations differ significantly from those applicable to private real estate syndications.

## Benefits for Sponsors

The decision to raise capital from outside investors rather than investing solely from personal resources is not cost-free. It introduces regulatory obligations, investor relations demands, document preparation costs, and ongoing reporting requirements that direct investing does not. Sponsors who choose to syndicate do so because the benefits outweigh those costs, and when the platform is properly structured, they outweigh them substantially.

### Access to Capital at Scale

The most immediate benefit is access to a pool of capital that allows sponsors to pursue acquisitions beyond their personal equity capacity. The compounding effect of that access over time is the more significant story.

A sponsor who executes a first syndication successfully, who delivers distributions on schedule, communicates accurately and consistently with investors, and ultimately returns capital with a solid return, has created a track record. That track record, properly documented, makes the next capital raise easier. Investors who participated in the first deal and were well treated are natural participants in the second. Their referrals expand the investor base. The investor network grows with each successful execution, and the sponsor's ability to raise larger amounts of capital for increasingly sophisticated opportunities grows with it.

This compounding dynamic is one of the features that distinguishes a syndication platform from a series of individual transactions. Sponsors who approach their first syndication as a single transaction are often surprised to discover that building an investor base is as much a long-term relationship management endeavor as it is a capital-raising exercise.

### Building a Scalable Investment Platform

A sponsor who raises equity from investors can pursue more transactions, larger transactions, and build the team and infrastructure to support multiple simultaneous investments. The economics of the fee structure, including acquisition fees, asset management fees, and the promoted interest, create revenue streams that support a professional investment management enterprise rather than a series of individual transactions.



This platform-building dynamic is the deeper opportunity in the syndication model. The sponsor who executes consistently, builds a documented track record, and develops the operational infrastructure to manage an institutional-quality investor program is building a business: one with genuine enterprise value that extends beyond any individual deal.

### Participation in the Investment Upside

The promoted interest allows sponsors to participate meaningfully in investment profits without contributing a proportionate share of the equity. A sponsor who contributes 5% of the equity but earns 20% of the profits above the preferred return is converting expertise, deal-sourcing capability, and operational execution into an economic outcome that personal capital deployment alone could not produce.

This is also the mechanism that aligns the sponsor's economic interests with investors' interests. The promote has value only if the investment performs above the hurdle rate. A sponsor whose promoted interest is worthless unless investors first receive their capital back and their preferred return has a direct financial incentive to maximize investment performance, an incentive built into the structure rather than merely asserted.

### Fee Income from the Management Function

Separately from the promoted interest, sponsors typically earn fees in connection with the management of the investment. Acquisition fees, asset management fees, property management fees, and disposition fees are common. These fees provide operating revenue for the sponsor's platform, revenue that supports the team, the infrastructure, and the ongoing operations of the investment management business.

The structure and disclosure of affiliated fees is one of the most legally sensitive aspects of syndication practice. Fees that are reasonable in light of the services provided, properly disclosed in the PPM, and honestly earned are a legitimate component of the sponsor's economics. Fees that are excessive, inadequately disclosed, or structured in ways that misalign the sponsor's interests from investors' create both legal exposure and reputational damage that is disproportionate to any fee income they generate.

## Benefits for Investors

The passive investor in a real estate syndication is making a deliberate exchange: capital for access, operational burden for professional management, and concentrated risk for the potential of diversification. Understanding what investors receive, and what they surrender, is essential to structuring offerings that genuinely serve both sides of the relationship.

### **Access to Institutional-Quality Investments**

The assets that real estate syndications typically target, including institutional-quality apartment communities, Class A industrial facilities, and well-located mixed-use developments, require equity investments that most individual investors cannot supply independently. Through a syndication, an investor with \$250,000 to deploy can participate in a transaction that might require \$5 million or more of equity in a direct ownership arrangement.

This access to scale is one of the genuinely compelling features of the syndication model. It allows individual investors to build real estate exposure that approximates the quality and diversity of an institutional portfolio rather than the retail investment grade of direct property ownership at an individual scale.

### **Passive Ownership and Professional Management**

Most investors who participate in real estate syndications are not seeking an operational role. They want economic exposure to real estate, the income, the appreciation, and the tax attributes, without the management responsibilities that direct property ownership entails. The syndication delivers that exposure.

True passivity in a real estate syndication is both its appeal and its risk. Investors who delegate management to the sponsor are accepting dependence on the sponsor's judgment, execution, and integrity. The quality of that delegation, including how the sponsor is selected, what protections the governing documents provide, and how performance is monitored and reported, determines whether the passive investor's experience is a productive one.

### **Portfolio Diversification**

Investors who participate in multiple syndications across different sponsors, asset classes, and markets build real estate portfolios that would be difficult or impossible to construct through direct ownership. Each investment is individually small enough to

allow capital to be spread across many opportunities. The aggregate exposure can achieve meaningful diversification.

This diversification dynamic creates a reciprocal opportunity for sponsors who understand it. The investor building a diversified portfolio of syndication investments is a better long-term partner than the investor treating any single deal as a concentrated position. Sponsors who consistently provide access to quality opportunities, communicate reliably, and execute professionally build investor relationships that persist across multiple transactions.

### **Tax Advantages of Pass-Through Ownership**

Real estate syndications structured as LLCs or limited partnerships pass income, losses, and tax attributes through to investors on a pro-rata basis. Investors receive the tax benefits of real estate ownership, including depreciation deductions, cost segregation benefits, and interest deductions, without directly owning and operating property.

The depreciation benefit in particular is significant. A properly structured real estate investment generates paper losses, tax losses that arise from depreciation deductions, that can offset other passive income and reduce the investor's effective tax cost of the investment. Cost segregation studies accelerate a portion of that depreciation, often producing substantial first-year tax benefits. These attributes are a genuine and material component of the economic value of real estate investment that the syndication structure preserves and passes through to investors.

## **A Typical Real Estate Syndication: Walking Through the Structure**

Abstract descriptions of investment structures produce limited understanding. A concrete example clarifies the mechanics.

Consider a value-add multifamily acquisition. A real estate sponsor has identified a 180-unit apartment community in a growing Sun Belt market. The purchase price is \$28 million. After arranging senior debt financing of \$19.6 million from a multifamily lender, representing 70% of the purchase price, the sponsor has determined that the transaction requires \$8.4 million in equity capital. Additional transaction costs, including

acquisition fees, legal fees, due diligence, and closing costs, are estimated at \$600,000, bringing the total equity requirement to \$9 million.

The sponsor organizes a limited liability company, Pine Ridge Apartments LLC, to acquire and hold the property. The sponsor's management entity serves as the managing member of Pine Ridge Apartments LLC. The sponsor then raises \$9 million from a pool of accredited investors, each of whom executes a subscription agreement and contributes capital to Pine Ridge Apartments LLC in exchange for non-managing membership interests.

| Transaction Capitalization    |                                        |
|-------------------------------|----------------------------------------|
| Purchase Price                | \$28,000,000                           |
| Senior Debt (Lender)          | \$19,600,000 (70.0% of purchase price) |
| Equity Required (net of debt) | \$8,400,000 (30.0% of purchase price)  |
| Closing Costs and Fees        | \$600,000                              |
| Total Equity Raise            | \$9,000,000                            |
| Approximate Investor Count    | 25 to 36 accredited investors          |
| Typical Investor Contribution | \$250,000 to \$360,000 per investor    |

The sponsor's management entity earns an acquisition fee at closing and an asset management fee throughout the hold period. The operating agreement establishes an 8% cumulative preferred return for investors and a 20% promoted interest for the sponsor on profits above that threshold.

During the hold period, the sponsor implements the value-add business plan: unit renovations, common area improvements, new property management, and adjusted pricing to bring rents toward market rate. Quarterly distributions are made from operating cash flow. Investors receive quarterly reporting and annual audited financial statements with K-1s.

After approximately four years, the sponsor sells the property. The sale proceeds, after repayment of the mortgage and closing costs, are distributed through the waterfall defined in the operating agreement: first, return of investor capital; then, payment of the

accrued preferred return; then, the sponsor catch-up; then, the residual split between investors and the sponsor.

The economics are specific, the governance is defined, and the legal obligations of every party throughout this lifecycle are established in writing before any investor commits capital. That is what a properly structured real estate syndication looks like.

## The Relationship Between Real Estate Syndications and Securities Laws

The single most important conceptual clarification in this chapter, and the one that most sponsors new to capital raising have not fully internalized, is this:

**A real estate syndication is a securities offering.**

Not because of the size of the raise. Not because of the number of investors. Not because of the sophistication or lack of sophistication of the parties. A real estate syndication is a securities offering because of what it is: a structure in which investors contribute capital and rely on the managerial efforts of a sponsor to generate their returns.

### Why Securities Laws Apply

The Securities Act of 1933 was enacted in the aftermath of the stock market collapse of 1929 and the widespread investor abuses that preceded it. Its foundational principle is straightforward: before selling a security to the public, the seller must either register the offering with the SEC, providing the full disclosure that registration requires, or conduct the offering pursuant to a valid exemption from registration.

The definition of a security under federal law is deliberately broad. Section 2(a)(1) of the Securities Act defines security to include, among many other instruments, investment contracts: a category that courts have interpreted expansively to capture any arrangement in which investors contribute capital to a common enterprise with an expectation of profits from the efforts of others.

That definition, derived from the Supreme Court's 1946 decision in *SEC v. W.J. Howey Co.*, describes a real estate syndication precisely. Investors contribute capital. The enterprise is common, since all investors participate in the same property's performance. Returns are expected. And those returns depend primarily on the

managerial efforts of the sponsor, not the operational efforts of the investors themselves.

## What Compliance Requires

The application of securities law to real estate syndications does not mean that raising capital from investors is prohibited or impractical. It means that raising capital must be done through the right structure, with the right documents, and in compliance with the applicable regulatory framework.

For most private real estate syndications, the relevant framework is Regulation D under the Securities Act, specifically the Rule 506(b) or Rule 506(c) exemptions from registration. These exemptions allow sponsors to raise capital from accredited investors without registering the offering with the SEC. Rule 506(b) permits up to 35 sophisticated non-accredited investors alongside an unlimited number of accredited investors, but prohibits general solicitation. Rule 506(c) permits general solicitation but requires that all investors be verified as accredited. These exemptions are the foundation of the private real estate capital market, and they are addressed in depth in Chapter 12.

What the regulatory framework requires, at a minimum:

- A valid securities exemption, selected based on the offering's size, investor composition, and marketing approach, and complied with throughout the offering.
- A disclosure document, typically a Private Placement Memorandum, that provides investors with material information about the investment, the risks, the sponsor, and the terms of the offering in sufficient detail to allow an informed investment decision.
- Governing documents, including an operating agreement that defines investor rights and the sponsor's obligations, and a subscription agreement that documents the investor's representations and the issuer's acceptance.
- Regulatory filings, including Form D with the SEC within 15 days of the first sale of securities, and state blue sky notice filings in each state where investors are located.
- Ongoing compliance, including investor reporting, transfer restriction enforcement, and adherence to the requirements of the applicable exemption throughout the investment's life.

### **The Compliance Threshold**

Sponsors who raise capital from passive investors without understanding and complying with the applicable securities framework are not simply taking a legal risk in the abstract. They are potentially violating federal law in ways that expose them to SEC civil enforcement, investor rescission rights, state securities law liability, and, in cases involving willful misrepresentation, criminal prosecution.

The regulatory framework is not an obstacle to the real estate investment business. It is the framework within which that business must be conducted. Sponsors who build compliance infrastructure properly from the beginning, including the right documents, the right exemption, the right filings, and the right counsel, build a more durable platform than those who treat compliance as an afterthought.

### **The Anti-Fraud Standard: A Broader Obligation**

Beyond the registration and exemption framework, the anti-fraud provisions of the federal securities laws, specifically Section 17(a) of the Securities Act and Rule 10b-5 under the Exchange Act, apply to every offer and sale of securities, registered or not, exempt or not. These provisions prohibit material misrepresentations, material omissions, and fraudulent conduct in connection with any securities transaction.

The anti-fraud standard is the legal context in which every communication between a sponsor and a prospective investor must be evaluated. The pitch deck. The projected returns in the PPM. The description of the sponsor's track record. The characterization of the risks in the risk factors section. The representations made in investor calls and meetings. All of these communications are subject to the anti-fraud standard, and inaccuracies, whether intentional or negligent, can give investors grounds for securities fraud claims regardless of whether the offering otherwise complied with the registration requirements.

Understanding the anti-fraud standard is not primarily a matter of knowing when liability attaches. It is a matter of understanding the professional standard that every communication about the offering must meet: complete, accurate, and not misleading in light of the circumstances under which it is made.

## **Syndications, Funds, and Other Structures: A Comparison**

The following table summarizes the key structural differences among the primary vehicles through which private real estate capital is organized. The differences have

both operational and legal significance, and understanding them is important for any sponsor evaluating which structure is appropriate for a specific investment program.

| Element                          | Single-Asset Syndication                 | Real Estate Fund                              | Direct Ownership or JV               |
|----------------------------------|------------------------------------------|-----------------------------------------------|--------------------------------------|
| <b>Investment object</b>         | Specific identified property             | Portfolio of assets per defined strategy      | Specific identified property         |
| <b>Investor decision basis</b>   | Specific deal evaluation                 | Manager, strategy, and track record           | Direct property evaluation           |
| <b>Sponsor role</b>              | Managing member or GP of the SPV         | Fund manager; GP of the fund entity           | Active co-owner or sole owner        |
| <b>Passive investor class</b>    | Yes, mandatory for securities compliance | Yes, limited partners or non-managing members | Not required; often not present      |
| <b>Securities offering</b>       | Almost always yes                        | Almost always yes                             | Depends on investor involvement      |
| <b>Primary offering document</b> | PPM for the specific deal                | PPM for the fund strategy                     | Not required if no passive investors |
| <b>Capital structure</b>         | Fixed equity raise at closing            | Committed capital; drawn via capital calls    | Fixed equity at closing              |
| <b>Diversification</b>           | Single asset; concentrated               | Multiple assets; portfolio-level              | Single asset; concentrated           |
| <b>Typical hold period</b>       | 3 to 7 years per deal                    | 8 to 10 years for the fund                    | Indefinite                           |
| <b>Regulatory complexity</b>     | High; securities offering framework      | Higher; may trigger IA registration           | Lower if no passive investors        |

## Why the Legal Framework Requires Experienced Counsel

The structure of a real estate syndication and the regulatory framework that governs it interact in ways that require specific legal expertise to navigate correctly. This is not a general observation about the value of legal advice. It is a specific statement about the nature of the work involved.

Selecting the correct securities exemption requires a multi-factor analysis specific to the offering: the size of the capital raise, the composition of the investor base, the marketing approach, the sponsor's existing investor relationships, and whether prior offerings might implicate the integration doctrine. Getting the exemption wrong, or complying



imperfectly with the conditions of the correct exemption, creates legal exposure that can extend to every investor in the offering.

Drafting the operating agreement requires understanding how the economic terms of the deal, including the preferred return, the waterfall, the promoted interest, and the fee structure, translate into precise legal language that functions correctly across every scenario the investment might encounter over a multi-year hold period. Ambiguity in the waterfall provision is not a drafting inconvenience. It is a future dispute.

Preparing the PPM requires applying the anti-fraud standard to every material fact about the investment, the sponsor, and the risks involved, not at a general level, but with the specificity that the particular deal requires. A risk factors section that was adequate for a stabilized multifamily acquisition may be wholly inadequate for a ground-up development offering.

Managing state blue sky compliance requires tracking notice filing requirements in every state where investors are located, meeting filing deadlines, and monitoring changes in state-level filing requirements over the life of the offering. Missing a filing in a state with an active enforcement program is a material compliance failure.

None of this analysis is produced automatically by general legal competence. It requires specific experience in private securities offerings and, ideally, experience with the specific asset class and deal type involved. Sponsors who use general practice attorneys for syndication work, or who rely on document services that produce forms without the benefit of transaction-specific legal analysis, are not saving money. They are deferring cost to a later point at which corrections are substantially more-expensive.

#### **A Note on Counsel Selection**

The legal questions in a real estate syndication are specific: Which exemption applies and what does it require? What risk factors are material to this deal? Does the waterfall provision work as intended across all scenarios? Is the track record disclosure accurate and complete?

These questions require a securities attorney with direct experience in private placement offerings and familiarity with the real estate industry. For sponsors who are building an investment platform rather than executing a single transaction, that counsel relationship is one of the most important professional relationships the platform will have.

Sponsors who want to discuss what a specific offering requires are welcome to reach out directly at [crowdfundlawyer.com](https://crowdfundlawyer.com).

## Practical Takeaways

- A real estate syndication is a structure in which a sponsor manages a real estate investment on behalf of passive investors who have contributed equity capital. The sponsor provides expertise and management. Investors provide capital and receive passive economic interests.
- The passive investor structure that makes syndications economically viable, specifically investors relying on the sponsor's efforts to generate returns, is precisely what makes most syndications securities offerings under federal law. These two facts are inseparable.
- Syndications exist because they solve genuine problems for both sponsors and investors: the capital constraint that prevents individual operators from pursuing institutional-quality assets, and the expertise constraint that prevents most investors from managing those assets themselves.
- The economic structure of a syndication, including the preferred return, the promoted interest, and fee income, is designed to align sponsor and investor incentives. The alignment is real but imperfect, and the quality of that alignment depends on how clearly the economic terms are documented and how honestly they are disclosed.
- Federal securities law applies to virtually every real estate syndication regardless of size, investor sophistication, or the sponsor's intent. Compliance with the applicable exemption from registration, the disclosure obligations of the offering documents, and the anti-fraud standard is not optional.
- The legal complexity of a real estate syndication, including exemption selection, operating agreement drafting, PPM preparation, and state blue sky compliance, requires specific legal experience. Generalist legal competence, however capable in other contexts, is not a substitute.

## CHAPTER TWO

# What Is a Real Estate Fund?

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There is a question that experienced real estate operators eventually encounter from institutional investors, wealth management platforms, and sophisticated individual investors who have seen enough single-deal syndications to want something different: do you run a fund?

The question reflects a different set of expectations. Investors who ask it are not asking whether the sponsor can execute a single acquisition. They are asking whether the sponsor has built the infrastructure, the team, the compliance program, the governance framework, the track record, to manage capital across a portfolio of investments over a multi-year fund lifecycle. Those are different capabilities, and the legal framework that applies to a fund is, in meaningful respects, a different framework than the one that applies to a single-asset syndication.

A real estate fund pools investor capital into a single vehicle that deploys it across multiple assets over a defined investment period, holds those assets through a defined fund term, and returns capital to investors as assets are realized. The investor in a fund is not evaluating a specific property. They are evaluating a manager and a strategy, making a commitment to a team and an investment thesis rather than to a particular deal. That distinction has significant implications for the legal structure, the offering documents, the regulatory obligations, and the investor relationship.

This chapter addresses what real estate funds are, how they differ structurally and legally from single-asset syndications, what the principal fund structures look like and how they function, and how sponsors should think about the transition from deal-by-deal capital raising to a fund model. That transition is one of the most consequential decisions a growing investment platform makes, and it deserves a clear-eyed assessment of what it actually requires before the commitment is made.

## How Funds Differ from Single-Asset Syndications

The most fundamental distinction between a real estate fund and a single-asset syndication is the object of the investment. In a syndication, investors know what they are buying. The PPM describes a specific property, a defined market, a specific

business plan, and a projected hold period. Investors can evaluate the specific opportunity on its own merits before committing capital.

In a fund, investors are committing capital to a manager and a strategy, not to a specific asset. The fund will acquire properties over time, using committed capital as it is deployed. At the time investors commit, they may not know what properties the fund will own. They are investing in a blind pool.

That distinction has legal significance that sponsors sometimes underestimate. The securities disclosure obligations for a blind pool fund are different from those of a single-asset offering, because there is no specific property to describe. The PPM must instead describe the investment strategy, the manager's track record and decision-making process, the investment parameters that will govern what the fund can acquire, and the governance framework that will protect investors in the absence of deal-specific visibility. Every one of those elements requires careful drafting by securities counsel with specific fund formation experience.

### **The Blind Pool and the Manager's Discretion**

When investors commit to a fund, they are delegating investment discretion to the manager. They are expressing confidence that the manager will identify, evaluate, and execute on opportunities consistent with the stated strategy, and they are accepting that they will not have the same deal-level visibility they would have in a single-asset syndication.

That delegation of discretion carries corresponding obligations. A fund manager owes fiduciary duties to the fund's investors that are more formally defined and more rigorously enforced than those in a typical single-asset syndication. The duties of loyalty and care, the obligation to act in investors' interests and to manage the fund with appropriate competence, are not aspirational standards in a fund context. They are enforceable legal obligations that govern every material decision the manager makes, including how capital is deployed, how conflicts of interest are managed, how information is disclosed, and how fees and compensation are structured.

The investment guidelines in a fund's offering documents, the parameters that define what the fund can and cannot invest in, are the contractual expression of the strategy investors committed to. Violations of those guidelines are not strategy deviations. They are breaches of the fund's governing documents with legal consequences.

## The Manager as the Investment Thesis

In a single-asset syndication, the investment thesis is the property. In a fund, the investment thesis is the manager. Investors who commit to a fund are betting on the team's ability to find, underwrite, execute, and exit investments across an entire portfolio over multiple years, not on the merits of a single deal they can independently evaluate.

This is why track record matters so differently in the fund context. A sponsor who can present a single successful syndication is positioned to raise a follow-on syndication. A sponsor who seeks to raise a blind pool fund must present a body of work substantial enough to justify investor confidence in their judgment across an investment program they have not yet defined. The evidentiary bar is meaningfully higher, and the legal disclosure obligations around track record presentation, including accuracy, attribution, and the prohibition on selective presentation of results, apply with correspondingly greater significance.

### The Structural Distinction: Single-Asset Syndication vs. Fund

#### Single-Asset Syndication

- Investors evaluate and commit to a specific identified property.
- Capital funded at or near closing; no ongoing capital call obligation.
- Hold period tied to the specific asset's business plan, typically 3 to 7 years.
- Sponsor authority defined by operating agreement for the specific entity.
- Regulatory profile: Regulation D exemption; lower compliance overhead.

#### Real Estate Fund (Closed-End)

- Investors commit to a manager and strategy; assets are acquired over time.
- Capital drawn through capital calls as investments are made.
- Fund term defined by the LPA, typically 8 to 10 years.
- Manager authority governed by LPA investment guidelines; LPAC oversight.
- Regulatory profile: may trigger investment adviser registration; more complex.

## Why Sponsors Move from Syndications to Funds

The transition from deal-by-deal syndications to a fund structure is driven by a combination of strategic motivations and operational realities. Understanding both is

important for sponsors evaluating whether the transition makes sense for their platform, and for investors evaluating whether a fund is the appropriate vehicle for their capital.

## Scaling the Investment Platform

The deal-by-deal syndication model reaches natural constraints as a platform grows. Each new transaction requires a new capital raise, a new offering document package, a new closing timeline, and a diversion of management attention from the existing portfolio to the fundraising effort. As the number of active assets grows, the administrative overhead of maintaining multiple single-asset entities, managing multiple investor groups, and coordinating multiple reporting streams multiplies substantially.

A fund structure consolidates that complexity into a single investor-facing vehicle. Investors commit capital once and receive exposure to a portfolio of assets. They evaluate the strategy and the manager once, rather than evaluating every deal the sponsor brings to them. The sponsor raises capital during a defined fundraising period and then deploys it according to the investment strategy, without returning to investors for participation in each individual acquisition.

This consolidation has real operational value. It frees the management team to focus on deal execution and asset management, the activities that actually create value, rather than cycling through investor communications, subscription processing, and offering document preparation with each new acquisition.

## Reducing Per-Deal Transaction Costs

The fixed costs of a private securities offering, including legal fees, document preparation, state blue sky filings, and fund administration setup, are meaningful in absolute terms. For a single-asset syndication raising \$5 million, those costs represent a non-trivial percentage of the raise. For a fund raising \$50 million, those same costs are amortized across the entire capital pool, and the per-dollar cost of legal and administrative infrastructure decreases substantially.

This efficiency argument is valid, but it deserves honest qualification. Fund formation has its own upfront costs that are typically higher than those of a single-asset syndication. A well-drafted limited partnership agreement for a blind pool fund is a materially more complex document than a single-asset operating agreement, and the PPM disclosure requirements are more-extensive. The net efficiency gain materializes over the life of the fund, not at formation.

## Building Institutional Credibility

There is a segment of the investor market, including family offices, registered investment advisers, and institutional allocators, that essentially does not participate in single-asset syndications. Not because they lack interest in real estate, but because their compliance, due diligence, and relationship frameworks are built around fund structures. They want a formal limited partnership agreement with investor protections they recognize. They want audited financial statements. They want a track record presented in the format their analysts evaluate every day.

For sponsors whose long-term platform development involves accessing institutional capital, the fund structure is the entry ticket. The question is not whether to eventually adopt a fund structure. It is whether the platform is ready to operate one correctly when the decision is made.

## Closed-End Real Estate Funds

The closed-end fund is the dominant structure in private real estate fund formation, and it is the structure most sponsors encounter when they first move toward a fund model. Its defining characteristics, a fixed capital raise, a defined investment period, and a finite fund life, create a clear temporal framework within which the fund's economic activity occurs.

### The Basic Architecture

A closed-end real estate fund raises capital over a defined offering period, reaches a target amount of committed capital, closes to new investors, deploys that capital into real estate assets over a defined investment period, manages those assets through their respective hold periods, and returns capital to investors as assets are sold. The entire lifecycle, from initial close to final distribution, typically spans eight to ten years, though the specific term is defined in the fund's governing documents.

The fund entity is typically a limited partnership or LLC in which investors hold limited partnership interests or non-managing membership interests. The sponsor controls the fund through a general partner entity or managing member entity, the same two-tier structure that governs a well-structured single-asset syndication, but operating at the fund level rather than the asset level. Individual assets are held in separate SPVs owned by the fund, providing asset-level liability isolation.

### **Closed-End Fund Architecture**

#### **Management Company (Sponsor)**

Controls the Fund GP or Managing Member. Earns management fees and carried interest.

#### **Fund GP LLC or Fund Managing Member LLC**

General partner or managing member of the Fund entity.

#### **Fund Entity (LP or LLC)**

Investor-facing vehicle. Holds committed capital. Calls capital for investments.

#### **SPV #1 (LLC) | SPV #2 (LLC) | SPV #3 (LLC)**

Each SPV holds a single real estate asset. Each is the borrower under its mortgage.

Investors commit capital to the Fund entity. The Fund entity owns the SPVs.

The Management Company controls the Fund GP, which controls the Fund entity.

### **Capital Call Mechanics and Investor Commitments**

One of the defining features of a closed-end fund is the capital call mechanism.

Investors in a fund do not wire their committed capital at the initial closing. Instead, they commit to contribute up to a specified amount over the life of the fund and fund that commitment incrementally as the manager calls capital to make specific investments.

An investor who commits \$500,000 to a fund retains that capital in their own accounts, earning returns on it in the meantime, until the manager issues a capital call notice. The notice specifies the amount being called, the purpose of the call, and the deadline by which investors must fund. Capital calls are typically issued with ten business days' advance notice, and they are mandatory. Investors who committed to the fund are contractually obligated to fund capital calls up to their commitment amount.

The legal obligations associated with the capital call commitment are enforceable and consequential. Investors who fail to fund a capital call by the specified deadline become defaulting investors, triggering remedies specified in the fund's governing documents: forfeiture of prior contributions, dilution of their interests, interest charges on the unfunded amount, or forced transfer of their interests at a discounted price. These remedies are not punitive in design. They reflect the fund's legitimate need for reliable capital to fund closing timelines that cannot accommodate unfunded commitments.

The capital call mechanism also creates an obligation that sponsors sometimes underestimate when evaluating whether investors are appropriate for a fund. Individual high-net-worth investors who are accustomed to single-deal syndications, where capital



is funded once at subscription, may not have the liquidity management discipline that capital call investing requires. An investor who commits \$500,000 to a fund but does not maintain accessible liquidity sufficient to fund capital calls within ten business days is a credit risk to the fund regardless of their overall net worth. Investor education on this obligation, and appropriate diligence on investor liquidity, is part of the fund manager's responsibility.

### **The J-Curve: Why Fund Returns Are Back-Loaded**

Investors accustomed to evaluating single-asset syndications, where a successful investment might generate quarterly distributions beginning shortly after closing, sometimes express concern when a fund shows negative or flat interim returns in its early years. This reaction reflects an unfamiliarity with the J-curve dynamic that is a structural feature of the closed-end fund model.

The J-curve describes the typical pattern of fund returns over a fund's life. In the early years, the fund is deploying capital into acquisitions but has not yet begun generating realized returns. Management fees and organizational costs are being charged against committed capital. Properties have been acquired at full transaction cost, but the business plans that will drive value creation, such as renovations, lease-up, and repositioning, are still in progress. On a mark-to-market basis, the fund's NAV may be below the capital invested, producing an apparent negative return.

As the investment period progresses and assets are acquired, improved, and ultimately sold, the fund begins generating realized returns. Distributions from early exits flow to investors. The fund's mark-to-market value improves as properties appreciate and income stabilizes. By the time the fund reaches its harvest phase, when most assets are being monetized, the cumulative return typically reflects the full benefit of the strategy.

Understanding the J-curve is essential for both sponsors and investors. Sponsors who fail to prepare investors for early-year interim metrics that may look underwhelming, even when the underlying business plan is on track, are creating investor relations problems that are entirely avoidable. Investors who evaluate a fund's interim performance without understanding the J-curve may draw conclusions about the fund's success or failure that the actual state of the portfolio does not support.

### **The J-Curve: A Simplified Illustration**

Years 1 to 2 (Investment Period, Early): Capital deployed; fees accruing; no realizations.

Interim NAV often below invested capital. Management fees charged.

Years 3 to 5 (Investment Period, Late): Business plans executing; values improving.

Interim NAV begins recovering. First asset realizations may occur.

Years 6 to 8 (Harvest Phase): Assets being sold; distributions accelerating.

Cumulative returns substantially positive for well-performing funds.

Years 9 to 10 (Wind-Down): Final assets sold; remaining capital returned.

Final distributions; fund dissolved; ultimate return determined.

The J-curve is not evidence of underperformance. It is a structural feature of the closed-end model that every investor should understand before committing capital.

### **Waterfall Distributions and Carried Interest in a Fund Context**

The distribution waterfall in a closed-end fund follows the same basic architecture as in a single-asset syndication: return of capital, preferred return, catch-up, and residual split. The implementation is more complex, however, because the fund holds multiple assets that are realized at different times and at different levels of performance.

The critical structural question for a closed-end fund is whether the waterfall is calculated on a deal-by-deal basis, sometimes called the American waterfall, or on a whole-fund basis, sometimes called the European waterfall. This distinction has significant economic implications for both sponsors and investors, and it is one of the most actively negotiated provisions in institutional fund documents.

In a deal-by-deal waterfall, the carried interest is calculated and paid as each asset is realized. If an asset generates returns above the hurdle, the sponsor receives carry on that asset's distributions before moving to the next asset. The advantage for sponsors is earlier receipt of carried interest: carry is paid out of early winners without waiting for the full portfolio to be realized. The risk for investors is that the sponsor can receive substantial carried interest on strong early performers before the fund's overall performance is established. If later assets underperform, investors may have been disadvantaged by paying carry on a portfolio that, in aggregate, underperformed the hurdle.

In a whole-fund waterfall, all investor capital across all assets must first be returned and all investors must receive their preferred return before the sponsor receives any carried

interest. This approach eliminates the early carry payment risk associated with deal-by-deal structures and is more clearly aligned with investors' interests. It requires the sponsor to wait longer for economics but eliminates the clawback complexity associated with deal-by-deal structures.

Clawback provisions, which require the sponsor to return previously received carried interest if the fund's overall performance ultimately falls below the hurdle, are essential in deal-by-deal waterfall structures. A fund that pays substantial carry on early winners, only to have later assets underperform, has effectively transferred value from investors to the sponsor absent an enforceable clawback. According to the 2021 ILPA market data report, investors were successful in negotiating interim clawbacks in over 50% of fund negotiations. By 2024, a Paul Weiss survey found that nearly 64% of funds include interim clawback provisions. Drafting the clawback provision with sufficient specificity, including the calculation methodology, the timing of the obligation, and the liquidity of the principals, is one of the most consequential pieces of legal work in any fund formation.

## Open-End Real Estate Funds

An open-end fund, also called an evergreen fund, operates on a fundamentally different model than a closed-end fund. Rather than raising a fixed pool of capital, investing it over a defined period, and returning it through asset dispositions, an open-end fund continuously accepts new capital, continuously acquires and manages assets, and provides investors with periodic opportunities to redeem their interests.

The open-end model addresses one of the most significant objections to private real estate fund investing: the absence of liquidity. Investors in a closed-end fund commit their capital for eight to ten years without the ability to exit early. An open-end fund offers a different experience: periodic liquidity windows at which investors can redeem some or all of their interests, at a price reflecting the fund's current net asset value.

That promise is valuable. It is also operationally complex to fulfill in an asset class as fundamentally illiquid as real estate.

### The Evergreen Structure

An open-end fund does not have a fixed capital raise or a defined fund life. It accepts new investor subscriptions on a continuous or periodic basis, typically quarterly, at a

price equal to the fund's current NAV per unit. It manages an ongoing portfolio of assets, acquiring new properties as capital is available and disposing of properties when appropriate. It is designed to operate indefinitely, building a permanent portfolio rather than a time-limited one.

The governance framework of an open-end fund reflects this perpetual character. Management fee calculations, distribution policies, and governance mechanisms must all be designed to function across a continuously changing investor base, a continuously evolving portfolio, and an indefinite time horizon.

### **NAV-Based Pricing and the Valuation Challenge**

The continuous subscription and redemption mechanics of an open-end fund require that the fund's NAV be determinable at each subscription and redemption window. New subscribers pay the current NAV per unit; redeeming investors receive the current NAV per unit. For the system to function fairly, the NAV must accurately reflect the current value of the fund's assets.

Real estate assets are not marked-to-market by nature. Their value is determined through periodic appraisals, a process that is both costly and inherently backward-looking. In a period of rapid market movement, whether up or down, the appraised values used to calculate NAV can diverge significantly from what the assets would actually command in a transaction. This valuation lag creates fairness concerns: investors who subscribe at a NAV based on stale appraisals may overpay relative to current market value; investors who redeem at a stale NAV may exit at prices that do not reflect current conditions.

Managing this dynamic requires a rigorous, independent appraisal process conducted at appropriate frequency, clear policies governing when and how valuations are updated, and transparency to investors about the methodology and its inherent limitations. Sponsors operating open-end funds without institutional-quality valuation infrastructure are accepting both legal exposure and investor relations risk that the open-end model requires them to manage continuously.

### **Liquidity Management: Redemption Queues and Gates**

The structural mismatch between the open-end fund's liquidity promise and the underlying illiquidity of real estate assets creates the most significant operational challenge in the open-end model. Real estate cannot be liquidated quickly or cheaply.

When redemption requests from investors exceed the fund's available liquidity, whether cash on hand, proceeds from recent dispositions, or capital from new subscriptions, the fund faces a gap between what it has promised and what its assets can deliver.

The standard mechanism for managing this gap is a redemption gate: a provision in the fund's governing documents that limits total redemptions in any given period to a specified percentage of net assets, typically 5% to 10% per quarter. When redemption requests exceed the gate, they are either pro-rated among requesting investors or queued for processing in future redemption windows.

Gates are disclosed in the fund's offering documents and are not a sign of distress. They are a structural feature of the open-end model that every investor should understand before committing. When gates are invoked in practice, however, they are almost always experienced as a disappointment by investors who expected liquidity and received a queue position instead. The investor relations management required when a gate is triggered, including prompt, transparent, specific communication about the timeline and mechanics, is a test of the sponsor's institutional quality that the fund's governance documents should anticipate.

### **The Open-End Liquidity Promise: Understanding Its Limits**

An open-end fund's periodic redemption windows do not transform real estate into a liquid asset class. The underlying assets are still illiquid. The liquidity available at any redemption window depends on the fund's cash position, recent asset dispositions, and the net of new subscriptions against redemption requests.

Before marketing an open-end fund on the basis of liquidity features, sponsors must have concrete liquidity management policies in place: gate provisions, redemption queues, and a framework for communicating with investors when gates are triggered. Marketing periodic redemption as equivalent to stock-like liquidity, without clear disclosure of the gate mechanics and the conditions under which redemptions may be deferred, creates both securities disclosure obligations and investor relations liability.

### **Why Open-End Structures Are Challenging for Smaller Sponsors**

The operational demands of an open-end fund, including continuous portfolio management, periodic independent appraisals, active redemption queue management, NAV calculation and reporting, and the ongoing administration of a continuously changing investor base, require a level of institutional infrastructure that most emerging sponsors have not yet built.

The minimum viable infrastructure for a properly operated open-end fund includes: a fund administrator capable of managing NAV calculations, subscription and redemption processing, and investor account maintenance across a dynamic investor base; an independent appraiser willing and able to value a growing portfolio at appropriate frequency; a compliance program capable of managing the ongoing securities offering that continuously accepting new investors represents; and an investor relations operation capable of communicating effectively with a large and heterogeneous investor base.

None of this is impossible for a smaller manager. But it is materially more-expensive and operationally more demanding than a closed-end fund, which is itself more demanding than a single-asset syndication. Sponsors evaluating the open-end model for the first time should have candid conversations with experienced fund administration and legal professionals about what the ongoing operational requirements actually look like before committing to the structure.

## **Interval Funds and Non-Traded REITs as Hybrid Structures**

Between the pure closed-end fund and the pure open-end fund, several hybrid structures occupy meaningful portions of the private real estate market. Sponsors evaluating the fund landscape should understand what these structures are and how they differ, even if most emerging managers will not use them on their first fund.

### **Interval Funds**

An interval fund is a registered investment company under the Investment Company Act of 1940 that provides investors with periodic repurchase opportunities, typically quarterly, at defined percentages of outstanding shares, rather than daily redemption rights or full illiquidity. The periodic repurchase mechanism gives interval funds a middle-ground liquidity profile: more liquid than a closed-end fund, less liquid than a conventional mutual fund.

The interval fund structure has become a significant vehicle in the non-traded real estate market because it allows continuous capital raising, subject to registration, while providing periodic liquidity events. Its appeal to sponsors is the ability to raise capital from a broad retail investor base on an ongoing basis without the liquidity demands of a fully open-end structure.

The regulatory complexity of the interval fund is substantial. Registration as an investment company requires compliance with a detailed regulatory framework that is considerably more demanding than the Regulation D exemptions governing most private funds. The ongoing reporting obligations, the requirements for independent directors, and the limitations on affiliated transactions make the interval fund appropriate only for sponsors with meaningful legal and compliance resources.

## Non-Traded REITs

Non-traded REITs are real estate investment trusts registered with the SEC whose shares do not trade on a national securities exchange. They raise capital from retail and accredited investors through broker-dealer networks and registered investment adviser platforms, and they distribute income on a pass-through basis consistent with REIT qualification requirements.

The REIT election imposes specific income, asset, distribution, and organizational requirements that must be satisfied on an ongoing basis. Maintaining REIT qualification requires continuous monitoring of the fund's portfolio composition and income sources. The consequences of inadvertent REIT disqualification, including loss of the pass-through tax treatment for the fund year in which disqualification occurs, are severe enough that qualified tax counsel is a non-negotiable advisor for any REIT structure.

For most sponsors exploring fund formation for the first time, non-traded REITs and interval funds are not the right starting point. They are noted here because sponsors may encounter them in the market and should understand broadly what they are, and because some sponsors, as their platforms mature, may find the additional regulatory burden worth the broader investor access these structures enable.

## The Investment Advisers Act: A Critical Regulatory Consideration for Fund Managers

There is one regulatory dimension of the fund structure that sponsors who have operated exclusively in the single-asset syndication world often overlook, sometimes with significant consequences. Sponsors who manage real estate funds may be investment advisers under the Investment Advisers Act of 1940, with registration obligations and ongoing compliance requirements that do not apply to single-asset syndication sponsors.



The Investment Advisers Act defines an investment adviser broadly: any person who, for compensation, engages in the business of advising others, directly or indirectly, about investing in securities. A real estate fund manager who receives a management fee for managing a fund whose interests are themselves securities may fall squarely within this definition. Whether the analysis goes further, however, depends critically on what assets the fund holds.

### **The Section 3(c)(5)(C) Question: When Real Estate Fund Managers Are Not Investment Advisers**

A fund that directly owns real estate, and relies on the Section 3(c)(5)(C) exclusion from the Investment Company Act of 1940, occupies a different regulatory position than a fund relying on Section 3(c)(1) or Section 3(c)(7). The Section 3(c)(5)(C) exclusion is available to any entity primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. To qualify, at least 55% of the fund's total assets must consist of qualifying real estate assets, meaning whole mortgage loans, certain mezzanine loans satisfying specific conditions, and fee interests in real property; at least 80% must consist of qualifying assets and real-estate-related assets combined.

Because a fund qualifying under Section 3(c)(5)(C) holds real property rather than securities, the manager who directs acquisitions, dispositions, and operations of those properties may not be advising about securities at all. The Investment Advisers Act applies to advice about securities, not advice about real estate. A management company that advises solely a fund qualifying under Section 3(c)(5)(C), and whose advice concerns the acquisition, management, and disposition of direct real estate interests, may not be an investment adviser under the Advisers Act. If it is not an investment adviser, no registration or exemption analysis is necessary.

The analysis changes immediately and completely for fund-of-funds structures. A fund that invests in other real estate funds holds interests in those funds, and fund interests are securities. The SEC's staff confirmed in a 1984 no-action letter to Realex Capital Corporation that limited partnership interests in a fund constitute investment contracts and therefore securities, not real estate interests for purposes of Section 3(c)(5)(C). A fund-of-funds that invests in other real estate funds holds securities, is an investment company unless it qualifies under Section 3(c)(1) or Section 3(c)(7), and has a manager who is advising about securities and is therefore an investment adviser.



## The Private Fund Adviser Exemption

When a fund manager is an investment adviser, whether because the fund relies on Section 3(c)(1) or Section 3(c)(7), the most commonly used exemption from investment adviser registration for real estate fund managers is the private fund adviser exemption. Advisers with less than \$150 million in regulatory assets under management attributable to private funds, and who do not serve as investment advisers to any registered investment companies or business development companies, qualify for the private fund adviser exemption provided they have their principal office and place of business in the United States.

Advisers relying on the private fund adviser exemption are exempt from registration but are not exempt from all obligations. They must file Form ADV Part 1 with the SEC as exempt reporting advisers. They must maintain certain books and records. They must report information on their private fund clients on Schedule D of Form ADV. And advisers relying on this exemption must act solely as advisers to qualifying private funds. The moment the management company begins advising separate accounts, personalized co-investment vehicles that are not structured as private funds, or any non-fund client on securities matters, the solely condition fails and the exemption is lost. The threshold for moving from exempt reporting adviser status to full registration is \$150 million in regulatory assets under management, a threshold that growing fund platforms can reach faster than they anticipate.

### Investment Adviser Analysis Is Required Before Fund Formation

The investment adviser registration analysis is not an afterthought to be performed after the fund is launched. If registration is required and the fund manager is not registered, every management fee received and every management decision made constitutes an unregistered investment advisory activity in violation of the Advisers Act.

Before forming a real estate fund, sponsors should have their securities counsel conduct a complete investment adviser analysis, including the applicable state law analysis for managers below the federal registration threshold. The consequences of operating as an unregistered investment adviser when registration is required include SEC enforcement, disgorgement of fees received, and personal liability for the managers involved.

This analysis must be specific to the fund's structure, the nature of the management relationship, and the assets under management. It cannot be resolved by general reading or online research.

## Key Fund Governance Provisions: What the Documents Must Address

The governing documents of a real estate fund, the limited partnership agreement or operating agreement, the subscription agreement, and the PPM, must address a set of provisions that do not arise in single-asset syndication documents. These provisions are not boilerplate. They are the contractual architecture that defines the investor relationship and the manager's authority for the fund's entire multi-year life.

### The Investment Period and Fund Term

The investment period is the window during which the fund may make new investments and call capital for those acquisitions. Once it expires, the fund transitions to its harvest phase, managing and eventually disposing of existing assets, without making new acquisitions. The investment period typically spans the first three to five years of a ten-year fund, and its expiration is tied to specific governance consequences: the management fee base may shift, the successor fund restriction may lift, and the manager's authority to call capital for new acquisitions terminates.

The fund term defines the total operating life of the fund. Extensions of the fund term beyond the stated period, necessary when assets cannot be monetized on the expected timeline, typically require LPAC approval or a supermajority vote of investors. The process for requesting and obtaining extensions needs to be defined in the governing documents with enough specificity that it can be executed without ambiguity when the time comes.

### Key Person Provisions

Key person provisions identify the specific individuals whose continued active involvement in the fund's management is material to investors' commitment. When a key person event occurs, such as a named individual leaving the firm, becoming incapacitated, or failing to meet a specified time-commitment requirement, the investment period is suspended and investors are given a defined period to vote on whether to continue with existing management, allow replacement of the departed key person, or begin an orderly wind-down.

The key persons should be named individuals, not generic roles, and the time commitment requirement should be specific enough to be enforceable. Key person

provisions that are vague about who qualifies or what percentage of time is required are provisions that may fail to protect investors when the event actually occurs.

## GP Removal

GP removal provisions give investors the ability to remove the fund manager for cause, such as fraud, willful misconduct, gross negligence, or material breach of the governing documents, or in some fund structures, without cause upon a supermajority vote. For-cause removal typically requires a majority vote and is a baseline investor protection that institutional investors treat as non-negotiable. No-fault removal, which allows investors to remove the manager without specific wrongdoing, requires a higher threshold, typically 66.67% or 75% of investor interests, and is one of the most heavily negotiated provisions in institutional fund documents.

The post-removal mechanics, including how the transition to successor management is managed, what happens to the removed manager's carried interest in the existing portfolio, and who manages the fund during the transition, must be defined with enough specificity to function in practice. A removal provision that creates a governance vacuum rather than a structured transition process fails investors at precisely the moment they need it most.

## The Limited Partner Advisory Committee

The LPAC is a committee composed of representatives from a subset of the fund's largest or most active investors. It serves as an oversight body for specific categories of decisions, including conflict of interest approvals, investment guideline waivers, valuation questions, and fund term extensions, without managing the fund's investments directly. The LPAC provides a structured governance mechanism that allows the manager to obtain investor input on sensitive decisions without convening the full LP body, and that gives investors a formal voice in fund governance without crossing the line into active management.

For sponsors raising institutional capital, the LPAC is not optional. It is an expectation. Its composition, authority, and decision-making processes should be defined in the governing documents before the fund launches, not assembled reactively when a conflict of interest or governance question first arises.

## Comparing Syndications and Funds: A Decision Framework

The decision between a single-asset syndication program and a fund structure is not primarily a legal decision. It is a business decision with significant legal dimensions. The right structure depends on the sponsor's track record, investor base, deal flow, operational infrastructure, and strategic objectives. The wrong structure, adopted prematurely or without adequate preparation, creates both legal risk and operational strain that can impair the investment platform rather than advance it.

| Dimension                       | Single-Asset Syndication                | Closed-End Fund                               | Open-End Fund                                      |
|---------------------------------|-----------------------------------------|-----------------------------------------------|----------------------------------------------------|
| <b>Investment object</b>        | Specific identified asset               | Portfolio per strategy; blind pool            | Permanent portfolio; blind pool                    |
| <b>Investor commitment</b>      | Funded at or near closing               | Capital calls over investment period          | Ongoing subscriptions at NAV                       |
| <b>Fund life</b>                | Asset hold period (3 to 7 years)        | Defined term (8 to 10 years)                  | Indefinite                                         |
| <b>Investor liquidity</b>       | None until exit                         | None until distributions or exit              | Periodic redemption windows (with gate)            |
| <b>Diversification</b>          | Single asset                            | Multiple assets; portfolio-level risk         | Multiple assets; continuous rebalancing            |
| <b>Manager discretion</b>       | Limited to specific asset               | Broad within investment guidelines            | Broad within investment guidelines                 |
| <b>Track record required</b>    | Helpful but not essential               | Essential for blind pool credibility          | Essential; NAV history also required               |
| <b>Valuation requirement</b>    | None (cost basis until sale)            | Periodic for reporting; not NAV-based         | Periodic independent appraisals required           |
| <b>Formation cost (typical)</b> | \$15,000 to \$40,000                    | \$30,000 to \$75,000 or more                  | \$50,000 to \$150,000 or more                      |
| <b>Ongoing admin burden</b>     | Lower; asset-level reporting            | Higher; portfolio-level reporting             | Highest; continuous NAV, sub/red processing        |
| <b>IA registration risk</b>     | Generally none                          | May apply; analysis required                  | Very likely; analysis required                     |
| <b>Investor type</b>            | HNW individuals; smaller family offices | HNW individuals; family offices; institutions | Institutional; large family offices; pension funds |

## When a Single-Asset Syndication Remains the Right Structure

Single-asset syndications make sense for sponsors who are still building their track record, whose investor base is primarily high-net-worth individuals who want deal-level

visibility and control over their exposure, whose deal flow does not yet support the volume needed to justify fund overhead, or whose investors have come to expect the ability to evaluate each opportunity individually.

There is no hierarchy that makes funds categorically superior to syndications. Many of the most respected private real estate operators continue to run primarily single-asset structures, particularly at larger deal sizes where institutional co-investors have specific views on how they want to participate in individual transactions. For sponsors at that stage of platform development, the single-asset model is not a transitional structure. It is the right structure.

### **When a Closed-End Fund Structure Makes Sense**

A closed-end fund tends to make sense when several conditions are simultaneously present: the sponsor has a track record substantial enough to support a blind pool commitment from investors; deal flow is consistent and deep enough to deploy a defined capital pool within a reasonable timeframe; the investor base includes or is developing toward family offices or other institutional capital sources; and the sponsor has, or is building, the operational and compliance infrastructure that fund management requires.

Two additional signals are worth considering. If existing investors are consistently re-investing across multiple syndications, that is a strong indicator they have confidence in the manager's judgment and may be receptive to a fund commitment. And if the sponsor is consistently passing on acquisitions that met their underwriting criteria because capital from the last syndication has been fully deployed and the next raise has not yet closed, that is a concrete operational problem that a fund, with committed capital available to call, is designed to solve.

### **When Neither Is Ready Yet**

Perhaps the most important function of this framework is helping sponsors recognize when neither a fund nor an accelerated syndication program is the right next step. Sponsors who have not yet built the compliance infrastructure, fund administration relationships, and investor communications discipline that a fund requires are not ready for a fund regardless of how compelling the market opportunity appears.

The fund structure does not fix operational problems. It amplifies them. A sponsor whose investor relations function is already strained by managing three active

syndications will not find that managing a ten-asset fund is more manageable. The discipline required to operate a fund well must be developed before the fund is launched, not improvised after the capital has been raised.

## An Illustrative Example: The Same Platform, Two Structures

To make the structural concepts concrete, consider a single real estate investment platform that has been operating deal-by-deal syndications and is now evaluating whether to launch a first fund.

### The Platform

Sponsor: Established real estate operator with 5-year track record.

Strategy: Value-add multifamily; Sun Belt markets; \$5 million to \$15 million equity per deal.

Historical deals: 6 completed syndications; \$40 million total equity raised; average 2.1x equity multiple.

Current investor base: approximately 80 accredited investors; average \$200,000 per deal.

Deal flow: 4 to 6 qualifying opportunities identified per year.

Operational infrastructure: 4-person team; fund administrator relationship in place.

Under a deal-by-deal model, the sponsor continues raising a new LLC for each acquisition, conducting a new Regulation D offering for each deal, and managing a growing portfolio of single-asset entities each with its own investor group, reporting obligations, and governance structure. As deal volume grows toward six deals per year, the administrative burden of maintaining multiple parallel investor groups, multiple sets of annual financial statements, and multiple K-1 preparation processes becomes a material constraint on the team's capacity.

Under a fund model, a \$50 million closed-end fund with a four-year investment period, the same platform raises capital once, in a single Regulation D offering with a single PPM and a single LP agreement. The fund calls capital as deals are identified, typically closing three to five assets in the first two years of the investment period. Investors receive consolidated quarterly reporting on the fund's portfolio rather than deal-specific statements. K-1 preparation is consolidated at the fund level. The team's administrative capacity is reallocated from investor onboarding and reporting across multiple entities to the investment and asset management work that creates value.

The fund model is not simply more efficient. It is structurally different in ways that affect the investor experience, the governance obligations, the regulatory profile, and the legal infrastructure required. The decision to make that transition should be made with a clear understanding of both what changes and what the transition requires.

## The Legal Infrastructure a Fund Requires

The formation of a real estate fund requires legal work that is materially more-extensive than the legal work of a single-asset syndication. Sponsors who attempt to apply a single-deal template to a fund formation, or who use generalist legal counsel without fund formation experience, frequently discover the insufficiency of that approach at a moment when correction is expensive and time-consuming.

The core legal documents for a fund include a limited partnership agreement or operating agreement, a private placement memorandum, and a subscription agreement, the same categories as a single-asset syndication, but with substantially greater complexity in each. The LPA or operating agreement must address the full fund governance architecture: investment period mechanics, capital call procedures, defaulting investor remedies, LPAC composition and authority, key person provisions, GP removal, successor fund restrictions, management fee calculation and offset, carried interest mechanics including clawback, fund term and extension procedures, and the mechanics of dissolution and final distribution.

Each of these provisions interacts with the others in ways that require comprehensive drafting rather than piecemeal assembly from separate templates. A management fee offset provision that is not coordinated with the carried interest calculation can produce unintended economic outcomes that neither the sponsor nor investors anticipated. A key person provision that is not coordinated with the investment period mechanics can create governance gaps when a key person event occurs mid-investment-period. The timeline for proper fund formation, including investment adviser registration analysis, governing document drafting, PPM preparation, and state blue sky analysis, is typically four to six months when conducted properly.

### A Note on Fund Formation Legal Counsel

Fund formation for a private real estate fund requires a securities attorney with specific experience in both real estate fund structures and private fund governance. The legal

analysis required, including exemption selection, investment adviser registration analysis, operating agreement architecture, LPAC governance design, and PPM disclosure, cannot be effectively performed by generalist counsel adapting a single-asset syndication template.

The consequences of deficiencies in the fund's governing documents emerge over years, not weeks. An operating agreement that works adequately for a single-asset deal but fails to address fund-specific governance scenarios will fail when those scenarios arise, and they will arise across a multi-year fund lifecycle.

Sponsors preparing to launch a first fund are encouraged to engage securities counsel with demonstrated fund formation experience well before the targeted fundraising launch. Compressing that timeline produces documents that reflect the compression.

Sponsors who want to discuss what a specific fund structure requires are welcome to reach out at [crowdfundlawyer.com](https://crowdfundlawyer.com).

## Practical Takeaways

- A real estate fund pools investor capital into a single vehicle that deploys it across multiple assets over a defined investment period. Investors commit to a manager and a strategy, not to a specific property. That distinction has legal significance that affects the offering documents, the regulatory profile, and the investor relationship throughout the fund's life.
- The blind pool character of a fund requires a disclosure framework built around the manager's track record, decision-making process, and investment guidelines rather than around a specific asset's characteristics. The legal standard for adequate disclosure in a blind pool offering is demanding and cannot be met by repurposing single-asset syndication templates.
- Closed-end funds have a defined capital raise, a defined investment period, and a finite fund life. Capital calls, the J-curve dynamic, and the waterfall architecture, particularly the deal-by-deal versus whole-fund debate, are structural features that both sponsors and investors must understand before committing to the structure. According to the 2024 Paul Weiss survey, nearly 64% of funds now include interim clawback provisions, reflecting how standard investor protections have become in institutional fund practice.



- Open-end funds offer periodic investor liquidity but require institutional infrastructure that most emerging sponsors do not yet have: rigorous NAV calculation processes, independent appraisal programs, redemption gate administration, and continuous investor communications. The liquidity promise of an open-end fund is real but conditional, and marketing it without accurate disclosure of its limitations creates legal exposure.
- The Investment Advisers Act analysis is not optional for fund managers. Whether registration is required, or whether the private fund adviser exemption applies, depends on the specific structure of the fund and the manager relationship, including whether the fund holds direct real estate under Section 3(c)(5)(C) or securities under Section 3(c)(1) or Section 3(c)(7). This analysis must be completed before the fund launches, with the assistance of qualified securities counsel.
- Fund governance provisions, including investment period mechanics, key person provisions, GP removal, and the LPAC, are not boilerplate. They are the contractual architecture that governs the sponsor-investor relationship across the fund's multi-year life. Deficiencies in these provisions surface in the scenarios investors hoped would never occur, at the worst possible times.
- The transition from single-asset syndications to a fund is a significant operational and legal step that should be undertaken when the platform is ready, not when the market opportunity seems compelling. Sponsors who launch funds before building the required infrastructure find that the structure amplifies their operational problems rather than solving them.
- Fund formation legal work requires a securities attorney with specific real estate fund experience. The governing documents of a fund must address a governance architecture that single-asset syndication templates do not contemplate. Applying an inadequate template to a fund formation creates deficiencies that emerge over years and are expensive to correct.

## CHAPTER THREE

# When Does Real Estate Become a Security?

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There is an assumption that surfaces with considerable regularity at the beginning of conversations with real estate operators who are raising capital for the first time: we are buying real estate, not selling securities, so the securities laws do not apply to us.

That assumption is wrong. The gap between what operators believe about their regulatory obligations and what those obligations actually are is one of the most persistent sources of serious legal exposure in the private real estate market.

The instinct behind the assumption is understandable. Real estate is a tangible asset. Buying and selling property feels fundamentally different from buying and selling stocks. Real estate transactions are governed by property law, contract law, and landlord-tenant law, bodies of law that most real estate operators know reasonably well. The securities regulatory framework, with its exemptions and registration requirements and disclosure obligations and anti-fraud rules, seems to belong to a different world.

It does not. The securities laws apply to most private real estate investment structures, and they have for decades. The analysis is fact-specific. It depends on the economic substance of the arrangement, not its label or the form of the assets involved. For the overwhelming majority of real estate syndications and funds that involve passive investors, the conclusion is the same: the interests being offered are securities, and the regulatory framework that governs how they can be offered and sold applies in full.

This chapter works through the legal analysis that produces that conclusion: why securities laws exist and what they are designed to accomplish, how the definition of a security reaches well beyond conventional stocks and bonds, the Howey test and how its four elements apply to real estate investment structures, where the line between active and passive participation sits, how state law adds an additional layer of analysis, what the most common misconceptions are and why each fails, and what the consequences of non-compliance look like in practice. Understanding this analysis is not an academic exercise. It is the foundation on which every compliant real estate capital raise is built.

## Why Securities Laws Exist

Securities laws in the United States were not designed for the real estate industry. They were written in direct response to the financial catastrophes of the late 1920s and early 1930s, when the collapse of markets and widespread investment fraud destroyed the savings of ordinary people who had invested in enterprises they could not evaluate and could not monitor.

The Securities Act of 1933 and the Securities Exchange Act of 1934 codified a single governing principle: before a person is asked to commit capital to an investment they do not control, they are entitled to honest, complete information about what they are investing in, who is managing it, and what the material risks are. This is the disclosure mandate. It does not guarantee investment outcomes. It does not judge whether an investment is wise. It requires that the information necessary to make an informed decision be made available.

The framework also established the anti-fraud baseline: whether or not an offering is registered or exempt from registration, the prohibition on material misrepresentations and material omissions in connection with the purchase or sale of a security applies to everyone, in every transaction.

These principles apply to real estate syndications because the economic dynamic they are designed to address is precisely the dynamic that defines a real estate syndication. Passive investors commit capital to an enterprise controlled by a sponsor. They have no meaningful ability to monitor the sponsor's day-to-day decisions. They cannot independently verify the condition of the property, the accuracy of the financial projections, or the quality of the management decisions being made on their behalf. The information asymmetry between sponsor and investor is real and substantial. Securities law steps in to fill that gap, with disclosure obligations, with anti-fraud rules, and with the compliance infrastructure that private offerings must maintain.

That is why the securities laws apply to real estate syndications. Not because real estate is a financial instrument in the conventional sense, but because the investor's position in a real estate syndication, passive, dependent on the sponsor's efforts, lacking independent access to material information, is exactly the position the securities laws were designed to protect.

## What Is a Security? The Broader Definition

The statutory definition of a security is considerably broader than most non-lawyers expect. Section 2(a)(1) of the Securities Act of 1933 defines security to include any note, stock, treasury stock, security future, 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, and various options and derivative instruments, as well as any interest or instrument commonly known as a security.

That is a long list, and it is deliberately long. Congress understood in 1933 that financial markets would continue to produce new instruments and new arrangements, and it wrote the statutory definition to be broad enough to reach them regardless of form. Courts have given effect to that intent, consistently declining to limit the securities law analysis to instruments that look like conventional stocks and bonds.

### Investment Contracts: The Category That Reaches Real Estate

For real estate syndications and funds, the critical statutory category is the investment contract. An investment contract is not defined by form or label. It is defined by economic substance, based on the criteria the Supreme Court established in its landmark 1946 decision in *SEC v. W.J. Howey Co.*

The investment contract concept is what allows the securities laws to reach arrangements that do not look anything like conventional securities: citrus grove service contracts in *Howey* itself, whiskey warehouse receipts in *SEC v. C.M. Joiner Leasing Corp.*, earthworm farming ventures in *Smith v. Gross*, limited partnership interests in oil and gas programs, and, most relevant here, membership interests in LLC entities that hold and operate real estate.

The form of the instrument, whether it is denominated as a membership interest, a limited partnership unit, a participation interest, or something else entirely, is not the question. The question is whether the economic substance of the arrangement satisfies the criteria the Supreme Court articulated in *Howey*. If it does, the interest is a security regardless of how it is labeled.

## The Howey Test: The Governing Framework

In 1946, the Supreme Court of the United States decided *SEC v. W.J. Howey Co.*, a case involving a Florida citrus grove operation that sold parcels of land to investors and simultaneously contracted to tend, harvest, and sell the citrus on those parcels. Investors had no agricultural expertise and played no active role in the enterprise. The Court held that these arrangements, including the sale of real property, constituted investment contracts and therefore securities.

The Court's reasoning was straightforward: the economic substance of the arrangement was that investors were committing money to an enterprise in which the efforts of others would generate their return. That is the essence of what securities law regulates, and the label attached to the instrument, or the tangibility of the underlying asset, is irrelevant to the analysis.

The test the Court articulated has remained the governing framework for nearly eight decades. An investment contract, and therefore a security, exists when there is:

#### **The Howey Test**

1. An investment of money,
2. In a common enterprise,
3. With a reasonable expectation of profits,
4. Derived primarily from the efforts of others.

All four elements must be present. The analysis is based on economic substance, not on the label attached to the instrument or the form of the assets involved.

Each element deserves careful examination, not as an abstract checklist, but as a practical analytical framework for understanding how real estate investment structures are evaluated under the securities laws.

#### **Element One: Investment of Money**

The first element is satisfied when an investor transfers something of value, whether cash, property, services, or any other form of consideration, in exchange for an ownership interest. In a real estate syndication, investors wire capital to the project-owning entity in exchange for membership interests or limited partnership units. The first element is met at the moment that exchange occurs.

Courts have interpreted investment of money broadly, consistent with the statute's general purpose. Contributions of services or property can satisfy this element in appropriate circumstances, though most real estate syndications involve straightforward cash contributions that present no analytical difficulty.

### **Element Two: Common Enterprise**

The common enterprise element is satisfied when the investors' fortunes are tied together, when their returns depend on the performance of a shared enterprise rather than on individual, independent investments. Courts have applied this element in slightly different ways, but the most widely accepted interpretation, horizontal commonality, is met when multiple investors pool their capital and their returns are pro-rata based on the performance of the same venture.

In a real estate syndication, all investors hold interests in the same entity, which owns the same property. Their returns, including distributions from cash flow, proceeds from refinancing, and gain or loss at disposition, are all functions of that single asset's performance. The common enterprise element is satisfied by the basic structure of the investment.

### **Element Three: Expectation of Profits**

Investors in real estate syndications are, virtually without exception, seeking financial returns: distributions of cash flow during the hold period, a preferred return on their invested capital, and a share of appreciation at disposition. That expectation of profit is not incidental to the investment. It is the entire purpose of it.

Courts have defined profits to include both income distributions and capital appreciation. Both are present in a typical real estate syndication. The preferred return structure, which pays investors a specified annual return before the sponsor participates in profits, is itself an expression of the profit expectation that investors bring to the transaction. This element is satisfied in virtually every real estate syndication without requiring detailed analysis.

### **Element Four: Efforts of Others, The Critical Element**

The fourth element is where the analytical weight sits in the real estate context. It is also the element that most clearly explains why the form of the arrangement, including the

type of entity used and the manner in which ownership interests are represented, does not change the securities law analysis.

In a typical real estate syndication, the division of labor is explicit. The sponsor identifies the opportunity, underwrites the acquisition, arranges the financing, executes the business plan, manages the property operations, maintains the lender relationship, and ultimately controls the disposition decision. Investors contribute capital and receive returns. The investor's economic outcome depends almost entirely on what the sponsor does: on the sponsor's expertise, judgment, execution, and relationships.

That is the precise arrangement the fourth Howey element captures: the investor's profits are derived primarily from the efforts of the sponsor, not from the investor's own efforts. The investor does not manage the property. The investor does not direct the renovation. The investor does not select the property manager, negotiate the refinancing, or decide when to sell. All of those decisions, the ones that determine what returns investors receive, are the sponsor's decisions.

Some governing documents give investors approval rights over major decisions, such as selling the property, taking on additional debt, or removing the sponsor for cause. Those approval rights do not transform investors from passive to active participants. Courts have consistently held that nominal governance rights exercisable only by a dispersed, supermajority investor vote do not satisfy the efforts-of-others requirement. The question is where the operational management responsibility actually sits, and in a real estate syndication, it sits with the sponsor.

## Applying the Howey Test to Real Estate Syndications

The following table applies each Howey element to the structure of a typical real estate syndication.

| Howey Element              | How It Applies to Real Estate Syndications                                                                                            | Satisfied?                                  |
|----------------------------|---------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------|
| <b>Investment of money</b> | Investors contribute equity capital to the project-owning entity in exchange for membership interests or LP units.                    | Yes, in virtually every case.               |
| <b>Common enterprise</b>   | All investors hold interests in the same entity owning the same asset. Returns are pro-rata based on the same property's performance. | Yes, by definition of the pooled structure. |

|                               |                                                                                                                                                |                                                                              |
|-------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------|
| <b>Expectation of profits</b> | Investors expect cash flow distributions, preferred returns, and appreciation at disposition. Profit is the entire purpose of the investment.  | Yes, in virtually every case.                                                |
| <b>Efforts of others</b>      | The sponsor manages the property, executes the business plan, controls the disposition, and generates investor returns. Investors are passive. | Yes, in virtually every real estate syndication involving passive investors. |

The conclusion that follows from this analysis is straightforward: most real estate syndications are securities offerings. Not most large ones, not most formally structured ones. Most of them, including small ones, informally structured ones, and those involving investors who are friends or family of the sponsor.

### Why Most Syndications Are Securities Offerings

The passivity of the investor relationship is the definitive feature. When investors commit capital and rely on the sponsor's efforts to generate their return, the fourth Howey element is satisfied regardless of the size of the deal, the number of investors, the sophistication of the parties, or the personal relationship between sponsor and investor.

This conclusion holds even when the investment is structured using entity forms, such as limited liability companies or limited partnerships, that are not conventional securities. The form of the entity does not determine the securities law analysis. The economic substance of the investor relationship does.

It also holds when the sponsor and investors know each other personally. The anti-fraud provisions of the securities laws protect investors regardless of their relationship with the sponsor. And the registration requirement, or the requirement to comply with an applicable exemption from registration, applies regardless of whether investors are friends, family members, colleagues, or strangers.

### Active vs. Passive Participation: Where the Line Sits

The Howey test might seem to leave room for real estate investment arrangements that fall outside the definition of a security, specifically those in which investors play a genuinely active management role rather than relying on the efforts of others. That exception exists in principle. In the real estate syndication context, it is much narrower than sponsors sometimes hope.



The clearest case for non-security status is the genuine active joint venture: two experienced real estate operators, both contributing capital and both contributing substantial management effort, who jointly acquire and operate a property. If neither party is primarily relying on the other's efforts to generate their return, the arrangement may fall outside Howey. Courts have sometimes reached that conclusion in true equal-partnership structures.

The analysis fails when investor involvement is nominal rather than genuine. Courts scrutinize arrangements in which governance documents appear to give investors control, including voting rights and approval requirements for major decisions, but in which the practical reality is that investors have neither the information nor the organizational capacity to exercise that control meaningfully. A hundred investors spread across the country, each holding a 1% membership interest, who must convene a supermajority vote to override the managing member on any significant decision, are not active managers. They are passive investors with nominal consent rights. Howey reaches them.

The relevant question is always the actual locus of operational decision-making. Not the governance rights that documents describe, but the management responsibility that the structure allocates in practice. When that responsibility sits primarily with the sponsor, the investor relationship is passive and the investment is a security.

#### **Governance Rights Do Not Transform Passive Investors Into Active Ones**

A common structuring approach among sponsors seeking to avoid securities regulation is to grant investors voting rights or approval rights over major decisions, on the theory that investor involvement in governance means the fourth Howey element is not satisfied.

Courts have consistently rejected this approach when the governance rights are nominal rather than genuine. The question is not whether investors have rights on paper. It is whether investors have real, practical operational control over the enterprise. When investors are passive in practice, relying on the sponsor's management to generate their returns, the securities analysis applies regardless of the governance provisions in the operating agreement.

Sponsors who structure offerings around this theory, without the guidance of experienced securities counsel, are accepting significant legal risk on the basis of an argument that has repeatedly failed.

## The Risk Capital Test and State Law Variations

Federal securities law, the Howey test, is the primary analytical framework for determining whether a real estate investment interest is a security. But it is not the only one. Every state has its own securities laws, commonly called blue sky laws, and some states apply analytical frameworks that are broader than the federal Howey test.

### The Risk Capital Test

The risk capital test originated in a 1961 California Supreme Court decision, *Silver Hills Country Club v. Sobieski*, and has been adopted in various forms by approximately a third of the states. The test focuses on a different dimension than Howey: rather than asking whether profits are derived from the efforts of others, the risk capital test asks whether investors are placing capital at risk in an enterprise that they are not in a position to control or protect.

The key difference is that the risk capital test does not require the fourth Howey element, efforts of others, to be clearly satisfied. Under the risk capital test, an arrangement can be a security even if investors have genuine management involvement, provided their investment is at genuine risk and they are not in a position to protect themselves through active management. This can reach arrangements that might fall outside Howey in a close case.

California is the state where the risk capital test most frequently matters in practice. The California Department of Financial Protection and Innovation has a robust enforcement program and has applied the risk capital test in real estate investment contexts. Sponsors who raise capital from California investors need to conduct both the federal Howey analysis and the California risk capital analysis before concluding that their offering is structured correctly.

Other states with active enforcement programs, including New York, Massachusetts, Texas, and Florida, each have their own statutory frameworks and enforcement practices that can extend the reach of securities regulation beyond what the federal Howey analysis alone would establish. A transaction structured to comply with federal securities law may still require additional analysis under the laws of each state where investors are located.

### Why State Law Analysis Is Not Optional

The practical significance of state blue sky law for real estate sponsors is this: compliance with the federal securities framework is necessary but not sufficient. Every state where investors are located, not where the property is located but where the investors are, potentially subjects the offering to that state's securities laws. Sponsors who focus exclusively on federal compliance and neglect state law analysis are accepting exposure that can be significant in states with aggressive enforcement programs.

State blue sky compliance is addressed in detail in Chapter 19. The point relevant here is that the threshold question, whether this is a security, may have a broader answer at the state level than at the federal level, and the compliance obligations that follow from that determination must be analyzed under both frameworks.

## **Common Misconceptions About Securities Law and Real Estate**

The gap between what real estate operators believe about securities law and what the law actually provides is wide enough, and consequential enough, to warrant direct treatment of the most common misconceptions. Each of the following reflects an argument that sponsors actually make, and each of them fails.

### **"We Are Just Buying Real Estate"**

The most pervasive misconception is the one this chapter opened with: that because the underlying asset is real property, the transaction is a real estate deal rather than a securities offering, and the securities laws accordingly do not apply.

Howey itself refutes this argument. The citrus grove parcels in Howey were real property. The Court held that the arrangements were securities. The nature of the underlying asset does not determine the securities law analysis. The economic substance of the investor relationship does.

A real estate syndication is simultaneously a real estate transaction and a securities offering. Both bodies of law apply. Compliance with real estate law, including title insurance, property contracts, zoning, and landlord-tenant regulations, does not satisfy securities law obligations, and compliance with securities law does not satisfy real estate law obligations. They are parallel requirements, and a sponsor cannot satisfy one by complying with the other.

## **"Our Investors Are Sophisticated and Know the Risks"**

Investor sophistication affects which securities exemptions are available and what disclosure obligations apply. It does not determine whether the offering is a security in the first place, and it does not reduce or eliminate the securities compliance obligations that attach to the offering.

Under Rule 506(b) of Regulation D, one of the primary exemptions used by real estate sponsors, up to 35 non-accredited but sophisticated investors can participate alongside an unlimited number of accredited investors. Sophisticated investors receive somewhat different disclosure requirements than non-accredited investors in that context. But the offering is still a securities offering, the exemption conditions still apply, and the anti-fraud rules apply in full regardless of investor sophistication.

A sophisticated investor who loses money in an improperly structured securities offering has exactly the same legal remedies available as any other investor. Sophistication does not waive securities law protections.

## **"We Only Have a Small Number of Investors"**

The number of investors is relevant to certain exemption conditions. Rule 506(b)'s limitation on non-accredited investors is the most prominent example. But the number of investors has no bearing on whether the offering is a security. A two-investor LLC in which both investors are entirely passive, contributing capital and relying on the managing member's efforts to generate their returns, is a securities offering. So is a three-investor deal. The number of investors determines certain aspects of exemption availability. It does not determine the threshold question of whether the securities laws apply.

## **"The Investors Know the Sponsor Personally"**

Personal relationships between sponsors and investors are relevant to the general solicitation analysis under Regulation D, specifically to whether a pre-existing, substantive relationship exists that allows a 506(b) offering to be conducted without general solicitation. Personal relationships do not affect whether the offering is a security.

Selling an unregistered, non-exempt security to a close friend is the same securities law violation as selling it to a stranger. The anti-fraud provisions apply with full force to offerings made among acquaintances. Investors who are personal friends of the

sponsor retain every legal remedy available under the securities laws, including the right to rescind the investment and demand their money back.

### **"We Have Been Doing This for Years Without a Problem"**

The absence of a problem to date is not evidence that there is not one. Securities law violations do not always produce immediate consequences. The statute of limitations for securities fraud claims extends for years after the underlying violation. Investors who are satisfied with their returns rarely scrutinize the compliance history of the offering they participated in. Investors who are dissatisfied, or who lose money, sometimes hire counsel, and counsel sometimes asks questions that expose compliance failures that predated the specific dispute.

The sponsor who has been operating non-compliant offerings for several years without an enforcement action has not necessarily avoided the problem. The problem may simply not have surfaced yet. And when it does, often in connection with a deal that has underperformed or an investor relationship that has deteriorated, it surfaces as potential rescission liability across multiple prior offerings simultaneously.

#### **The Statute of Limitations Problem**

Under Section 12(a)(1) of the Securities Act of 1933, an investor who purchased a security in a transaction that violated the registration requirements has the right to rescind the purchase and recover the purchase price plus interest, minus any income received, for up to three years from the date of the sale, or one year from discovery of the violation, whichever period ends later. In some states, the limitation period is longer.

This means that a sponsor who has been conducting non-compliant offerings for three years potentially faces rescission liability across all of those offerings simultaneously, not just the most recent one. The liability is not extinguished by subsequent compliance. And it can be exercised selectively by investors who are unhappy with specific deals, applying only to the transactions where rescission benefits them.

The compounding exposure from multi-year non-compliance is one of the most serious structural problems sponsors face when they seek legal counsel after the fact. The resolution is almost always more-expensive and more complicated than early compliance would have been.

## **Consequences of Failing to Recognize a Security**

The consequences of treating a securities offering as if it were an ordinary real estate transaction are concrete, serious, and in the worst cases career-ending. They deserve to be understood in full, not to alarm, but because the severity of the consequences is directly relevant to why early compliance planning is not optional.

### **Investor Rescission Rights**

Section 12(a)(1) of the Securities Act grants investors who purchased securities in transactions that violated the registration requirements an absolute right to rescind, to demand their money back plus interest at the applicable rate minus any income received. This right does not require proof of harm. It does not require proof of fraud. It does not require proof of misrepresentation. The violation of the registration requirement is itself sufficient to trigger the right.

The rescission remedy is powerful because it is symmetric with respect to investment performance. An investor who received distributions and achieved reasonable returns can still exercise rescission rights if the offering was improperly structured, and may choose to do so if they discover the compliance failure and calculate that rescission leaves them better off than retaining the investment.

In practice, investors exercise rescission rights selectively. Investors who are satisfied with their returns rarely pursue rescission. Investors who are dissatisfied, or who have suffered losses, are precisely the investors most likely to investigate the compliance history of the offering and most likely to act on what they find. The result is asymmetric exposure: the sponsor faces rescission demands on the transactions that underperform, from investors who are already unhappy, at a time when the portfolio may already be under stress.

### **SEC Civil Enforcement**

The SEC has broad civil enforcement authority over violations of the registration and anti-fraud provisions of the federal securities laws. In the real estate context, SEC civil enforcement actions against improperly structured offerings can seek injunctions against future violations; disgorgement of profits earned from the offering, including fees and carried interest received across the entirety of the relevant investment program; civil monetary penalties; and in some cases, bars against individual principals from serving in securities industry roles.

Disgorgement in particular can be severe. The SEC's disgorgement authority is not limited to profits from the specific non-compliant offering. It extends to all profits the respondents earned in connection with the violation. For a sponsor whose investment platform has operated for several years, the disgorgement exposure can encompass fees and carried interest across the entire portfolio, not just the transactions that first attracted enforcement attention.

### **State Securities Enforcement**

Every state has its own securities regulatory apparatus, its own enforcement resources, and its own enforcement priorities. State regulators can bring independent enforcement actions for violations of state securities law concurrently with or independently of federal enforcement. Penalties vary by state but can include fines, disgorgement, and injunctions. In some states, anti-fraud violations under state law carry criminal penalties.

The geographic breadth of a real estate syndication that raises capital from investors in multiple states creates regulatory exposure in each of those states. A sponsor whose investor base spans ten states has potential enforcement exposure from ten separate state regulatory bodies, in addition to the SEC. State regulators in California, Texas, New York, and Massachusetts have active enforcement programs and have brought real estate securities enforcement actions resulting in substantial penalties and reputational damage for sponsors.

### **Private Civil Litigation**

Beyond regulatory enforcement, investors retain private rights of action under both federal and state securities statutes. A class of investors asserting rescission rights across a portfolio of non-compliant offerings can present an extraordinary litigation burden, even when the sponsor ultimately prevails on some claims, because the cost of defending securities litigation is substantial and the disruption to ongoing business operations is significant.

Class action risk is proportional to the size of the investor pool. A sponsor with a broad investor base across multiple offerings has more-exposure to class action treatment of securities claims than a sponsor with a small number of sophisticated investors in a single deal. This is one of the dimensions in which scale amplifies rather than reduces risk when the underlying offering structure is deficient.

### **Criminal Penalties**

Section 24 of the Securities Act makes it a federal crime to willfully violate the registration requirements of the Act or to willfully make material misrepresentations in connection with a securities offering. The maximum penalty is twenty years of imprisonment per count and a fine of up to \$5 million per count.

Criminal prosecution is reserved for cases involving willful violations and, typically, a meaningful element of intentional fraud or deception. The sponsor who simply did not know that securities law applied to their offering is in a very different position from one who understood the regulatory requirements and deliberately structured around them. Willfulness requires that the person knew they were violating the law, not that they knew the specific statutory provision being violated.

The most significant criminal exposure in the real estate securities context arises not from inadvertent compliance failures, but from affirmative misrepresentations to investors: false track records, fabricated financial projections, undisclosed conflicts of interest, that accompany an improperly structured offering. The combination of a non-compliant offering and deliberate investor deception is where criminal prosecution becomes a realistic outcome.

| Type of Exposure                    | Primary Legal Basis                                | Who Can Bring It                              | Potential Remedy                                                         |
|-------------------------------------|----------------------------------------------------|-----------------------------------------------|--------------------------------------------------------------------------|
| <b>Investor rescission</b>          | Securities Act Section 12(a)(1)                    | Each investor individually                    | Return of purchase price plus interest; no proof of harm required        |
| <b>SEC civil enforcement</b>        | Securities Act Section 15; Exchange Act Section 32 | U.S. Securities and Exchange Commission       | Injunction; disgorgement; civil penalties; officer and director bars     |
| <b>State securities enforcement</b> | State blue sky statutes                            | State securities regulators (varies by state) | State-specific fines, disgorgement, injunctions; criminal in some states |
| <b>Private civil litigation</b>     | Securities Act Section 12; state law               | Investors; class plaintiffs                   | Damages; rescission; potentially class action treatment                  |
| <b>Criminal prosecution</b>         | Securities Act Section 24; 18 U.S.C. Section 1348  | Department of Justice; state prosecutors      | Up to 20 years per count; fines up to \$5 million per count              |

## What Compliance Actually Requires, and Why It Is Manageable



The analysis in this chapter could be read as suggesting that real estate capital raising is extraordinarily complex and legally fraught. That reading would be incomplete. The legal framework is demanding, but it is well-developed, well-understood, and navigable for sponsors who approach it properly.

Hundreds of thousands of private real estate securities offerings are completed every year in full compliance with the applicable framework. Most of them use Regulation D exemptions that have been available for decades, do not require SEC registration, and can be conducted without the expense and delay of a public offering. The compliance burden, including selecting the right exemption, preparing adequate offering documents, making the required regulatory filings, and maintaining compliance through the hold period, is real but proportionate to the economic activity being undertaken.

What compliance requires, at a minimum:

- Recognition that the offering is a securities offering and that the regulatory framework applies from the beginning of the capital raise, not from the date a lawyer is first consulted.
- Selection of an appropriate securities exemption based on the size of the raise, the investor composition, and the marketing approach, and before any investor solicitation begins.
- Preparation of adequate offering documents: a Private Placement Memorandum that discloses material information about the investment, the risks, the sponsor, and the terms; an operating agreement that defines investor rights with sufficient precision; and a subscription agreement that documents investor representations and the issuer's acceptance.
- Investor qualification: confirming that every investor meets the eligibility requirements of the applicable exemption before accepting their subscription.
- Regulatory filings: Form D with the SEC within fifteen calendar days of the first sale of securities, and state blue sky notice filings in each state where investors are located, on the applicable state timelines.
- Ongoing compliance: maintaining the conditions of the exemption throughout the offering period, enforcing transfer restrictions, and meeting the reporting obligations that the exemption and the governing documents require.

None of this requires a public offering. None of it requires SEC review of the offering documents. And the consequences of getting it right, a compliant capital raise, a

protected investor base, a sponsor whose legal exposure is limited to the performance risk of the investment itself rather than the compliance risk of how it was structured, are worth considerably more than the cost of the legal work required to achieve them.

### **The Cost of Getting the Securities Analysis Right Is Not the Problem**

Securities counsel fees to properly structure a private real estate offering are a defined, predictable cost. Rescission liability, SEC enforcement defense, state enforcement penalties, and investor litigation are not. The sponsors who most regularly find themselves in serious legal difficulty are the ones who treated legal structuring as optional, until something went wrong.

The securities laws have applied to private real estate capital raising for generations. That framework is not going away. Sponsors who build their investment platforms on a compliant foundation, with the right documents, the right exemption, the right filings, and the right counsel, build platforms that can survive the inevitable stressed periods, the investor disputes, and the market cycles that every active real estate investor will eventually encounter.

Sponsors who build on a deficient foundation find that the legal problems compound precisely when the operational problems are already most severe.

### **The Timing Problem: Why Early Planning Is Not Optional**

One of the most consistent patterns in securities compliance failures is timing. Sponsors identify a deal, begin talking to investors, accept informal commitments, start marketing the opportunity, and then bring in legal counsel to address compliance after the fact.

This sequencing creates problems that are sometimes impossible to fully resolve. Securities violations do not disappear because a lawyer was subsequently retained. The window for rescission claims runs from the date of the original transaction. And certain actions taken early in the capital-raising process, in particular general solicitation before a compliant exemption is in place, can permanently affect which exemptions are available regardless of what is done later.

The right time to address the securities compliance framework is before the offering begins: before capital is solicited, before any public statements are made about the investment, and before any investor commitments are accepted. That is when the legal structure, the exemption selection, and the offering documents should all be aligned and ready.

The March 12, 2025 SEC Division of Corporation Finance no-action letter, issued in response to a request from Latham and Watkins LLP, simplified the accredited investor verification burden for Rule 506(c) offerings. Under that guidance, a sponsor may satisfy the reasonable steps verification requirement without reviewing tax documents or obtaining professional certifications when three conditions are met: the investor commits to a minimum investment of at least \$200,000 for natural persons or \$1,000,000 for legal entities; the investor provides a written representation confirming accredited investor status and that the minimum investment amount is not financed by a third party for the specific purpose of making the investment; and the issuer has no actual knowledge of facts indicating the investor is not accredited or that the investment was third-party financed for this purpose. That guidance meaningfully reduced the friction that had historically discouraged sponsors from using Rule 506(c). Sponsors considering a transition to publicly marketed 506(c) offerings should confirm with securities counsel that the state blue sky compliance infrastructure, which is more demanding under 506(c) than under 506(b), is in place before any public advertising begins.

## Practical Takeaways

- Most real estate syndications involving passive investors are securities offerings under federal law. The Howey test, investment of money in a common enterprise with an expectation of profits derived primarily from the efforts of others, is satisfied by the basic structure of the typical real estate syndication without requiring detailed analysis.
- The form of the instrument does not determine the securities law analysis. Whether the investment interest is denominated as a membership interest, limited partnership unit, participation interest, or any other label, economic substance governs. LLC membership interests are not a safe harbor from the securities analysis.
- Governance rights that are nominal rather than genuine do not transform passive investors into active participants. The relevant question is where operational management responsibility actually sits, not what governance documents say on paper. Courts have consistently rejected the argument that paper voting rights satisfy the efforts-of-others element when investors exercise no practical operational control.

- State securities laws, including the risk capital test and state blue sky frameworks, can extend the reach of securities regulation beyond the federal Howey analysis. California applies the risk capital test in real estate investment contexts through active enforcement by the Department of Financial Protection and Innovation. State law compliance is not optional.
- The most common misconceptions about securities law and real estate, that the nature of the underlying asset controls, that investor sophistication eliminates compliance obligations, that the number of investors determines whether securities laws apply, that personal relationships with investors are relevant, and that the absence of prior problems indicates absence of prior exposure, are all wrong. Understanding why they are wrong is the foundation of compliance planning.
- The consequences of non-compliance include investor rescission rights under Section 12(a)(1) of the Securities Act, SEC civil enforcement including disgorgement of all fees and carried interest, state securities enforcement, private civil litigation, and in cases involving willful fraud, criminal prosecution carrying penalties of up to twenty years imprisonment and fines of up to \$5 million per count.
- Compliance is manageable. Hundreds of thousands of compliant private real estate offerings are completed every year through well-established regulatory frameworks that do not require SEC registration and are proportionate in cost and burden to the economic activity involved.
- Early planning is essential. The compliance framework must be in place before the offering begins, before investors are solicited, before public statements are made, and before commitments are accepted. The March 2025 SEC no-action letter simplified 506(c) verification for raises above \$200,000 per natural person or \$1,000,000 per entity, but choosing the right exemption and aligning the marketing strategy with it must happen before the campaign begins, not after.

## CHAPTER FOUR

# Types of Real Estate Syndications and Funds

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Not all real estate syndications and funds are structured the same way. That observation is obvious to anyone who has spent time in the private real estate market. Its implications are less obvious: the type of investment, defined by asset class, strategy, capital structure, investor profile, and portfolio scope, shapes every significant legal decision that follows from it.

Which securities exemption is available depends in part on the investor composition the deal is designed to attract. What the PPM must disclose depends on the nature of the asset and the investment strategy. How the operating agreement allocates risk depends on whether investors hold common equity in a stabilized asset or participate in a debt fund that lends against transitional properties. The compliance obligations that apply throughout the investment's life depend on whether the sponsor is managing a single asset or a portfolio, whether investors are accredited individuals or institutional allocators, and whether the investment strategy involves identified assets or a blind pool.

Sponsors who approach deal structuring without this perspective, who use a generic LLC form and a template PPM regardless of deal type, consistently produce documents that fail to address the specific issues the particular investment presents. The risk factors are wrong. The fee disclosure does not match the actual structure. The waterfall mechanics are misaligned with the capital stack. The exemption selected does not fit the investor base. Each of these failures creates legal exposure that is entirely avoidable.

This chapter surveys the landscape of real estate syndications and funds across five organizational dimensions: asset class, investment strategy, capital structure, geographic focus, and investor profile. The goal is not to catalog every possible variation but to establish the analytical framework sponsors need to understand how deal type shapes legal structure, and to identify where the legal analysis diverges most significantly from one deal type to another.

## By Asset Class

Asset class is the first dimension of the taxonomy. It defines what kind of real estate the investment vehicle is acquiring and operating, and it drives meaningful differences in the legal analysis, the disclosure obligations, and the risk profile that investors need to understand before committing capital.

### Multifamily Residential

Multifamily, apartment communities of five or more units, has been the dominant asset class in private real estate syndication for most of the past decade. The fundamentals are durable: people will always need places to live, demand drivers are deep and persistent, and the operational model is well understood. Agency financing through Fannie Mae and Freddie Mac provides competitive debt terms for stabilized multifamily properties that are not generally available to other commercial asset classes.

From a legal structuring standpoint, multifamily syndications are the most common fact pattern in the private securities offering market. The documentation conventions are the most developed and the regulatory compliance path is the most well-worn. The frequency with which multifamily deals are done does not reduce the legal complexity of any individual offering. A first-time syndicator raising \$4 million for a 60-unit value-add multifamily deal faces the same exemption selection analysis, the same PPM disclosure obligations, and the same ongoing compliance requirements as an established platform raising \$40 million for a portfolio.

The risk factor disclosure for a multifamily offering should address, at a minimum: floating-rate debt risk where applicable; renovation budget and timeline risk for value-add deals; market-specific supply risk where new construction could affect projected rent growth; property management execution risk; and the specific lender consent provisions in the mortgage that could affect investors' ability to transfer their interests.

### Industrial and Logistics

Industrial real estate, including warehouses, distribution centers, last-mile logistics facilities, and manufacturing plants, has produced strong risk-adjusted returns in commercial real estate over the past decade. E-commerce growth, supply chain reconfiguration, and increasing demand for proximity to dense population centers have driven sustained rent growth and cap rate compression in this asset class.

Industrial syndications present a different legal profile than multifamily in one important respect: tenant concentration. A single-tenant industrial building with a 10-year NNN lease has a fundamentally different risk profile than a 200-unit apartment community with hundreds of individual leases. The income stream is more predictable in the near term, but the rollover risk at lease expiration is more acute, and the creditworthiness of the specific tenant is material to the investment thesis in a way that individual apartment tenants are not.

PPM disclosure for single-tenant industrial deals must address tenant credit risk specifically, including a description of the tenant, the lease term, the renewal options, and what the property's value and income profile would look like if the tenant vacates. Generic risk factor language about leasing risk that does not address the specific tenant dynamics of a single-tenant industrial offering fails the materiality standard.

## Office

Office is the asset class that the pandemic disrupted most fundamentally, and the market is still working through the implications. The question of how much permanent demand destruction has occurred, how many square feet of office space will never return to use as a consequence of structural shifts in work patterns, has not been answered definitively. Vacancy rates in many markets remain elevated, sublease availability has compressed effective rents, and the flight-to-quality trend means that the bifurcation between well-located, amenity-rich Class A assets and everything else has widened substantially.

Sponsors raising capital for office investments must address the current market environment honestly in the PPM. A risk factor section for an office deal that was adequate in 2019 is not adequate today. The material risks specific to office, including structural demand questions, the sublease overhang in the relevant submarket, the mark-to-market exposure on rolling leases, and the lender underwriting constraints that affect the financing market for office, must be addressed with current-market specificity.

This is not to say that office is uninvestable. Sponsors with genuine conviction in specific opportunities, including distressed acquisitions at prices that reflect current uncertainty and high-quality assets in proven locations where long-term demand fundamentals are defensible, can make compelling investment cases. But the disclosure must match the risk profile that the current market presents, not the one that existed before the landscape changed.

## Retail

Retail has been navigating structural headwinds since well before the pandemic. E-commerce displacement of physical retail, uneven across categories but persistent across the market, has created permanent demand reduction for some formats while leaving others largely unaffected. The result is a highly bifurcated asset class where the investment thesis depends almost entirely on which segment of retail is involved.

Grocery-anchored neighborhood centers have held their values and their tenant bases better than most retail categories. The grocery anchor drives traffic; the adjacent inline tenants benefit from that traffic; the investment thesis is durable for well-located assets with dominant grocers. Net-lease retail with creditworthy essential-service tenants, including pharmacies, dollar stores, and medical users, has similarly maintained investor interest.

Enclosed regional malls and power centers anchored by big-box tenants who have faced their own structural challenges present a different picture. PPM disclosure for retail assets must address the specific tenant composition, the lease term profile, co-tenancy clauses that could allow tenants to reduce rent or terminate if anchor occupancy falls below specified thresholds, and the specific submarket dynamics that affect the asset's competitive position. Retail PPM disclosure that does not address these asset-specific risks fails investors who need that information to make an informed investment decision.

## Hospitality

Hotel and hospitality investments are among the most operationally intensive and cyclically sensitive asset classes in commercial real estate. Revenue per available room, or RevPAR, responds quickly to economic cycles, travel demand patterns, and competitive supply additions. The pandemic demonstrated what a demand shock looks like when RevPAR approaches zero across the entire industry simultaneously.

Hospitality syndications require disclosure of risks that do not appear in other asset class PPMs: flag and franchise relationships, the terms of the franchise agreement and the franchisor's ability to terminate or impose property improvement plan costs, the dynamics of the management company relationship, and the specific revenue performance drivers that distinguish the subject hotel's competitive position from the broader market.



Sponsors who have not previously syndicated hospitality deals should understand that the investor qualification analysis for a hospitality offering is more demanding in practice than for stabilized commercial asset types. The business risk is higher, the operational complexity is greater, and the return profile is more volatile. Sophisticated investors understand this and will ask questions about the sponsor's specific hospitality operating experience that they would not ask of a multifamily operator. If the sponsor does not have that experience, disclosing the gap, and describing what operational support the deal structure provides to compensate for it, is both an ethical obligation and a legal one.

### **Self-Storage**

Self-storage has demonstrated remarkable resilience across economic cycles. The operational model is relatively simple: storage units do not require renovation between tenants, the tenant base is highly fragmented, month-to-month leases provide pricing flexibility, and the barriers to entry in established markets are meaningful once a self-storage facility achieves market-dominant scale. The asset class has attracted substantial institutional capital over the past decade, compressing cap rates and making opportunistic entry more difficult in primary markets.

Value-add opportunities in self-storage typically involve converting older, poorly operated facilities to modern platforms with technology-driven pricing, enhanced security, and climate-controlled unit mixes that command premium rates. These conversions require operational expertise in self-storage management and technology that is distinct from the expertise required in other commercial real estate categories. PPM disclosure should address the sponsor's specific operational experience with self-storage, or, if the sponsor is deploying a third-party management platform, the terms and track record of that platform.

### **Data Centers and Specialty Assets**

Data centers, life science facilities, medical office, senior housing, and student housing represent the specialty end of the commercial real estate spectrum. Each has distinct operational characteristics, tenant profiles, financing dynamics, and risk factors.

Data centers have attracted significant attention as cloud computing and AI infrastructure buildout have driven demand growth that outpaced available supply in key markets. But data center investing requires specialized technical knowledge, including

power infrastructure requirements, cooling systems, connectivity specifications, and the implications of PUE (power usage effectiveness) metrics, that most generalist real estate sponsors do not possess. A PPM for a data center investment that does not disclose the specific technical infrastructure requirements, the power cost exposure, and the tenant's lease structure in appropriate technical detail is not providing adequate disclosure for that asset type.

Senior housing presents its own distinct regulatory environment, including state licensing requirements, staffing regulations, and the interaction between the real estate investment and the healthcare services provided, that creates disclosure obligations going beyond what a standard commercial real estate PPM addresses. Life science facilities require disclosure of the highly specific tenant requirements for laboratory and wet lab space that limit the pool of potential replacement tenants in a vacancy scenario.

The principle common to all specialty asset types is that the PPM disclosure must be specific to the asset class. Generic commercial real estate risk factor language does not satisfy the disclosure obligation for an investment whose material risks are unique to a specialized property category. Sponsors who use standard PPM templates for specialty asset offerings without making the specialized disclosures those assets require are creating legal exposure that a properly drafted PPM would have avoided.

### **Mixed-Use and Diversified Portfolios**

Mixed-use properties, combining retail, office, residential, and sometimes hospitality in a single development, present structuring challenges that reflect the complexity of operating multiple asset classes within a single entity. The different components have different operational profiles, different financing treatment, and sometimes different optimal ownership structures.

For a fund investing across multiple asset classes, the offering documents must clearly define the investment parameters, specifying which asset classes are permitted, what concentration limits apply, and what the manager's authority is to allocate among categories. The risk factors must address the aggregate risk profile of a diversified portfolio rather than the specific risk profile of any single asset type. Investors who committed to a multifamily-focused fund and discover that the manager has made substantial allocations to hospitality may have grounds to assert that the investment guideline provisions of the governing documents were violated.

## By Investment Strategy

Asset class tells you what the investment vehicle owns. Investment strategy tells you what it does with what it owns and how it intends to generate returns. Strategy drives the risk profile, the return expectations, the financing approach, the hold period, and the complexity of the operational execution. It also drives significant differences in the legal documentation required.

The four-tier framework that has become standard in the institutional real estate market provides the organizing structure:

| Strategy             | Net Return Target    | Primary Risk                          | Value Creation Source                             | Typical Hold            |
|----------------------|----------------------|---------------------------------------|---------------------------------------------------|-------------------------|
| <b>Core</b>          | 6 to 9 percent       | Market and financing risk             | Stable income from quality tenants on long leases | 7 to 10 years or longer |
| <b>Core-Plus</b>     | 8 to 12 percent      | Operational and leasing risk          | Income plus modest operational improvements       | 5 to 8 years            |
| <b>Value-Add</b>     | 12 to 18 percent     | Execution and renovation risk         | Renovation, repositioning, lease-up to market     | 3 to 7 years            |
| <b>Opportunistic</b> | 18 percent and above | Development, distress, or market risk | Ground-up development, distressed acquisition     | 3 to 7 years            |

### Core: Stable Income from Quality Assets

Core real estate investing targets high-quality, well-leased assets in primary markets where the investment thesis is income stability rather than value creation. The portfolio of a core real estate fund, including Class A multifamily in infill locations, grocery-anchored retail centers with dominant anchors on long leases, and well-located industrial facilities with creditworthy tenants, is designed to generate predictable distributions with minimal operational intervention.

Core real estate is primarily the domain of large institutional investors. The return targets, 6 to 9 percent net, are too modest to attract most individual high-net-worth investors who can deploy capital in private real estate syndications. Institutional minimums are common, and the investor base is composed of pension funds, endowments, insurance companies, and sovereign wealth funds whose liability structures and return requirements align with the predictable, long-duration income that core real estate provides.

For sponsors considering a core or core-adjacent strategy, the legal implication is that the investor base effectively determines the regulatory profile. Institutional investors

bring their own compliance requirements, negotiated LP agreement provisions, and due diligence standards that smaller sponsors who have operated primarily with high-net-worth individuals will find demanding. The transition to a core strategy is not simply a change in the property type being acquired. It is a change in the sophistication and expectations of the investor base, with corresponding legal and governance implications.

### **Core-Plus: The Middle Ground**

Core-plus investing targets good-quality assets with identifiable operational upside that does not require the full renovation intensity of a value-add strategy. Rolling leases to market, modest capital improvements, and property management optimization are the tools of core-plus execution. The return target is more attractive than pure core, the execution risk is lower than value-add, and the hold period is typically intermediate.

Core-plus deals are popular with sponsors whose investor base includes both high-net-worth individuals seeking stable distributions and family offices seeking better risk-adjusted returns than pure value-add or opportunistic strategies provide. The disclosure profile for a core-plus offering should clearly distinguish the investment from both core and value-add alternatives, specifically addressing the nature and extent of the operational improvements contemplated and the risk that those improvements may take longer or cost more than projected.

### **Value-Add: Where Most Private Market Sponsors Operate**

Value-add is the dominant strategy across the private real estate syndication and fund market, and it is where most sponsors building investment platforms focus their energy. The thesis is coherent and, when executed well, capable of generating strong risk-adjusted returns: acquire an underperforming or under-improved asset at a price reflecting its current condition, implement a business plan to improve it, and sell at a price reflecting the improved asset's value.

The execution risk is genuine and must be honestly disclosed. Value-add investing depends on the sponsor's ability to complete the renovation on budget and on schedule, lease the improved space at projected rents, and exit at a cap rate that reflects the improvement in asset quality. Each of those variables, including renovation costs, renovation timeline, lease-up pace, lease-up rents, and exit cap rate, is subject to uncertainty, and the uncertainty compounds across variables.

A PPM for a value-add deal that presents a single-scenario underwriting without stress-testing the key assumptions is not providing adequate disclosure. Investors who commit capital to a value-add deal without understanding how the investment performs under alternative scenarios are not making informed investment decisions. The April 2026 post on risk factor drafting published at [crowdfundlawyer.com](https://crowdfundlawyer.com) puts the test plainly: a specific, well-drafted risk factor answers four questions in sequence. What is the risk? Why is this particular issuer exposed to it? What happens if it materializes? And what is the consequence for the specific securities being offered? A generic renovation risk factor that simply notes that costs may exceed budget, without quantifying the exposure or stating the consequence for investor distributions, answers only the first of those questions.

#### **Value-Add PPM Disclosure Must Match Value-Add Risk**

The most common PPM deficiency in the private real estate market is a disconnect between the actual risk profile of a value-add deal and the disclosure provided to investors. Generic risk factor language, applicable to any real estate investment, does not satisfy the disclosure obligation for an investment whose returns depend on specific renovation execution, specific lease-up assumptions, and a specific exit market.

A properly drafted value-add PPM discloses: the renovation scope and budget with specificity; the assumptions driving the projected lease-up timeline; sensitivity analysis showing how returns change under alternative assumptions; and the specific market conditions that support the exit underwriting. Risk factors that address these specific variables, not just general real estate investment risk, are what the anti-fraud standard requires.

Sponsors who use template PPMs without adapting them to the specific risk profile of the deal are creating legal exposure that the template was not designed to protect against.

### **Opportunistic: Development, Distress, and Higher Complexity**

Opportunistic real estate encompasses ground-up development, major redevelopment, distressed acquisitions, and other strategies where the return potential is highest and the execution complexity and market uncertainty are correspondingly elevated. The risk profile of an opportunistic investment is materially different from a stabilized or value-add deal, and the legal documentation must reflect that difference.

Ground-up development introduces risk dimensions that do not exist in stabilized or value-add investments: entitlement risk (the risk that permits are delayed, conditioned, or denied), construction cost risk (which has been elevated by supply chain disruptions

and labor market constraints), interest reserve adequacy risk (the risk that the construction period extends beyond the term of the interest reserve), and lease-up risk (the risk that the completed project does not attract tenants at the projected pace or at projected rents). The combination of these risks means that a development deal's outcome is less predictable than a value-add deal's outcome, which is reflected in the higher return targets and which must be reflected in the disclosure.

Distressed acquisitions, including acquiring assets in default, in foreclosure, or from lenders who have taken back collateral, require expertise in workout dynamics, lender negotiation, and often bankruptcy law that most generalist real estate sponsors do not have. The sponsor's specific experience with distressed real estate is a material fact in a distressed acquisition offering. Investors relying on the sponsor's execution of a distressed strategy are placing capital at risk in a way that depends on specific capabilities the sponsor may or may not possess.

## By Capital Structure

The third dimension of the taxonomy is the capital structure of the investment: where in the capital stack the investors' interests sit, and what economic rights and risk profile that position carries. Capital structure drives significant differences in the legal documentation, the tax treatment, the disclosure obligations, and the securities analysis.

### Equity Syndications and Funds

Common equity represents residual ownership, the interest that receives whatever remains after all senior claims are satisfied. Equity investors in a real estate syndication bear the first loss in a downside scenario and participate in the upside through distributions of cash flow and appreciation at disposition. The promote structure, preferred return to investors followed by carried interest to the sponsor, is the economics of common equity investment.

Common equity is what most individual investors in a real estate syndication actually hold. The operating agreement governing the LLC is the document that defines their rights, their economic terms, and the sponsor's obligations. That document, not the PPM, which is the disclosure document, and not the subscription agreement, which is the investor's entry-point contract, is the governing legal instrument for the life of the investment.

## Preferred Equity Structures

Preferred equity occupies the middle of the capital stack, senior to common equity and subordinate to debt. A preferred equity investor holds an equity interest in the entity, not a loan to it, but that interest carries a specified return that must be paid before common equity holders receive anything. Preferred equity is used to fill gaps in the capital stack that cannot be efficiently filled with either senior debt or common equity.

From a legal structuring standpoint, preferred equity arrangements add complexity to the operating agreement that common equity alone does not present. The preferred return mechanics, including whether the preferred return is cumulative, whether it accrues when unpaid, and what the consequences are if it falls into arrears, must be defined with precision. The relative priority of the preferred equity versus the common equity at exit, and in a distressed scenario, must be clearly established. The interaction between the preferred equity arrangement and the senior mortgage, specifically whether the lender's consent is required before the preferred equity can be issued and what restrictions the mortgage imposes on subordinate equity arrangements, must be analyzed before the structure is finalized.

Many commercial mortgages restrict preferred equity arrangements without lender consent. A sponsor who closes a mortgage and then layers a preferred equity tranche on top of the common equity without reviewing the mortgage's transfer restriction and subordinate financing provisions may inadvertently default under the senior loan documents. That analysis is not optional.

## Debt Funds and Mortgage Pools

A real estate debt fund does not acquire properties. It lends money to property owners or developers, earning interest on those loans. Investors in a debt fund are effectively providing the capital that funds the fund's lending activity, and their returns derive from the interest income the loans generate rather than from property appreciation.

Debt fund interests are securities. The Howey analysis for a debt fund, investors contributing capital to a pooled enterprise with an expectation of returns derived from the manager's lending activity, satisfies all four elements. The same registration or exemption requirement applies. The same disclosure obligations attach. Sponsors who structure debt fund offerings without securities counsel, on the theory that they are raising money for lending rather than for equity investment, are making a fundamental error in the securities analysis.



The legal documentation for a debt fund differs from an equity syndication in important respects. The fund's investment guidelines specify the lending criteria, including loan types, LTV limits, geographic focus, and borrower profile, rather than property acquisition criteria. The risk factors address credit risk, default risk, and foreclosure risk rather than property appreciation and lease-up risk. The waterfall mechanics reflect the fund's income-generation model rather than an appreciation-and-disposition model. Each of these differences requires document-specific drafting rather than adaptation from an equity syndication template.

### **Mezzanine and Bridge Lending Funds**

Mezzanine lending, subordinate to the first mortgage and secured by a pledge of equity interests rather than a first lien on the property, and bridge lending, short-term first-mortgage financing for transitional properties, are sub-categories of real estate debt investment with distinct risk profiles and correspondingly distinct legal documentation requirements.

Mezzanine debt enforcement, when a loan defaults, proceeds through a UCC Article 9 foreclosure on the pledged equity interests rather than a real property foreclosure. This process can be faster than real property foreclosure in some states, but it requires specific legal expertise in UCC foreclosure procedures that general real estate counsel may not have. The fund's operating documents must address the mezzanine enforcement process, and the loan documents for each mezzanine investment must be drafted or reviewed by counsel familiar with the specific requirements of UCC Article 9 enforcement in the relevant jurisdiction.

Bridge lending funds face a different set of risks centered on the transitional nature of the underlying collateral. Borrowers who take bridge loans are typically doing so because their property does not yet qualify for permanent financing: it is in renovation, in lease-up, or in some other transitional state. The collateral value supporting the bridge loan depends on the successful execution of the borrower's business plan, which creates credit risk that is materially different from lending against a stabilized, income-producing asset. PPM disclosure for a bridge lending fund must address this collateral risk profile specifically.

### **Hybrid Structures: Debt and Equity Combined**



Some investment structures combine elements of debt and equity deliberately, including participating mortgages that combine interest payments with a share of appreciation, convertible notes that convert to equity upon specified conditions, and structured preferred equity instruments with debt-like priority and equity-like participation. These hybrid instruments can be effective solutions to specific structuring problems, but they add legal complexity that pure debt or pure equity instruments do not present.

The most important legal question for a hybrid instrument is how it is classified for securities law purposes. Is the instrument a debt security? An equity security? An investment contract? The classification affects which disclosure framework applies, how the instrument is characterized in the PPM, and in some cases which exemption from registration is most appropriate. These classification decisions require careful legal analysis. A classification made hastily, based on the label attached to the instrument rather than its economic substance, may later be contested by investors or regulators who reach a different conclusion.

## By Geographic Focus

The geographic scope of a real estate investment program has both operational and legal significance. On the operational side, it defines where the sponsor's market expertise and deal sourcing relationships must be concentrated. On the legal side, it determines the blue sky compliance footprint of the offering, the scope of the risk factor disclosure required, and in some cases the applicable regulatory framework.

### Single-Market Funds and Syndications

Many sponsors, particularly those building their first investment programs, focus on a single market or metropolitan area where they have established relationships, specific local knowledge, and a presence that supports competitive deal sourcing. The single-market focus allows genuine expertise to develop and creates competitive advantages in deal sourcing that broad geographic mandates cannot replicate.

The legal implication of a single-market focus is that geographic concentration risk must be disclosed specifically and honestly in the PPM. A fund that invests exclusively in Phoenix multifamily is exposed to the Phoenix market cycle in a way that a national fund is not. If Phoenix experiences a specific supply shock, employment disruption, or demand decline, the fund's entire portfolio is affected simultaneously. Investors need to understand this concentration. It is material to their assessment of the investment's risk

profile, and a PPM that treats it as generic real estate market risk rather than a specific geographic concentration risk fails the disclosure standard.

State blue sky filing obligations are determined by where investors are located, not where properties are situated. A sponsor whose properties are all in Texas but whose investors include residents of California, New York, and Massachusetts has notice filing obligations in each of those states. The California DFPI blue sky requirements may apply in ways that affect the offering's structure or marketing approach regardless of the Texas location of the underlying assets.

## **Regional Funds**

Regional funds, those focused on a defined multi-state geography such as the Sun Belt, the Mountain West, or the Southeast, offer broader diversification than single-market programs while preserving the geographic expertise that justifies a focused investment thesis. For many sponsors, regional expansion is the natural progression after establishing a track record in a home market.

The legal considerations for a regional fund include the articulation of the investment guidelines in terms that accurately describe the geographic scope, specifying which states, which markets within those states, and whether the fund can pursue opportunistic investments outside the primary regional focus with LPAC approval. Regional market risk as a disclosure matter requires more specificity than a broad national market risk disclosure: the fund should identify the economic drivers of the specific regional markets it targets and the specific risks those markets present, not just recite generic real estate market risk factors.

## **National Platform Funds**

National funds deploy capital across the country based on a strategy-driven thesis rather than a geographic one, pursuing the best risk-adjusted opportunities wherever they appear within the defined asset class and strategy parameters. National platforms require either a large, centralized team capable of underwriting and asset managing investments across diverse markets, or a network of regional operating partners who provide local expertise under the fund manager's oversight.

For emerging sponsors, a national mandate without the underlying team and infrastructure to support it creates both operational and legal risk. Operationally, the inability to source, underwrite, and manage investments with genuine local market

knowledge is a competitive disadvantage in a market where many high-quality opportunities are sourced through relationships and local presence. Legally, a PPM that describes a national investment mandate without disclosing the limitations of the sponsor's geographic reach is potentially misleading. The investor who believes they are hiring a sponsor with genuine national market coverage may be receiving something materially less.

## **International and Cross-Border Structures**

Cross-border real estate investment, whether U.S. sponsors investing in non-U.S. properties, non-U.S. investors investing in U.S. properties, or structures that combine both, introduces legal complexity that extends well beyond the domestic private placement framework. The securities and investment regulation of the jurisdictions where properties are located, the tax framework applicable to cross-border investment flows, FIRPTA withholding obligations for non-U.S. investors in U.S. real estate, and currency risk all require legal analysis that goes beyond domestic securities counsel.

Regulation S, the SEC's safe harbor for offerings made exclusively to non-U.S. persons outside the United States, provides a path for raising capital from international investors without the full domestic securities compliance framework, subject to specific conditions including the requirement that no directed selling efforts be made in the United States. The conditions of Regulation S are specific and must be strictly observed. A Regulation S offering that fails to meet those conditions does not qualify for the exemption and may be an unregistered offering.

Cross-border structures require coordinated legal counsel across the relevant jurisdictions. A U.S. sponsor acquiring European real estate with capital from non-U.S. investors needs counsel who understands not only the U.S. securities framework but also the applicable European regulatory requirements, the tax treaty landscape, and the local real estate law of the countries where properties are located. Assembling that team before the offering is structured, not after it is underway, is essential.

## **By Investor Profile**

The investor profile of an offering is perhaps the most directly consequential dimension for the legal analysis. The investor base, including who is eligible to invest, how they are verified, and what disclosures they require, determines which securities exemptions are

available, what marketing is permitted, what ongoing compliance obligations the sponsor maintains, and what investor relations practices are appropriate.

### Accredited Investor-Only Structures

The large majority of private real estate syndications are structured as accredited investor-only offerings under Regulation D. The accredited investor standard, individual net worth exceeding \$1 million excluding primary residence, or income exceeding \$200,000 individually (\$300,000 jointly), among other criteria, is the baseline investor qualification requirement that permits unlimited capital raising without SEC registration under Rules 506(b) and 506(c).

The choice between Rule 506(b) and Rule 506(c) is one of the most consequential early decisions in any offering. Rule 506(b) prohibits general solicitation, including advertising the offering publicly or soliciting investors without a pre-existing substantive relationship, but permits up to 35 non-accredited but sophisticated investors and allows accredited investors to self-certify their status. Rule 506(c) permits general solicitation and public advertising but requires that all investors actually be accredited and that the sponsor take reasonable steps to verify that status.

The verification requirement under Rule 506(c) has been simplified by the March 12, 2025 SEC Division of Corporation Finance no-action letter issued in response to a request by Latham and Watkins LLP. Under that guidance, a sponsor may satisfy the reasonable steps requirement without reviewing tax returns or obtaining professional certifications when three conditions are met: the investor commits to a minimum investment of at least \$200,000 for natural persons or \$1,000,000 for legal entities; the investor provides a written representation confirming accredited investor status and that the minimum investment amount is not financed by a third party for the specific purpose of making the investment; and the issuer has no actual knowledge of facts indicating the investor is not accredited or that the investment was third-party financed for this purpose. For most institutional and semi-institutional real estate raises whose minimum investment thresholds already meet or exceed these levels, this guidance substantially reduced the friction of 506(c) verification. That said, 506(c) state blue sky compliance is more demanding than 506(b), and sponsors migrating to public marketing under 506(c) should confirm that state notice filings are current before any advertising begins.

**Rule 506(c) Verification Is More Than a Checkbox**

Sponsors who select Rule 506(c) for its general solicitation benefits, including the ability to market through websites, social media, and public advertising, sometimes underestimate what the verification requirement actually demands. Self-certification by the investor, standing alone, does not satisfy the reasonable steps standard.

The March 2025 no-action guidance created a simplified pathway for offerings meeting the minimum investment thresholds. But that pathway still requires a specific written representation from the investor confirming accredited status and the absence of third-party financing for the investment. A general checkbox questionnaire does not satisfy it.

The exemption selected must be consistent with how the offering is actually conducted. If general solicitation is being used, Rule 506(c) must be used, and Rule 506(c)'s verification requirement must be met. The two cannot be separated.

**Institutional Co-Investment Vehicles**

When a real estate sponsor brings in an institutional equity partner, including a family office, pension fund, endowment, or sovereign wealth fund, the legal and commercial dynamics shift in ways that require specific documentation and a different approach to governance.

Institutional investors typically negotiate the terms of their participation directly, including provisions of the operating agreement or limited partnership agreement that are not standard in retail syndications. Information rights, approval requirements for major decisions, key person provisions, management fee offsets, LPAC representation, co-investment rights on future deals, and clawback mechanics are all potential negotiating points with institutional capital. The resulting document is a negotiated agreement, not a sponsor-driven form.

The process of negotiating with institutional investors, reviewing their proposed changes to the LPA, responding to due diligence requests that are more-extensive than individual investors typically make, and satisfying their compliance team's requirements for representations and certifications, is substantially more time-intensive than closing a retail accredited investor subscription. Sponsors entering their first institutional negotiation without experienced securities counsel familiar with institutional fund document conventions are at a meaningful disadvantage relative to their institutional counterparty.

**Retail Investor Structures: Regulation A+ and Non-Traded REITs**

Sponsors who want to raise capital from investors who do not meet the accredited investor standard have two primary regulatory pathways: Regulation A+ and the non-traded REIT structure. Both allow non-accredited investor participation. Both come with substantially higher regulatory complexity and cost than a standard Regulation D offering.

Regulation A+ permits offerings of up to \$75 million in a 12-month period to both accredited and non-accredited investors, with SEC review of the offering circular before sales may begin. According to SEC Division of Economic and Risk Analysis data released in May 2025, Regulation A in 2024 produced approximately \$896 million across 102 qualified offerings, a 67% decline from the 307 offerings qualified in 2022 and the lowest level since the post-JOBS Act amendments took effect. The SEC review process is substantive and typically requires three to six months from initial filing to qualification. Ongoing annual and semiannual reporting obligations apply after the offering is qualified. The economics of the offering need to support the upfront legal and compliance costs that Regulation A+ imposes before it represents a sensible choice.

Non-traded REITs combine the tax efficiency of REIT status with a non-exchange-traded offering structure that permits ongoing capital raising. The regulatory complexity of a non-traded REIT is substantial: REIT qualification requires satisfaction of specific income, asset, distribution, and organizational requirements on an ongoing basis, and SEC registration of the offering is required. The combination of REIT tax compliance and SEC reporting makes the non-traded REIT appropriate only for sponsors who have the institutional infrastructure to maintain those obligations continuously.

For completeness: Regulation Crowdfunding permits offerings of up to \$5 million in any 12-month period through a single SEC-registered intermediary, either a registered broker-dealer or a FINRA-registered funding portal. According to the same SEC DERA report, approximately \$1.3 billion was raised under Regulation Crowdfunding across the entire period from its May 2016 launch through December 31, 2024, across approximately 3,900 offerings from roughly 3,000 issuers. The framework reaches both accredited and non-accredited investors subject to annual investment limits, but the \$5 million cap, the mandatory intermediary requirement, and the ongoing annual reporting obligations make it a specialized tool for specific objectives, not a general-purpose framework for most private real estate sponsors.

## Single-Asset Syndications vs. Portfolio and Multi-Asset Funds

The final dimension of the taxonomy cuts across all of the others: whether the investment vehicle is organized around a single identified asset or a portfolio of assets to be acquired over time. This distinction has specific legal implications that shape the PPM disclosure, the governing document architecture, and in some cases the regulatory profile of the offering.

### Disclosure: Identified Property vs. Blind Pool

In a single-asset syndication, the offering documents describe a specific property. Investors can evaluate the actual real estate they are investing in: the location, the physical condition, the current income and occupancy, the comparable transactions that support the acquisition price, the specific renovation scope and budget, and the exit assumptions underlying the projected returns. The risk factors address the specific risks of that specific asset in that specific market.

In a multi-asset fund, the disclosure obligation shifts fundamentally. When there are no identified assets, or when identified assets represent only a portion of the capital to be deployed, investors cannot evaluate specific properties. The PPM must instead describe the investment strategy, the selection criteria the manager will apply, the geographic and asset class parameters within which investments will be made, and the governance mechanisms that protect investors in the absence of deal-specific visibility.

A blind pool PPM that is written as if it were a single-asset PPM, with generic property descriptions, placeholder risk factors, and investment criteria described so broadly as to be meaningless, fails the disclosure standard. The obligation is to give investors enough information to evaluate what they are actually committing to: the manager's track record, the investment strategy, the investment guidelines that will constrain the manager's discretion, the governance framework that will operate when the manager's authority is tested, and the realistic risk profile of the strategy the manager intends to execute.

### Governance: Defined Asset vs. Manager Discretion

In a single-asset syndication, the governance questions are relatively contained: what actions require investor approval, what are the major decision thresholds, and what happens if the sponsor needs to take an action not specifically authorized by the

operating agreement. These questions have answers because there is a specific asset whose management is being governed.

In a multi-asset fund, the governance framework must operate across an evolving portfolio, one that will change as properties are acquired, managed, and eventually sold, and that may not yet exist at all when investors make their commitment. The operating agreement must define the manager's investment authority precisely enough to constrain the scope of the manager's discretion while leaving sufficient operational flexibility for the manager to execute the strategy effectively.

Investment guidelines, the provisions that define what the fund can and cannot invest in, are the contractual expression of the strategy investors committed to. Violations of investment guidelines are not strategy adjustments. They are breaches of the governing documents, with legal consequences that include investor remedies through the LPAC or through litigation. Drafting investment guidelines that are specific enough to be enforceable without being so rigid that they constrain the manager's legitimate operational judgment is one of the most important and most legally demanding drafting challenges in fund formation.

### **The Legal Implication: Structure Drives Documentation**

The organizing principle that runs through this entire chapter is that the type of investment drives the legal documentation required, and documentation that does not match the actual investment structure creates legal exposure that properly tailored documents would avoid.

A single-asset value-add multifamily syndication in Austin needs a PPM that describes that specific property, that specific market, and that specific business plan, with risk factors specific to the renovation execution risk, the market-specific supply dynamics, and the floating-rate debt structure the deal is using. A national multifamily value-add fund needs a PPM that describes the manager's track record, the investment selection criteria, the geographic scope, the concentration limits, and the governance framework that protects investors across a portfolio of deals they have not yet seen.

These are different documents. They address different information. They satisfy different disclosure obligations. Using one as a template for the other produces a document that fails both.



**A Note on Document Specificity**

The most common PPM deficiency across all deal types is insufficient specificity. Generic risk factor language that applies to any real estate investment does not satisfy the disclosure obligation for a deal whose material risks are specific to its asset class, its strategy, its capital structure, or its investor profile.

Sponsors who use template PPMs without adapting them to the specific facts of the offering are not saving legal fees. They are deferring legal expense to a point at which it becomes substantially larger: rescission claims, enforcement proceedings, and investor litigation are all more-expensive than the cost of properly tailored offering documents would have been.

The legal work required to properly structure and document a real estate securities offering is specific to that offering. It cannot be efficiently performed by adapting a form document that was drafted for a different deal. Sponsors who want to discuss what properly tailored offering documents require for a specific deal type are welcome to reach out at [crowdfundlawyer.com](https://crowdfundlawyer.com).

**Practical Takeaways**

- The type of investment, its asset class, strategy, capital structure, geographic focus, and investor profile, shapes every significant legal decision downstream from it. There is no generic structure that fits all real estate securities offerings.
- Asset class drives specific disclosure obligations. Specialty assets, including hospitality, data centers, senior housing, and life science, require disclosure of risks unique to those property types. A PPM that uses generic commercial real estate risk factors for a specialty asset offering fails the disclosure standard.
- Investment strategy drives the risk profile that must be disclosed. Value-add and opportunistic strategies involve execution risk that is specific and material, including renovation costs, lease-up assumptions, and exit cap rate sensitivity. The April 2026 post on risk factor drafting at [crowdfundlawyer.com](https://crowdfundlawyer.com) is useful here: a well-drafted risk factor answers four questions, identifying the risk, explaining why this issuer is specifically exposed, stating what happens if it materializes, and describing the consequence for the specific securities being offered.
- Capital structure determines where investors sit in the stack and what legal rights they have. Preferred equity, mezzanine debt, and hybrid instruments each require document-specific legal analysis and drafting, not adaptation from a common equity template.

- Geographic focus determines both the blue sky compliance footprint and the risk disclosure obligations. Geographic concentration in a single market is a material risk factor that must be specifically disclosed. Blue sky filing obligations follow investors' locations, not properties' locations.
- Investor profile determines which securities exemptions are available and what their conditions require. The choice between Rule 506(b) and Rule 506(c) is consequential and must be made before the offering is marketed. The March 2025 SEC no-action guidance simplified 506(c) verification for minimum investment thresholds of \$200,000 for natural persons and \$1,000,000 for legal entities, but public marketing and compliant verification must be designed together before the campaign begins.
- The single-asset versus multi-asset dimension drives fundamental differences in the PPM disclosure framework. Blind pool offerings must describe the manager and the strategy with the specificity that identified-asset offerings provide for the specific property. Investment guidelines are legally binding constraints, not aspirational descriptions. Violations are breaches of the governing documents, not strategic adjustments.
- Structure drives documentation. Every deal type requires documents tailored to its specific facts. Template documents that are not adapted to the specific offering fail the disclosure standard for that offering. The cost of getting this right is fixed and predictable. The cost of getting it wrong is not.

## CHAPTER FIVE

# The Sponsor and Management Team

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Every serious treatment of real estate investment covers the sponsor and management team. That is not because the subject is obligatory. It is because experience in this market confirms, repeatedly and across all deal types, that the quality of the team executing the strategy is the most consequential variable in investment outcomes. A superior asset in the hands of a poorly equipped operator generates worse results than a mediocre asset managed by a disciplined, experienced team. The property, the market, the capital structure: all of it matters. None of it matters more than the people.

That observation is not new. What this chapter adds to it is the legal dimension that sponsors and investors frequently underestimate. The regulatory framework governing private real estate capital raising is organized not just around the investment vehicle, but around the individuals who manage it. The bad actor disqualification rules under Regulation D apply to people, not just entities. Track record disclosure obligations require accurate attribution to the specific individuals whose experience is being presented. The ongoing compliance obligations of a securities offering are borne by the sponsor's management team, not delegated away by forming an LLC.

This chapter covers the full sponsor and management team picture for a real estate syndication or fund: who the sponsor is and what the role actually requires across the investment lifecycle, what core competencies the team needs to execute the strategy compliantly and effectively, how the management team should be built and what the legal implications of team structure decisions are, how track record must be properly built and accurately disclosed, and what the bad actor disqualification rules require and what happens when they are ignored.

## Who Is the Sponsor?

The sponsor, sometimes called the syndicator, managing member, general partner, or fund manager, is the active party who organizes the investment vehicle, controls its management, and bears ultimate responsibility for the execution of the investment

strategy. The specific label attached to the role depends on the entity structure, but the economic and legal substance of the position is consistent across structures.

In every real estate syndication and fund, there are two sides of the relationship: the party who manages and the party who invests. The sponsor is the party who manages. Everything else, entity structure, securities exemption, documentation architecture, investor relations program, flows from that foundational division of roles. Understanding what the sponsor's role actually requires, across every phase of the investment lifecycle, is the starting point for understanding whether any given management team is equipped to execute it.

## The Sponsor's Role Across the Investment Lifecycle

The sponsor's responsibilities span the full lifecycle of the investment, from the moment an opportunity is identified to the moment capital is returned to investors. Each phase has distinct demands, and gaps in any phase create risk for both the investment program and the investors whose capital it manages.

### The Sponsor's Responsibilities Across the Investment Lifecycle

#### Phase 1: Deal Sourcing and Underwriting

Identifying opportunities; evaluating market conditions; underwriting financial projections; negotiating purchase agreements; securing financing commitments.

#### Phase 2: Offering Structuring and Capital Raising

Selecting the securities exemption; preparing offering documents; investor outreach; subscription processing; ensuring all offering conduct complies with applicable law.

#### Phase 3: Closing and Acquisition

Coordinating with lenders, title companies, and legal counsel; managing the closing process; entity formation and funding; regulatory filings after closing.

#### Phase 4: Asset Management and Execution

Implementing the business plan; overseeing property management; managing capital expenditure programs; monitoring lender covenant compliance; investor reporting.

#### Phase 5: Disposition or Refinancing

Managing the sale or refinancing process; calculating and distributing proceeds; final investor accounting; entity wind-down.

A sponsor who is highly capable in deal sourcing and underwriting but unprepared for the compliance demands of capital raising creates legal exposure that the strength of

the deal cannot offset. A sponsor who executes excellent acquisitions but lacks the asset management discipline to monitor and report on them accurately creates investor relations failures that damage the platform's long-term capital raising capacity. The sponsor role requires consistent competence across all five phases, not peak performance in one and neglect of the others.

### **Individual Sponsors vs. Institutional Sponsors**

The private real estate market includes sponsors operating at every scale, from individual operators raising a few million dollars for a single acquisition to institutional fund managers overseeing multi-billion-dollar portfolios. The same legal framework applies across this spectrum, but the practical execution looks very different.

Individual sponsors, those operating through a small team or largely through personal effort, constitute the majority of the private real estate syndication market by transaction count. Their competitive advantages are local market expertise, direct broker relationships, operational flexibility, and the ability to move quickly on opportunities that larger institutional platforms may not be positioned to pursue. Their vulnerabilities are capacity constraints, administrative burden as the portfolio grows, and the risk of the platform becoming entirely dependent on the continued availability and functioning of a single individual.

Key person dependence is not just an operational risk. It is a disclosure obligation. A fund whose investment success depends primarily on the capabilities of a specific individual must disclose that dependence to investors. Fund documents for platforms with concentrated key person risk should include key person provisions, defining who the key persons are, what time commitment they are required to dedicate to the fund, and what governance process is triggered if a key person is no longer available. A single-sponsor operation that does not address key person risk in its offering documents is presenting an incomplete picture of the investment's risk profile.

Institutional sponsors operate under a more formal governance framework, with dedicated teams across acquisitions, asset management, finance, legal, and investor relations. The legal and compliance infrastructure is more developed, the documentation is more sophisticated, and the investor expectations, particularly with institutional LP investors, are correspondingly more demanding. The transition from individual to institutional sponsor is not simply a matter of growing the team. It requires

building the governance architecture, the compliance program, and the investor relations discipline that institutional capital requires.

### **First-Time Sponsors vs. Established Platforms**

The distinction between a first-time sponsor and an established platform matters in specific legal ways that go beyond the obvious experience gap.

First-time sponsors have no track record to present, which means the PPM's management team disclosure cannot represent experience that does not exist, and the risk factor section must honestly disclose that the sponsor has not previously managed a real estate syndication. That disclosure is both legally required and strategically important. Investors who understand they are providing first-deal capital to an emerging operator can evaluate the opportunity accordingly. Investors who are misled into believing they are investing with an experienced team have a claim when the misrepresentation is discovered.

First-time sponsors also face heightened scrutiny from regulators because non-compliance with securities law often occurs among operators who are new to the regulatory framework and unfamiliar with its requirements. The SEC's enforcement history includes cases against first-time or inexperienced real estate sponsors who raised capital without complying with registration requirements, without preparing adequate offering documents, or with materially misleading representations about the investment opportunity.

The appropriate response to first-timer status is not to obscure it. It is to be transparent about it while demonstrating the other capabilities and relationships that support the investment. A first-time sponsor who has relevant prior experience at an established firm, or who has structured the deal with an experienced co-sponsor, or whose advisory team includes seasoned professionals, can present a credible investment program even without a personal track record. What that sponsor cannot do is represent a track record they do not have, attribute an employer's deals to themselves, or imply more-experience than exists.

### **Core Competencies Every Sponsor Needs**

There is no formal credentialing requirement to become a real estate sponsor. No license, no examination, no minimum experience threshold. The barriers to entry are

legal compliance and market credibility, not formal certification. This absence of regulatory gatekeeping makes the competency question more important, not less. Because anyone can technically raise capital for a real estate deal, the investor community and the regulatory framework rely on disclosure and diligence to separate capable operators from those who should not be managing other people's capital.

Four core competencies define whether a sponsor team is equipped to execute a private real estate investment program compliantly and effectively.

### **Real Estate Expertise and Market Knowledge**

This is the foundational competency: the specific operational knowledge that justifies the sponsor's role as the active manager of the investment. It encompasses market analysis, deal sourcing, property underwriting, acquisition execution, renovation management, lease administration, property operations oversight, and disposition strategy. It is not generic. Expertise in multifamily value-add in Austin does not qualify a sponsor to execute ground-up development in Dallas or manage a national industrial portfolio.

The specificity of required expertise has a disclosure dimension. A sponsor whose strategy is described in the PPM as value-add multifamily in major Sun Belt markets but who lacks direct experience in the specific markets where the fund will invest, or whose renovation execution experience is limited relative to the scope of the contemplated business plan, is presenting a gap between the strategy's implied experience requirements and the sponsor's actual capabilities. That gap is material and must be disclosed.

Market knowledge, the ability to read supply and demand dynamics with sufficient granularity to identify opportunities others miss and to stress-test projections against realistic alternative scenarios, is a distinct competency from operational execution. Both are required. A sponsor who can operate properties efficiently but cannot evaluate market conditions accurately will buy at the wrong time, at the wrong price, or in the wrong market. Either failure produces poor investment outcomes.

### **Capital Markets and Finance Proficiency**

Running a real estate syndication requires meaningful financial sophistication, not necessarily at the level of an institutional finance professional, but enough to understand the interaction between debt structure and equity returns, to read a lender

term sheet critically, to stress-test a financial model, and to communicate the financial logic of the investment clearly to investors.

The financial projections in a PPM are the sponsor's projections: not the projections of whoever built the model, not the projections of the lender who underwrote the debt, but the sponsor's projections, disclosed under the sponsor's name, in the sponsor's offering documents. The anti-fraud standard holds the sponsor responsible for material misstatements and omissions in those projections, which means the sponsor must understand them well enough to stand behind them.

A sponsor who delegates the financial modeling entirely to a third party, without genuinely understanding the assumptions underlying the projections or verifying their reasonableness, is accepting personal legal responsibility for projections they cannot intelligently defend. That is not a comfortable position when investors are unhappy and asking why the returns did not materialize as projected.

### **Operations and Asset Management Capability**

The gap between the deal that looks good on paper and the deal that actually generates the projected returns is almost always filled, or not filled, by operational execution. Renovation projects that overrun budgets. Lease-up timelines that extend. Property management relationships that require replacement mid-hold. Lender covenant violations that require negotiation. Market shifts that require business plan adjustment.

Operational competency encompasses the practical skills of construction management, property operations oversight, lender relationship management, and the judgment to make real-time decisions when circumstances deviate from the plan. These skills cannot be fully delegated to third parties. A sponsor who manages renovation entirely through a general contractor without project oversight, or who has no meaningful supervision process for a third-party property manager, is not providing the active management function that investors are compensating through the fee and promote structure.

This matters beyond performance. A sponsor who represents in the PPM that they will actively manage the investment, overseeing renovation execution, monitoring property performance, managing the lender relationship, and then delegates all of those functions to third parties without meaningful oversight, has created a gap between what



was promised and what was delivered. That gap is a securities disclosure issue, not just an operational one.

## **Investor Relations and Communication Skills**

The investor relations competency is the one most sponsors underestimate when they start, and the one that turns out to matter most for building a durable platform. Investor relations is not simply sending quarterly updates. It is the discipline of maintaining genuine trust with people who have committed their capital to an enterprise they cannot directly monitor, who have varying levels of real estate knowledge and financial sophistication, and who are entitled to honest, complete, and timely information about how their investment is performing.

The legal dimension of investor relations is direct. The anti-fraud provisions of the federal securities laws apply to every material communication between a sponsor and investors: not just the PPM, but quarterly reports, investor letters, email updates, and verbal communications at investor meetings. A material misstatement or material omission in any of those communications is a potential securities fraud violation, regardless of whether it appears in a formal offering document.

Sponsors who are transparent with investors when things go wrong, who communicate problems promptly, accurately, and with a clear explanation of what is being done about them, consistently build stronger investor relationships than those who delay or obscure bad news. The investor who receives an honest communication about a renovation cost overrun is in a fundamentally different and better relationship with the sponsor than the investor who discovers the same problem from a late quarterly report that minimizes it. Transparency as an investor relations discipline and transparency as a legal compliance obligation point in exactly the same direction.

The April 30, 2026, post on sophisticated investor expectations at [crowdfundlawyer.com](https://crowdfundlawyer.com) captures what the investor side of this relationship actually requires: complete track record disclosure including underperforming deals, stress-tested underwriting with disclosed assumptions, fee and waterfall disclosure specific enough that investors can model the economics, and investor reporting that reflects a history of consistent and specific communication. According to FINRA's 2026 Annual Regulatory Oversight Report, released in December 2025, private placements remain a perennial examination focus area, with past-performance representations and operational due diligence on issuer management consistently identified as recurring compliance

deficiencies. What FINRA identifies as regulatory obligations for broker-dealers recommending private placements, experienced investors apply as their own diligence standard.

## **Building the Management Team**

Most sponsors start as individuals or small teams and build organizational capacity as their investment platform grows. The decisions made about team structure, including who to hire, when to hire them, how to structure compensation, and how to define responsibilities, have both operational and legal implications that deserve deliberate attention.

### **The Legal Implications of Team Structure**

Team structure decisions have direct legal significance in the private securities offering context. The bad actor disqualification rules under Regulation D, discussed in detail later in this chapter, apply not just to the primary sponsor but to every officer, director, managing member, and 20%-or-greater equity owner of the issuer and any affiliated management entity, as well as to anyone who receives compensation in connection with the offering. Building a management team without considering who becomes a covered person under the bad actor rules, and whether any covered person has a disqualifying event, is a compliance oversight that can disqualify the entire offering.

Compensation arrangements for team members who participate in capital raising, including investor relations personnel, placement agents, or others involved in soliciting investors, must also be structured carefully. Paying transaction-based compensation to a person who is not a registered broker-dealer, for activities that constitute soliciting investors for a securities offering, creates an unregistered broker-dealer problem that can give rise to rescission rights for investors whose subscriptions were solicited by the unregistered person.

### **Portfolio Management and Acquisitions**

The acquisitions function, deal sourcing, underwriting, and transaction execution, is typically the founding sponsor's core competency. Building out this function requires hiring professionals with genuine market expertise and underwriting discipline, not just the ability to run numbers through a model.

As the acquisitions team grows, the quality control challenge grows with it. A second acquisitions professional can double transaction volume, but only if their underwriting meets the same standard as the founding sponsor's. Platforms that grow acquisitions capacity without investing proportionally in underwriting quality tend to find that deal quality degrades as volume increases, a pattern that produces poor investment outcomes and the investor relations and legal consequences that follow.

### **Asset Management and Property Operations**

Asset management, the ongoing oversight of investments after acquisition, is the function most commonly understaffed in early-stage platforms. It is also the function most directly responsible for investment returns during the hold period. A dedicated asset manager who monitors property performance against underwriting, manages the property management relationship, oversees capital project execution, and identifies deviations from the business plan before they become material problems is worth considerably more than the cost of the position.

The alternative, a sponsor who manages both acquisitions and a growing portfolio of existing assets simultaneously, is a recipe for one of the two functions being done inadequately. When it is the asset management function that suffers, investors in the existing portfolio bear the cost. And when investor reports eventually reflect that cost, the legal and investor relations consequences are more-expensive than the asset management capability that would have prevented them.

### **Finance, Accounting, and Reporting**

The finance and accounting function encompasses property-level financial reporting, fund-level consolidations, distribution calculations, K-1 preparation, audit coordination, and lender covenant compliance monitoring. Each of these requires specific expertise at the intersection of real estate and fund accounting that a general CPA without real estate fund experience may handle incorrectly.

K-1 errors are among the most disruptive investor relations events a platform can experience. An investor who receives an incorrect K-1 must file an amended tax return. A fund with dozens of investors and systematic K-1 errors must issue mass amended statements and absorb the investor relations damage that accompanies them. The cost of engaging a fund administrator or CPA firm with specific real estate partnership

accounting experience is modest relative to the cost of correcting K-1 errors across a multi-investor fund.

## Investor Relations and Capital Raising

As a platform grows, the investor relations and capital raising function becomes too large for the founding sponsor to manage alone. The volume of investor communications, the complexity of reporting across multiple active investments, and the ongoing work of maintaining investor relationships between deals all require dedicated capacity.

The critical legal constraint on building out this function is the broker-dealer registration requirement. Soliciting investors, discussing specific investment opportunities with prospective investors in ways designed to result in a securities sale, is regulated activity. Employees of the issuer who perform these functions are generally covered by the issuer exemption from broker-dealer registration, provided they do not receive transaction-based compensation tied to successful securities sales. Paying a salary to an investor relations team member who speaks with prospective investors is permissible. Paying that same person a commission on capital they raise is not, without broker-dealer registration. That distinction is not always observed by platforms that grow without legal counsel advising on the compensation structure.

### Transaction-Based Compensation for Capital Raising Requires Registration

Compensating any person, whether employee, consultant, or third party, on a transaction basis for introducing investors to a securities offering is broker-dealer activity that requires FINRA registration. This is not a technicality. The SEC has consistently enforced this requirement, and the consequences include rescission rights for investors whose subscriptions were solicited by unregistered persons.

The issuer exemption from broker-dealer registration covers officers and employees of the issuer who participate in capital raising, but only when their compensation is not transaction-based. A salary-plus-bonus structure where the bonus is discretionary and based on overall company performance is generally acceptable. A commission structure tied to specific subscriptions is not.

Before establishing any compensation arrangement for investor relations or capital raising personnel, sponsors should obtain specific legal advice on whether the arrangement is consistent with the broker-dealer registration requirements. The cost of that advice is predictable. The cost of rescission liability to investors solicited by an unregistered person is not.

## Track Record: Why It Matters and How to Build It

Track record is the primary currency of the private real estate market. More than any other single factor, it is what sophisticated investors rely on when committing capital to a sponsor they are trusting with a significant portion of their investable assets.

Understanding what a track record actually needs to look like, and the legal obligations that govern how it must be presented, is essential for any sponsor building an investment platform.

### What Sophisticated Investors Actually Examine

The question that sophisticated investors are trying to answer when they evaluate a sponsor's track record is deceptively simple: is this team likely to do well with my capital? Everything else, the specific return metrics, the attribution analysis, the deal count, the comparison to projections, is in service of that question.

FINRA Regulatory Notice 23-08, the most current comprehensive guidance on reasonable investigation obligations for private placements, frames sponsor evaluation as covering the issuer and its management, the business prospects of the issuer, the assets held or to be acquired, the claims being made, and the intended use of proceeds. The 2026 FINRA Annual Regulatory Oversight Report reiterates that private placements remain a perennial focus area and identifies failures in due diligence on issuer management and past performance representations as recurring compliance deficiencies. What FINRA identifies as regulatory obligations for broker-dealers recommending private placements, experienced investors apply as their own diligence standard.

| Element                       | What Investors Want to See                                                                                                                                                                                          | Common Presentation Failures                                                                                                                     |
|-------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Deal-level performance</b> | Acquisition date, total cost, hold period, disposition date and price, net IRR and equity multiple to investors after all fees and carry. Unrealized deals should include current estimated value with methodology. | Only realized deals included. Cherry-picking outperformers. Presenting gross returns without disclosing the impact of fees and carried interest. |
| <b>Attribution</b>            | Clear explanation of which deals the current team personally executed, and in what role. Was the sponsor the lead operator or a passive co-investor? Are deals attributed from prior employers?                     | Blending an employer's track record with personal track record without clear attribution. Describing co-investment roles as lead operator roles. |

|                                    |                                                                                                                                                                                         |                                                                                                                                                            |
|------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Performance vs. projections</b> | How did actual investor returns compare to what was projected in the original offering documents? Institutional investors ask this question specifically.                               | No comparison presented. Selective presentation of deals that met projections. No documentation underlying the claimed projections.                        |
| <b>Loss history</b>                | Honest disclosure of deals that lost capital, missed projections significantly, or generated investor disputes, with explanation of what occurred and what was learned.                 | Loss deals omitted entirely. Material underperformance described as market conditions without sponsor accountability.                                      |
| <b>Consistency over cycles</b>     | Evidence of performance across multiple market environments, not just in favorable conditions. A track record built entirely in 2015 to 2021 requires scrutiny.                         | No disclosure that the track record was built in a specific market environment. No discussion of how the strategy performs in different market conditions. |
| <b>Audited support</b>             | For institutional investors, the track record must be supportable by audited financial statements or at minimum verifiable underlying records. Methodology should be clearly described. | Unaudited track records with no methodology. Performance figures that cannot be tied to underlying records. No disclosure of verification approach.        |

## Presenting Track Record: The Disclosure Obligation

Track record presentation is not just a marketing question. It is a securities disclosure question, and it carries legal obligations that sponsors must understand before they present their deal history to prospective investors.

The anti-fraud provisions of the federal securities laws, specifically Rule 10b-5 under the Exchange Act and Section 17(a) of the Securities Act, prohibit material misrepresentations and material omissions in connection with the offer or sale of securities. That prohibition applies to track record presentations as squarely as it applies to financial projections or property descriptions. A track record presentation that is selectively favorable, that misattributes experience, or that fails to disclose material losses or underperformance is a potential securities fraud violation, not a marketing decision.

The most common track record disclosure problems:

**Selective presentation.** Showing investors only the deals that performed well and omitting or minimizing those that did not is a material misrepresentation of the complete track record. The standard is the complete record, not the favorable portion of it. An investor who would not have invested if the full track record had been disclosed has a compelling argument that the selective presentation was a material omission. FINRA

Regulatory Notice 23-08 specifically flags this practice, with explicit caution about presentations that are-exclusively selected based on positive results.

**Attribution without specificity.** A sponsor who presents deals executed primarily at a prior employer, or in which the sponsor played a minor co-investment role, as evidence of personal capability is misrepresenting the nature of the experience. Sophisticated investors ask specifically about attribution, and discrepancies between the presentation and the reality create both credibility problems and legal exposure.

**Gross vs. net performance.** The difference between gross returns and net returns, what investors actually received after all fees and carried interest, can be substantial. Presenting gross returns without clearly disclosing that they do not reflect the actual investor experience gives prospective investors an inflated picture of what they would have earned. In a market where asset management fees, acquisition fees, and carried interest together consume a material portion of gross investment performance, presenting only gross figures is incomplete disclosure.

**Missing projection comparison.** Experienced investors increasingly expect to see how actual results compared to what was projected in the original offering documents. A sponsor who projected a 14% IRR and delivered an 8% IRR but does not disclose the underperformance relative to projections is presenting an incomplete picture of execution quality.

#### **Track Record Misrepresentation Is a Securities Fraud Violation**

Presenting a materially false or misleading track record to investors in connection with a securities offering is not a marketing problem. It is a violation of Rule 10b-5 under the Securities Exchange Act and Section 17(a) of the Securities Act.

The consequences include SEC civil enforcement, investor rescission rights across every offering made with the misleading track record, and in cases of willful misrepresentation, criminal referral. The statute of limitations for securities fraud claims can run for years after the misrepresentation was made.

Track records should be presented with complete attribution, complete performance history including losses and underperformance, gross and net returns both presented, and a clear description of the methodology used to calculate the figures. If the track record cannot withstand honest, complete disclosure, it should not be presented.

## **Building Track Record as a First-Time Sponsor**

The first-mover challenge for first-time sponsors is real and has no shortcut. A track record cannot be manufactured and claiming credit for experience that does not exist is fraud, not marketing. What can be done is to approach the challenge strategically.

The most credible path for a first-time sponsor is to start with a smaller, more straightforward transaction: one where the execution risk is manageable, the capital requirement is modest, and the margin for error in the business plan is reasonable. A first deal done well, documented accurately, and communicated transparently to investors is worth more to the platform's long-term capital raising capacity than a larger first deal that goes poorly, or that was executed in a way that cannot be attributed clearly to the sponsor.

Some first-time sponsors address the track record gap by partnering with an established operator, either as a co-general partner or in a structured mentorship arrangement, on the first one or two deals. This approach allows the emerging sponsor to gain operational experience under the umbrella of a more established management team. The disclosure obligation is to be precise: what the first-time sponsor contributed to the execution, what the co-sponsor contributed, and what experience belongs to each. Misrepresenting the co-sponsorship as sole sponsorship is attribution fraud.

Others build track record through roles at established real estate firms before launching their own platform. Prior employer experience can be referenced, with clear disclosure that it belongs to the employer and that the sponsor's role was as an employee, with a description of that role's specific responsibilities. What cannot be done is attribute the employer's deals to the departing employee as if they were personal investments. The experience, relationships, and judgment built during that tenure are the sponsor's. The track record belongs to the firm.

Track record documentation should start on day one of the first deal. Not after the deal is successfully exited, not when the second raise is being prepared, but from the first acquisition. The documentation of how the underwriting was developed, what assumptions were made, how execution compared to projection, and how investor communications were managed throughout the hold period is the foundation of the platform's track record. It is easiest to build when the information is current rather than reconstructed from memory years later.

## **Bad Actor Disqualification Rules**



Of all the compliance requirements in this chapter, bad actor disqualification is the one sponsors most frequently overlook, and the consequences of overlooking it are among the most severe in the Regulation D offering framework. A single disqualifying event involving a single covered person can render an entire offering ineligible for the Rule 506 exemptions, retroactively, exposing the issuer to rescission liability, SEC enforcement, and state securities law consequences across the full scope of capital raised.

The bad actor rules under Rule 506(d) were adopted by the SEC in 2013, implementing requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Their purpose is straightforward: to prevent persons with a demonstrated history of securities law violations or fraud from using the Regulation D exemptions to raise additional capital from investors. The mechanism is equally straightforward. If a covered person has a disqualifying event, the offering is not entitled to rely on Rule 506 unless the disqualification is disclosed or the event is subject to a waiver or exception.

### Who Is Covered

The bad actor rules do not apply only to the sponsor entity or the primary principals. They apply to a specific and broader list of covered persons:

- The issuer itself, meaning the entity offering the securities.
- Each director, executive officer, and other officer of the issuer who participates in the offering.
- Any beneficial owner of 20% or more of the issuer's outstanding voting equity securities.
- Any promoter connected to the issuer in any capacity at the time of the offering.
- Any investment manager of an investment company issuer.
- Any general partner or managing member of the issuer.
- Any person who has been or will be paid, directly or indirectly, remuneration for solicitation of investors in connection with the offering, including placement agents and finders.
- The directors, executive officers, and general partners of any investment manager, general partner, or managing member of the issuer.

The breadth of this list is the source of the most common bad actor compliance failures. Sponsors who check their own background and the backgrounds of their primary principals, but do not check the backgrounds of placement agents, co-managers who hold 20% or more interests, or directors and officers of affiliated management entities, may be conducting an offering in which a covered person with a disqualifying event has not been identified.

## What Events Are Disqualifying

| Category                                                  | Specifics                                                                                                                                                                                      | Lookback Period           |
|-----------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------|
| <b>Criminal convictions</b>                               | Conviction for any felony or misdemeanor involving securities or commodities fraud; financial crimes; mail, wire, or bank fraud; any felony connected with the purchase or sale of a security. | 10 years                  |
| <b>Court injunctions and restraining orders</b>           | Any court order enjoining the person from engaging in securities-related conduct, including orders in connection with any securities offering.                                                 | Permanent (no expiration) |
| <b>Final orders from banking and financial regulators</b> | Orders from state banking regulators, credit union regulators, insurance regulators, the CFTC, or similar authorities, based on fraud, deceit, manipulation, or reckless practices.            | 10 years                  |
| <b>SEC disciplinary orders</b>                            | Orders under Exchange Act Section 15(b), Advisers Act Section 203(e) or (f), or Investment Company Act Section 9(b), suspending or barring the person from a securities industry role.         | Permanent                 |
| <b>SEC cease-and-desist orders</b>                        | Cease-and-desist orders entered within five years before the offering relating to scienter-based anti-fraud provisions.                                                                        | 5 years                   |
| <b>Suspension or expulsion from SRO</b>                   | Suspension or expulsion from FINRA or any other self-regulatory organization.                                                                                                                  | Permanent                 |
| <b>SEC stop orders</b>                                    | Stop orders or suspensions of the effectiveness of a registration statement.                                                                                                                   | 5 years                   |
| <b>U.S. Postal Service fraud orders</b>                   | Final orders of the U.S. Postal Service denying the privilege of using the mails.                                                                                                              | Permanent                 |

The lookback periods in the table reflect the rules as adopted. A criminal conviction for securities fraud from fifteen years ago is still a disqualifying event. It does not expire.

That is a longer reach than many sponsors anticipate when they first encounter these rules.

### Conducting the Bad Actor Check

Before launching any Regulation D offering, the issuer must exercise reasonable care to determine whether any covered person is subject to a disqualifying event. Rule 506(d)(2)(iv) provides a safe harbor: the disqualification will not apply if the issuer demonstrates it did not know and, in the exercise of reasonable care, could not have known of the disqualifying event.

What constitutes reasonable care is not defined by regulation, but the standard requires a minimum:

- Identifying every covered person, which requires a more thorough analysis than many sponsors initially assume, given the breadth of the covered person definition.
- Obtaining representations from each covered person that no disqualifying events exist, or, if any exist, obtaining disclosure of them.
- Conducting background checks appropriate to the circumstances, particularly for any covered person whose background is not personally known to the sponsor, including any placement agents, finders, or newly added management team members.
- Documenting the inquiry and retaining the representations obtained.

For principals of the sponsor entity whom the founding team has known for years, the inquiry can be relatively streamlined, though representations should still be obtained in writing. For third-party service providers, placement agents, or co-sponsors who come from outside the existing network, the inquiry must be more rigorous. Professional background check services that search court records, regulatory databases, and FINRA's BrokerCheck system are available at modest cost and are entirely appropriate to use for covered persons whose backgrounds are not personally known.

#### **Placement Agents Are Covered Persons: Check Them**

The most common bad actor compliance failure is not a founding sponsor with undisclosed history. It is a sponsor who conducted no diligence at all, who assumed that because the

founders had nothing to hide the check was unnecessary, and who later discovered that a placement agent or a co-manager had an undisclosed regulatory event.

Placement agents who assist with capital raising are covered persons under Rule 506(d). Their FINRA disciplinary history, state securities enforcement history, and federal court orders all affect the sponsor's Regulation D exemption. A placement agent who fails to disclose a disqualifying event does not solve the sponsor's problem by keeping it hidden. It compounds the problem by creating a situation where the sponsor cannot claim the reasonable care safe harbor.

Run the check. Use FINRA BrokerCheck for registered representatives. Use court and regulatory database searches for others. Do it before the offering opens, not after it has raised capital.

## Consequences of Failing to Conduct Diligence

If a disqualifying event exists with respect to any covered person and the offering proceeds without addressing it, the offering loses the benefit of the Rule 506 exemption. For a disqualifying event that occurred after the rule's effective date of September 23, 2013, this is not merely a technical deficiency. It means the offering is an unregistered, non-exempt securities offering.

The consequences cascade. Investors have rescission rights, the right to demand their money back plus interest, regardless of how the investment performed. The SEC may bring an enforcement action. State securities regulators may bring their own enforcement actions in each state where interests were offered or sold. The offering documents may be subject to scrutiny for the additional failure to disclose the disqualifying event.

For disqualifying events that occurred before September 23, 2013, the automatic disqualification does not apply. But a disclosure obligation does. Under Rule 506(e), the issuer must furnish investors with a description of any matters that would have been disqualifying but for the pre-effective date exception, a reasonable time prior to sale. That disclosure must be in writing, must specifically describe the disqualifying event, and must be provided before the investor subscribes. Omitting the Rule 506(e) disclosure on the theory that the old event does not affect the exemption is itself a compliance failure.

Waivers of the disqualification are available from the SEC, but they are not automatic, they take time, and they are not granted in every case. The waiver application process

involves submitting a detailed request with supporting documentation, and the SEC has discretion to deny the waiver. Waivers are more frequently granted for events that are genuinely historical, not suggestive of ongoing character issues, and where the applicant has demonstrated rehabilitation. They are not a reliable fallback when a disqualifying event is discovered close to an offering launch.

### **A Note on Counsel's Role in Bad Actor Compliance**

The bad actor diligence process, identifying all covered persons, obtaining representations, conducting background checks, and documenting the inquiry, is a legal compliance obligation that benefits materially from legal oversight. Securities counsel who has structured Regulation D offerings understands which persons qualify as covered persons, what documentation is sufficient to establish the reasonable care safe harbor, and what to do when a disqualifying event is discovered.

Sponsors who attempt to manage the bad actor compliance process without legal guidance sometimes identify the list of covered persons incorrectly, either over-inclusively, subjecting non-covered persons to unnecessary scrutiny, or under-inclusively, missing persons who are actually covered. Either error creates either unnecessary friction or genuine compliance exposure.

The bad actor compliance process should be built into the offering timeline from the beginning, not treated as a box to check after the offering has otherwise been structured. Sponsors who want to discuss how to structure the bad actor diligence process for a specific offering are welcome to reach out at [crowdfundlawyer.com](http://crowdfundlawyer.com).

## **Practical Takeaways**

- The sponsor's role spans the full investment lifecycle: deal sourcing, structuring, capital raising, closing, asset management, investor relations, and disposition. Consistent competence across all of these phases is what the sponsor's fees and promoted interest are supposed to represent. Gaps in any phase create risk for investors and legal exposure for the platform.
- Individual sponsors face capacity constraints and key person risks that must be disclosed to investors. Institutional sponsors face governance expectations and investor requirements that increase with the sophistication of the investor base. The regulatory framework applies consistently across the spectrum.

- Core competencies, including real estate expertise, capital markets proficiency, asset management capability, and investor relations discipline, are all required. A team that excels in deal sourcing but lacks the operational discipline to manage existing investments, or that can execute acquisitions but cannot communicate transparently with investors, is not positioned to build a durable platform.
- Track record must be presented completely, accurately, and with proper attribution. Selective presentation, attribution of others' deals, and failure to disclose material underperformance are potential securities fraud violations, not marketing decisions. FINRA Regulatory Notice 23-08 specifically identifies past-performance representations and cherry-picked results as a due diligence focus area. Track record documentation should begin on day one of the first deal.
- First-time sponsors must disclose their first-mover status honestly. The appropriate response is transparency about experience gaps combined with evidence of other capabilities, advisory support, and a deal structure appropriate to the team's experience level, not misrepresentation of a track record that does not exist.
- The bad actor disqualification rules apply to a broader set of covered persons than most sponsors initially expect, including placement agents, co-managers, 20%-or-greater equity holders, and officers and directors of affiliated management entities. Every covered person must be identified and checked before the offering opens. The disqualifying event lookback period for criminal convictions is 10 years; court injunctions and certain SEC disciplinary orders have no expiration.
- Transaction-based compensation for capital raising personnel is a broker-dealer registration issue. Paying commissions to unregistered persons for soliciting investors creates rescission rights for investors whose subscriptions were solicited. Get specific legal advice before establishing capital raising compensation arrangements.
- The bad actor compliance process, identifying covered persons, obtaining representations, running background checks, and documenting the inquiry, should be built into the offering timeline from the beginning. A disqualifying event discovered after an offering has raised capital is substantially harder to address than one identified before the offering opens.

CHAPTER SIX

# Key Third-Party Advisors in a Real Estate Syndication or Fund

A real estate syndication or fund is not a solo project. Every properly structured offering depends on a coordinated team of advisors whose specialized expertise the sponsor needs but does not possess, and whose failures or gaps create legal exposure that the sponsor's own competence cannot offset.

That statement deserves emphasis because the cost structure of early-stage platforms creates persistent pressure to minimize the advisory bench. Legal fees, accounting fees, fund administration costs, and audit fees are real costs that visibly reduce the capital available for investment. The temptation to use cheaper advisors who lack the relevant specialization, to defer engaging advisors until problems require them, or to handle internally what should be delegated to professionals is understandable. It is also, repeatedly, the source of the most expensive problems sponsors encounter.

The advisory team is not overhead. It is the infrastructure that makes a compliant, well-documented, professionally managed investment platform possible. The cost of getting it right is defined and predictable. The cost of getting it wrong, including rescission liability, SEC enforcement, investor litigation, K-1 restatements, and audit qualifications, is not.

This chapter covers the nine principal advisory categories that private real estate syndications and funds require: what each advisor does, why the specific expertise required is more narrowly defined than it might appear, how to evaluate whether a given advisor is genuinely equipped for the work, and where sponsors most commonly make mistakes. The summary table below provides a quick reference across all nine categories. The sections that follow go into the specificity the summary cannot.

| Advisor            | Primary Role and Selection Criteria                                                                                                                                                                                                                                                                             |
|--------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Securities Counsel | Structures the offering; selects the exemption; drafts the PPM, operating agreement, and subscription agreement; manages state blue sky compliance; advises on ongoing compliance. Selection criterion: specific experience with private real estate securities offerings, not just general corporate practice. |

|                                 |                                                                                                                                                                                                                                                                                                  |
|---------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Tax Counsel / CPA</b>        | Entity structure and tax efficiency; K-1 preparation; cost segregation planning; FIRPTA analysis for foreign investors; 1031 exchange and Opportunity Zone strategies. Selection criterion: specific real estate partnership taxation experience; familiarity with pass-through fund accounting. |
| <b>Real Estate Counsel</b>      | Acquisition due diligence; title review; purchase contract negotiation; lease review; closing coordination. Selection criterion: transactional real estate experience in the relevant asset class and markets.                                                                                   |
| <b>Lender / Mortgage Broker</b> | Source and structure debt financing; navigate lender requirements and term negotiation; coordinate closing requirements. Selection criterion: relationships in the relevant asset class and debt market.                                                                                         |
| <b>Property Manager</b>         | Day-to-day operations; leasing; maintenance; vendor management; financial reporting. Selection criterion: experience in the specific asset class and market; financial reporting capability; alignment of incentive structure.                                                                   |
| <b>Fund Administrator</b>       | Capital account maintenance; distribution calculations and waterfall mechanics; investor reporting; K-1 coordination. Selection criterion: specific real estate fund accounting experience; not general small-business bookkeeping.                                                              |
| <b>Placement Agent</b>          | Capital raising assistance from institutional or broader investor channels on a FINRA-registered basis. Selection criterion: registration verified through BrokerCheck; track record in the relevant investor market; bad actor background check required.                                       |
| <b>Auditor</b>                  | Independent audit of financial statements; required for institutional investors and many fund structures. Selection criterion: specific real estate fund audit experience; engaged before year-end, not in the following spring.                                                                 |
| <b>Insurance Advisor</b>        | Property, casualty, liability, D&O, and E&O coverage; coverage review as platform grows. Selection criterion: familiarity with real estate fund management exposure; not just property-level coverage.                                                                                           |

## Securities Counsel

If there is one advisor that is genuinely non-negotiable for any sponsor raising capital from outside investors, it is a securities attorney: not just any attorney, but one with specific experience in private placement securities law, Regulation D, and the practical realities of how these offerings work in the real estate market.

Securities law is a specialized practice. The skills required to structure a compliant private offering, draft adequate disclosure documents, and maintain ongoing compliance through an investment's lifecycle are built through repeated work in a specific context. A capable attorney who practices corporate mergers and acquisitions, commercial leasing, or general business law has not built those skills through their other



work. The legal analysis that governs a real estate syndication, including exemption selection, the anti-fraud standard and what it requires in disclosure, the integration doctrine and how prior offerings affect current ones, the bad actor analysis, and the state blue sky compliance framework, is specific, and getting it right requires specific experience.

## What Securities Counsel Actually Does

The securities attorney's role in a syndication or fund spans several distinct functions that operate sequentially and require ongoing coordination throughout the offering.

**Structuring the offering and selecting the exemption.** Before a word of the PPM is drafted, securities counsel should analyze how the offering should be structured: what entity form, what securities exemption, what investor qualification requirements, how the intended marketing approach affects exemption availability, and whether any prior offerings create integration risk. These decisions, once implemented, are-expensive to reverse. Getting them right at the outset is the most valuable thing securities counsel does.

**Drafting the offering documents.** The core offering documents, including the Private Placement Memorandum, the operating agreement or limited partnership agreement, and the subscription agreement, are legal instruments that carry real legal consequences. The PPM is the disclosure document that, if adequate, provides the sponsor's primary defense against investor fraud claims. The operating agreement defines the investor relationship for the full life of the investment. The subscription agreement documents the investor's eligibility and the issuer's acceptance. These documents need to be drafted by someone who has done this work many times and who understands what material facts must be disclosed for a specific deal type.

**Regulatory filings.** Securities offerings generate filing obligations: Form D with the SEC within 15 calendar days of the first sale, state blue sky notice filings in each state where investors are located, and in some cases amended filings as the offering progresses. Missing these filings creates regulatory exposure. Securities counsel tracks and manages these obligations across the full compliance calendar.

**Ongoing compliance advice.** The compliance obligations of a real estate syndication do not end at closing. Questions about secondary transfers of investor interests, material changes to the investment that require investor notification, the treatment of new investors in subsequent capital calls, and the disclosure obligations that arise when

circumstances change all require ongoing legal attention across the investment's hold period.

### Why General Practice Attorneys Are Often Insufficient

This point deserves direct treatment because it comes up regularly. Many sponsors have existing relationships with capable business attorneys, someone who formed their LLC, reviewed a commercial lease, or handled a prior business transaction, and they naturally consider using that attorney for their first syndication. Sometimes this works. More often, the limitations become apparent at a point that is more-expensive to address.

The securities laws governing private placements are a specialized practice area. The difference between Rule 506(b) and Rule 506(c), in their marketing restrictions, their verification requirements, and their integration with prior offerings, is not a technicality that a capable generalist will naturally navigate correctly. The anti-fraud standard and what it requires in terms of risk factor disclosure for a specific deal type is not something that general transactional experience reliably produces. The integration doctrine, the analysis of whether prior offerings affect the current offering's exemption, is a specific body of SEC guidance that requires direct familiarity.

The documents matter as much as the analysis. A PPM drafted by an attorney who has prepared many of them, who knows what risk factors are specific to value-add multifamily versus ground-up development versus a debt fund, is a fundamentally different document from one adapted from a template by counsel whose primary experience is elsewhere. The difference between a document that provides adequate disclosure and one that leaves material gaps is not visible until an investor is unhappy and a lawyer is reviewing what was and was not disclosed.

#### **The Cost of Adequate Legal Counsel Is Predictable; the Cost of Inadequate Counsel Is Not**

Legal fees for a properly structured Regulation D offering, covering the PPM, operating agreement, subscription agreement, and blue sky filings, are a defined cost that can be estimated before engagement. Rescission liability, SEC enforcement defense, investor litigation, and K-1 restatements arising from inadequate documents are not.

Sponsors who save \$5,000 to \$15,000 in legal fees by using a generalist attorney or a document preparation service for their first offering, and who later face a disclosure-related investor claim, have not made a good trade. The asymmetry is severe: the upside of the

savings is small, and the downside of the resulting exposure can dwarf the entire offering's returns.

The selection criterion for securities counsel is not hourly rate. It is relevant experience: how many Regulation D real estate offerings has this attorney personally structured and documented in the past three years? If the answer is not many, they are not the right counsel for this work.

## How to Evaluate Securities Counsel

The questions worth asking when evaluating a securities attorney for a real estate syndication or fund:

- How many Regulation D real estate offerings have you personally structured and documented in the last three years? Not how many your firm has handled: how many you personally have worked on.
- What is your specific experience with the exemption I am considering? If I am planning a Rule 506(c) offering with general solicitation, have you structured those before and do you understand the verification requirements, including the March 2025 SEC no-action guidance, in practice?
- What is your experience with real estate fund formation, as distinct from single-asset syndications? The documents and regulatory analysis differ significantly between the two.
- How do you handle state blue sky compliance: do you manage those filings in-house or refer them out, and how do you track deadlines as the investor list grows?
- What is your approach to risk factor drafting: do you adapt a standard template to the specific deal, or do you build risk factors from the deal's actual characteristics?
- How do you handle ongoing compliance questions after the offering closes: is that billed separately or included in the engagement?

The answers to these questions reveal quickly whether the attorney has genuine depth in this practice area or handles securities work occasionally alongside a broader general practice.

## **Tax Counsel and CPA**

The tax dimension of real estate syndications and funds is substantial, genuinely complex, and consequential enough to require advisors with specific real estate fund taxation experience. Not a capable generalist CPA who handles small business returns, but a tax professional who has worked extensively with the partnership tax rules, real estate-specific depreciation and cost recovery mechanics, and the complex provisions, including FIRPTA, the passive activity rules, and carried interest taxation under Section 1061, that require specific expertise to navigate correctly. A tax advisor who has not dealt with these provisions in a real estate fund context may handle them incorrectly without recognizing the error until the K-1s have been issued and investors are asking questions.

## **Entity Structure and Tax Efficiency**

The entity structure decisions made at formation have tax implications that persist through the full lifecycle of the investment. Whether to use an LLC or a limited partnership, how the management entity is structured relative to the operating entity, and how the economic terms of the waterfall are characterized for tax purposes: these decisions interact with the tax code in ways that require planning, not just compliance. The right tax advisor is involved in the structuring conversation from the beginning, not brought in to prepare returns after the structure is set.

The sponsor's own economics, including management fees, carried interest, and co-investment returns, carry tax implications worth addressing deliberately. Management fees are ordinary income. Carried interest income may qualify for long-term capital gain treatment under certain conditions, but Section 1061's three-year hold rule adds complexity to that analysis for fund structures with shorter hold periods or deal-by-deal waterfalls. Getting the characterization of carried interest right requires tax counsel who understands both the fund economics and the current state of Section 1061.

## **K-1 Reporting Obligations**

Every investor in a real estate syndication structured as an LLC or limited partnership receives a Schedule K-1 each year reporting their share of the entity's income, losses, deductions, and credits. K-1 preparation for real estate partnerships is not a simple accounting function. The capital account methodology, the allocation of depreciation among investors at different entry points, the treatment of the sponsor's promoted

interest, and the characterization of various items as ordinary versus capital all require specific expertise.

K-1 errors are disruptive in direct proportion to the number of investors affected. A single K-1 error can be corrected with amended returns and a communication to the affected investor. Systematic K-1 errors across a fund with forty investors require mass reissuance, investor communications explaining why their returns were mischaracterized, and in some cases formal amendment of prior-year tax returns, all of which consume management time and damage investor confidence. The cost of engaging a fund administrator or CPA firm with specific real estate partnership K-1 experience is modest relative to the cost of correcting systematic errors.

### **Cost Segregation and Depreciation Planning**

One of the most powerful tax benefits in real estate investment is accelerated depreciation through cost segregation. A cost segregation study reclassifies components of a building's cost from the standard 39-year (commercial) or 27.5-year (residential) depreciation schedule to shorter recovery periods, typically 5, 7, or 15 years, by identifying personal property and land improvement components that qualify for faster cost recovery.

On a \$10 million commercial acquisition, a cost segregation study might identify \$1.5 million to \$3 million of costs eligible for shorter recovery periods, generating substantial first-year depreciation deductions that pass through to investors as tax losses. For investors who can use those losses against other passive income, subject to the passive activity rules, the tax benefit is a real and material component of the investment's after-tax return.

Bonus depreciation rules have significantly amplified this benefit in recent years, though the specific percentage has been phasing down from the 100% bonus depreciation that applied through 2022. The current and projected bonus depreciation rules require a tax advisor who is current on the legislation and regulations, not one who learned the rules when they were more favorable and has not updated their analysis.

### **FIRPTA and Foreign Investors**

The Foreign Investment in Real Property Tax Act imposes withholding obligations on distributions to foreign investors from investments in U.S. real property interests, including from LLC and LP entities that hold real estate. The withholding obligation

belongs to the distributing entity, not the foreign investor: the fund or syndication entity is responsible for withholding the required amounts, remitting them to the IRS, and issuing the required tax documentation.

The mechanics of FIRPTA withholding are specific, and the penalties for non-compliance, both for under-withholding and for certain procedural failures, are significant. Sponsors who have or expect to have foreign investors need a tax advisor who understands FIRPTA specifically, who has implemented FIRPTA withholding mechanics for fund distributions, and who can advise on the planning strategies available to mitigate withholding obligations in appropriate structures.

FIRPTA planning is most effective when addressed at the structuring stage, before the offering is launched. Certain entity structures and investor eligibility provisions can affect the FIRPTA analysis in ways that create planning opportunities, or eliminate them, depending on how they are implemented. A tax advisor who is not consulted until the first foreign investor has subscribed has missed the window for the most valuable planning.

### **1031 Exchanges and Opportunity Zone Structures**

Many investors who participate in real estate syndications do so as part of a 1031 exchange strategy, using proceeds from a prior sale to acquire a replacement interest without immediate capital gains recognition. The rules governing whether a syndication interest qualifies as like-kind replacement property are specific and technical, and the timing requirements are strict. Tax counsel who has worked with 1031 exchange investors in the syndication context can help sponsors structure offerings that accommodate exchange investors and avoid the technical traps that disqualify otherwise sound exchanges.

Qualified Opportunity Zone funds offer their own set of tax benefits, including deferral, step-up, and potential exclusion of gain, with their own set of compliance requirements for maintaining QOF qualification throughout the fund's life. Sponsors who structure Opportunity Zone investments need tax counsel with specific QOF experience. The compliance requirements are not trivial, and the benefits at stake are large enough that errors in maintaining qualification have significant economic consequences for investors.

## **Real Estate Counsel**

The real estate attorney handles the transactional side of the acquisition: the work that sits in property law, contract law, and title law rather than in securities law. These are distinct roles requiring distinct expertise, and in most larger transactions they are performed by different attorneys. A securities attorney who also handles the real estate due diligence is doing two jobs. The question is whether they are doing both well.

### **Acquisition Due Diligence and Title Review**

The due diligence phase of a real estate acquisition is where problems are found before they become closing disasters or post-closing litigation. The real estate attorney's job in this phase is to review the title commitment and schedule of exceptions, identify any title issues that must be resolved before closing, review the survey for encroachments or boundary discrepancies, review the existing leases and service contracts, and identify any legal issues in the due diligence materials that affect the property's value, use, or operability.

Title insurance covers what the policy insures, defined by the policy terms, the exceptions listed in the schedule, and the endorsements obtained. The real estate attorney's job is to ensure the title insurance is covering what it needs to cover and that the policy terms are appropriate for the transaction. Title insurance is not a substitute for careful title review. The insurer covers the defined policy risks, not every issue that could arise with title.

The quality of the title review correlates directly with the experience and thoroughness of the attorney conducting it. An experienced real estate attorney who has reviewed hundreds of title commitments can identify a problematic easement, an unresolved lien, or a defective prior conveyance that a less experienced attorney might miss. Those issues do not go away at closing. They become the buyer's problem. On a leveraged acquisition with investor capital at risk, a title issue discovered post-closing is a problem that could have been avoided.

### **Purchase and Sale Agreement Negotiation**

The purchase and sale agreement establishes the terms of the acquisition: price, earnest money structure, due diligence period, representations and warranties, conditions to closing, and the remedies available if either party defaults. The specific terms of this agreement have direct implications for the sponsor's investor relationships.

The earnest money structure deserves particular attention in the syndication context. If the capital raise is not fully closed at the time of the purchase contract execution, which is frequently the case, the sponsor is committing investor capital, or personal capital, to a deposit that becomes non-refundable at the end of the due diligence period. Losing an earnest money deposit is not just a business setback. It is an investor relations event that requires explanation. The conditions under which the deposit is and is not at risk should be clearly understood and, where appropriate, disclosed in the offering documents.

### **Lease Review and Landlord-Tenant Issues**

For commercial property acquisitions, the existing leases are among the most important documents in the due diligence package. The real estate attorney reviews leases for provisions that affect the acquisition itself, including assignment and change-of-control provisions that may require tenant consent, co-tenancy clauses that give tenants remedies if anchor tenants leave, and purchase options or rights of first refusal that could affect the property's marketability. The attorney also reviews provisions that affect the ongoing economics of the investment.

A lease with an outstanding tenant improvement allowance that has not been funded, a renewal option exercisable at below-market rates, or an early termination right triggered by a condition the acquisition may satisfy are issues that a careful lease review identifies and that affect the investment's underwriting in ways that investors deserve to know. Lease review is a technical skill, and the quality of the review matters directly to the accuracy of the financial projections the sponsor presents to investors.

### **Lenders and Mortgage Brokers**

The lender relationship is one of the most commercially important advisory relationships in any real estate syndication. The debt terms, including interest rate, loan term, amortization, prepayment provisions, covenant structure, and the consent requirements for ownership transfers, shape the investment's economics, its operational constraints, and its risk profile in ways that affect every investor who participates.

Most sponsors who transact regularly in a specific asset class have direct lender relationships. They know which agencies, banks, and debt funds are active in their market and asset type, what their programs look like, and what their underwriting standards require. For sponsors who are newer to a specific asset class or financing



structure, a mortgage broker, a professional who works across multiple lending relationships and can identify financing options the sponsor might not have direct access to, adds genuine value.

The interaction between the loan documents and the offering documents is an area that deserves specific attention. Commercial mortgages routinely contain transfer restriction provisions, including due-on-transfer clauses, consent requirements for ownership changes, and restrictions on preferred equity or mezzanine financing without lender approval, that affect investors' ability to transfer their interests and the sponsor's operational flexibility. These provisions need to be reviewed against the offering documents before the offering is launched. Offering documents that describe investor rights, including the ability to transfer interests or approve certain decisions, that the loan documents do not actually permit create a documentation inconsistency that becomes a problem when investors try to exercise the rights they believed they had.

The practical recommendation: real estate counsel should review the loan documents as part of the offering structuring process, specifically to identify any provisions that affect the investor relationship and that must be reflected in the PPM's risk factors and transfer restriction provisions. This review should happen before the offering documents are finalized, not after investors have subscribed based on representations that turn out to be inconsistent with the loan terms.

## **Property Managers and Third-Party Operators**

The property manager is the operational partner who runs the asset day-to-day: handling leasing, maintenance, vendor management, rent collection, tenant relations, and financial reporting. For most syndication sponsors who do not self-manage, the property manager is the most consequential operational relationship on any given deal.

The selection of a property manager is often treated as a real estate operations decision, which it is, rather than a legal and investor relations decision, which it also is. The property manager's performance directly affects the returns that investors receive. A property manager who cannot execute a renovation program on schedule, who loses occupancy through poor leasing practices, or whose financial reporting is unreliable creates problems that flow directly to the investment's bottom line and directly to the investor relations experience.

## The Property Management Agreement

The property management agreement is the legal document governing the operational relationship, and it deserves more attention than it routinely receives. Key provisions that often require negotiation in the syndication context:

- **Management fee structure:** typically a percentage of collected revenues, but the specific calculation and any minimum fees should be reviewed for alignment with the investment's income profile.
- **Expenditure authority:** the threshold above which the property manager must obtain sponsor approval before committing to an expense. This threshold should be appropriate to the property's budget, not a standard template figure that may be too high or too low for the specific investment.
- **Performance termination rights:** the conditions under which the sponsor can terminate the manager for performance failures without paying the full notice period or termination fee. A management agreement that does not include meaningful performance termination rights leaves the sponsor without adequate recourse if the manager is not performing.
- **Assignment provisions:** what happens to the management agreement if the property is sold, or if the management company is acquired or changes control. These provisions affect the sponsor's ability to execute an exit without the complication of a management relationship that does not convey with the property on acceptable terms.
- **Financial reporting obligations:** the frequency, format, and content of the financial reports the manager provides to the sponsor. These reports feed the investor reporting function. A manager who consistently produces late or unreliable financial statements creates investor reporting problems for the sponsor regardless of the property's actual performance.

The quality and enforceability of the property management agreement determines how much operational risk the sponsor actually retains versus transfers to the manager. Sponsors who sign standard management agreements without negotiating these terms are accepting risk allocation decisions that were made for someone else's deal.

## The Fund Administrator

Fund administration is the back-office function that maintains investor capital accounts, calculates distributions according to the waterfall mechanics in the operating

agreement, prepares quarterly investor statements, coordinates K-1 preparation with the tax advisor, processes capital call notices in fund structures, and provides the financial data that feeds the sponsor's investor reporting. It is the operational infrastructure that makes a professionally administered investment program possible.

Fund administration is consistently one of the most underinvested functions in early-stage platforms, and consistently one of the functions whose inadequacy has the most visible consequences. Distribution calculations that are systematically wrong because the waterfall logic was implemented incorrectly in the administrator's model can result in investors being overpaid or underpaid, requiring complex corrections and damaging investor trust. Capital accounts that do not reconcile with the underlying financial statements create audit complications and K-1 errors. Investor statements that are months late or contain obvious errors communicate, accurately, that the sponsor is not running a professionally managed platform.

### **Why Specialized Real Estate Fund Experience Matters**

Fund administration for a real estate partnership is not a general accounting function. The capital account methodology for a real estate LLC with multiple investor entry dates, a promoted interest structure, and cost segregation-driven loss allocations requires specific expertise. The waterfall calculation for a fund with a deal-by-deal carry structure, a catch-up provision, and multiple clawback scenarios is not a spreadsheet calculation that any competent accountant can perform correctly without specific experience.

The consequences of K-1 errors in a fund with significant investor losses, where the allocation of those losses among investors with different entry dates and different capital account balances may be the most important tax event of the year for some of those investors, are not limited to an inconvenience. A K-1 error in this context can require investors to file amended returns, can create disputes about the accuracy of the underlying allocation methodology, and can lead investors to question the overall competence of the management team.

### **Building vs. Outsourcing the Function**

Most sponsors in the early stages of building a platform outsource fund administration to a third-party administrator rather than building an in-house function. This is generally the right approach: professional fund administrators have the systems, the expertise, and

the processes to perform the function correctly, at a cost that is modest relative to the alternative. The decision to bring fund administration in-house is appropriate only when the platform has reached the scale and complexity at which a dedicated in-house function is more cost-effective than the outsourced alternative.

When outsourcing, the selection criteria matter. A fund administrator who manages real estate funds of similar size and structure to the sponsor's platform, who uses professional fund accounting software rather than spreadsheets, and who has a documented track record of timely and accurate K-1 delivery is the standard the selection process should be held to. A general small-business bookkeeping service with some real estate clients is not an adequate fund administrator for a multi-investor private offering.

#### **Fund Administration Errors Compound Over Time**

The most common fund administration failure pattern is a sponsor who starts managing capital accounts and distribution calculations internally, because the first deal has a small investor group and the mechanics seem manageable, and who discovers years later that the calculations have accumulated errors that require-expensive correction.

As the number of investors grows, as deals multiply, and as the waterfall calculations become more complex with multiple assets at different stages, what started as a manageable spreadsheet becomes an error-prone manual process. Bringing a professional administrator in at that stage, untangling prior work and establishing clean records, is more-expensive than professional administration from the start would have been.

Engage a qualified fund administrator from the first deal. The cost is modest. The operational discipline it establishes is valuable.

## **Placement Agents and Registered Broker-Dealers**

A placement agent is a FINRA-registered broker-dealer who assists sponsors with capital raising, introducing the offering to institutional or professional investors, providing due diligence support, and facilitating the subscription process, in exchange for a fee typically expressed as a percentage of the capital raised.

The placement agent relationship can be genuinely valuable: access to investor networks that the sponsor cannot reach independently, credentialing with institutional investors who prefer to work with registered intermediaries, and an organized capital

raise process for a segment of the market the sponsor is entering for the first time. For sponsors whose investor networks are concentrated in individual high-net-worth investors but whose capital requirements are growing toward institutional sizes, a placement agent can be the most efficient path to the next tier of capital.

### **Why Registration Matters and Is Non-Negotiable**

The act of soliciting investors for compensation, introducing prospective investors to a securities offering in exchange for a payment tied to the successful sale of the security, is broker-dealer activity that requires FINRA registration. This requirement applies to every third party that sponsors hire to help raise capital, regardless of what those third parties call themselves: finders, capital raising consultants, investor relations advisors, deal introducers. The label does not determine the legal analysis. The activity does.

A sponsor who pays an unregistered person a transaction-based fee for introducing investors to a securities offering is creating legal exposure that extends to investors whose subscriptions were solicited. Those investors may have rescission rights, the right to demand their money back with interest regardless of how the investment performed. The SEC and state regulators can bring enforcement actions against both the sponsor and the unregistered person. The unregistered person's failure to disclose their lack of registration does not reduce the sponsor's exposure. It may increase it by adding a disclosure violation to the underlying transaction-based compensation problem.

The practical implication is simple: before engaging any person or firm to assist with investor introductions in connection with a securities offering, verify their FINRA registration through BrokerCheck. If they are not registered, do not pay them transaction-based compensation. If they claim the arrangement is structured to avoid broker-dealer registration requirements, get specific legal advice on whether that claim is accurate before proceeding.

### **Bad Actor Diligence for Placement Agents**

Placement agents who participate in a securities offering are covered persons under the Regulation D bad actor rules. As discussed in Chapter 5, this means their FINRA disciplinary history, SEC enforcement history, state securities enforcement history, and court orders all affect the sponsor's ability to rely on the Regulation D exemption. A

placement agent with a disqualifying event who does not disclose it does not solve the sponsor's problem. It creates a worse one.

Before engaging any placement agent, sponsors should run a FINRA BrokerCheck search on the firm and each relevant registered representative, confirm that the bad actor check is documented in the offering's compliance records, and obtain representations in the engagement agreement that no disqualifying events exist. This is not a courtesy. It is a legal compliance obligation whose omission can cost the offering its entire Regulation D exemption.

### **Structuring the Placement Agent Engagement**

Placement agent engagement agreements should clearly define the scope of the agent's authority, the compensation structure, the representations and warranties the agent makes about their conduct and compliance with applicable law, and the indemnification provisions that apply if the agent's conduct creates liability for the issuer. These agreements should be reviewed by securities counsel before they are executed: not because the form is necessarily complex, but because the legal relationship between the issuer and a compensated solicitor in a securities offering has specific implications that standard commercial contract templates are not designed to address.

## **Auditors and Financial Statement Preparation**

Audited financial statements are not technically required by the securities laws for most Regulation D offerings. They are, however, effectively required by institutional investors. Any family office, registered investment adviser platform, or institutional allocator who participates in a fund will expect audited annual financial statements. As the private real estate market matures and investor expectations professionalize, the de facto standard for well-run platforms is extending toward annual audits even for platforms that are not yet raising institutional capital.

For fund structures with investment adviser registration obligations, platforms that have crossed the threshold triggering full SEC registration under the Investment Advisers Act, the SEC's custody rule imposes specific requirements around financial statement preparation and delivery that make annual audits a compliance obligation rather than a best practice.

### **Why Real Estate Fund Audit Experience Matters**

The audit of a real estate fund is not a standard financial statement audit with a few real estate modifications. The accounting treatment of real estate investments, including acquisition cost allocation, capitalization and depreciation of improvements, fair value measurement questions for funds with NAV-based pricing, and revenue recognition across different property types, involves specific technical judgments that require an auditor with extensive real estate fund experience.

A Big Four accounting firm has the relevant expertise. So do several national and regional firms with dedicated real estate fund practices. A general small-business accounting firm that handles some real estate clients does not. The difference is consequential: an auditor who applies incorrect accounting standards to a real estate fund's financial statements produces statements that may be materially inaccurate, that institutional investors' own auditors or compliance teams will identify as non-conforming, and that may need to be restated.

### **Timing: Engage Before Year-End, Not After**

Auditors need to be engaged before the fiscal year they are auditing ends, ideally several months before, so they can understand the transactions that occurred during the year, plan the audit procedures appropriately, and flag any accounting treatment questions that need to be resolved before year-end. Engaging an auditor in March to audit a December year-end on a compressed timeline produces either delayed financial statement delivery or a higher-than-necessary audit fee, or both.

For new funds, the initial engagement should occur before the fund receives its first capital call. The auditor's understanding of the fund's structure, its accounting policies, and its transaction workflow from the beginning of operations produces better work product and more efficient ongoing audits than an auditor who is brought in to audit a year of activity they did not observe in real time.

## **Insurance Advisors**

Insurance is the advisory category most commonly deferred, addressed reactively, and revisited inadequately as platforms grow. It is also the category where a single coverage gap can produce a loss that is both financially catastrophic and operationally disruptive at exactly the moment when the platform is most stressed.

### **Property and Casualty Coverage**

The most basic insurance requirement is at the property level: property and casualty coverage for the physical assets owned by the syndication. Lenders require this coverage as a condition of the loan, and property management companies typically coordinate procurement. The sponsor's role is to understand what is covered, what is excluded, and whether the coverage limits are adequate for the replacement cost of the specific property.

Properties with unusual risk profiles require specific attention: coastal properties with wind and flood exposure, older buildings with environmental or structural risk, and properties in geographic areas with elevated natural disaster exposure. Standard property policies commonly exclude or sublimit coverage for these risks. The gap between the coverage in place and the coverage that would actually make the investment whole in a catastrophic loss is something the sponsor should understand and disclose to investors where it is material.

### **Directors and Officers and Errors and Omissions Coverage**

Directors and Officers liability insurance covers claims made against the managers of the fund or syndication entity by investors: specifically, claims that the sponsor made material misrepresentations in the offering documents, breached fiduciary duties in managing the investment, or failed to disclose material information. These are exactly the claims that arise when a real estate investment underperforms and investors investigate whether the offering was properly conducted.

D&O coverage does not excuse misconduct. It covers defense costs and judgments for claims that arise despite a sponsor's good-faith compliance efforts. For sponsors who have raised capital from multiple investors across multiple offerings, D&O coverage is meaningful risk management. The defense costs of a securities fraud claim, including legal fees, expert witnesses, and document production, can run to hundreds of thousands of dollars before a case is resolved. Coverage that addresses those costs is worth considerably more than its annual premium in the context of a claim.

Errors and Omissions coverage, professional liability insurance for errors in the performance of management services, is the related coverage for sponsors whose platform takes on characteristics of a professional investment management business. As the platform grows and the management function becomes more formalized, the E&O coverage question becomes more relevant.



## Coverage Review as the Platform Grows

Insurance programs that were adequate for a single-asset syndication raising \$3 million may not be adequate for a ten-asset fund managing \$50 million. Coverage limits, policy terms, and the scope of the insured activities should be reviewed periodically, annually and whenever a significant change in platform scale or activity occurs. An insurance advisor who understands real estate fund management, not just property insurance but the full liability profile of an investment management operation, is better positioned to identify gaps than a general commercial insurance broker.

## Building the Advisory Team: Order of Operations

The advisory team for a real estate syndication or fund is not assembled randomly. It is assembled in a specific order that reflects the dependencies among the advisors' decisions. The choices made early in the process constrain or enable the choices available later. Getting the order right produces a coherent, well-integrated offering. Getting it wrong produces advisors working from inconsistent assumptions, documents that do not align, and compliance gaps that surface when they are most expensive to address.

### Advisory Team Engagement Sequence

#### Step 1: Engage Securities Counsel

Before any other decisions are made. The offering structure, exemption selection, investor eligibility framework, and document architecture must be determined first. Every other advisor's work depends on these decisions.

#### Step 2: Engage Tax Counsel (in coordination with Securities Counsel)

Confirm entity structure, distribution mechanics, and tax planning before SPV formation. FIRPTA planning for any foreign investor components.

#### Step 3: Engage Real Estate Counsel

Due diligence phase begins. Review title, leases, survey, and environmental reports. Review loan documents against offering document provisions.

#### Step 4: Engage Fund Administrator

Before first capital call. Capital account methodology confirmed with tax counsel. Distribution calculation model built and tested against operating agreement.

#### Step 5: Conduct Bad Actor Checks (All Covered Persons)

Before offering opens. Securities counsel identifies the full covered person list. Background checks run; representations obtained; results documented.

**Step 6: Engage Auditor**

Before fiscal year-end. Audit firm engaged; accounting policies confirmed.

**Step 7: Evaluate Placement Agent (if needed)**

FINRA registration verified. Bad actor check completed. Engagement agreement reviewed by securities counsel before-execution.

**Step 8: Insurance Review**

Property-level coverage coordinated with lender requirements. D&O coverage evaluated based on investor count and offering size.

The sequence above reflects the dependency structure: securities counsel's decisions shape every subsequent advisor's scope of work. A fund administrator who builds a distribution model before securities counsel has confirmed the waterfall mechanics may build the wrong model. A tax advisor who plans the entity structure before the securities exemption is selected may design an entity that creates complications for the offering. Advisors who are engaged before securities counsel has established the legal framework are advisors working from assumptions that may need to be revised.

**A Note on Advisory Team Coordination**

The advisors listed in this chapter do not work independently. They work in coordination, and the quality of that coordination determines the quality of the offering. Securities counsel and tax counsel need to agree on entity structure before documents are drafted. The fund administrator and tax advisor need to agree on capital account methodology before the first K-1 cycle. Real estate counsel and securities counsel need to reconcile the loan documents against the offering documents before investors subscribe.

Sponsors who engage advisors sequentially, using each one to complete a discrete task before engaging the next, produce offerings in which each advisor's work was technically competent but the pieces do not fit together. The operating agreement describes investor rights that the loan documents do not permit. The distribution model assumes tax characterizations that the CPA calculates differently. The fund administrator's capital account methodology does not match the allocation methodology in the operating agreement.

These coordination failures are common, they are avoidable, and they are best addressed through a securities attorney who is managing the overall process and ensuring that each advisor's work is consistent with the others'. Sponsors who want to discuss how to build and coordinate the advisory team for a specific offering are welcome to reach out at [crowdfundlawyer.com](http://crowdfundlawyer.com).

## Practical Takeaways

- The advisory team is not overhead. It is the infrastructure that makes a compliant, professionally managed investment program possible. The cost of adequate advisors is predictable. The cost of inadequate advisors is not.
- Securities counsel with specific Regulation D real estate experience is non-negotiable. General practice attorneys, however capable in other contexts, typically lack the specific skills required to structure compliant private offerings, draft adequate disclosure documents, and manage the ongoing compliance obligations that attach to a securities offering.
- Tax counsel and the fund administrator must have real estate fund-specific experience. K-1 errors, incorrect capital account methodology, and missed FIRPTA obligations are common consequences of using general-purpose advisors for specialized functions.
- The property management agreement governs an operational relationship that directly affects investor returns. Performance termination rights, expenditure authority thresholds, financial reporting obligations, and assignment provisions are all worth negotiating before the agreement is signed.
- Placement agents must be FINRA-registered. Paying transaction-based compensation to an unregistered person for investor introductions is an illegal broker-dealer arrangement with rescission consequences for investors. Verify registration through BrokerCheck before engaging any capital raising intermediary.
- Auditors should be engaged before fiscal year-end. Real estate fund audit experience is required, not general small-business accounting competence. The cost of an adequate audit is modest relative to the investor relations and compliance value it provides.
- Insurance review, including D&O coverage, should be part of the platform launch checklist and reviewed annually as the platform grows.
- The advisory team should be assembled in the right order: securities counsel first, then tax counsel in coordination, then the other advisors whose work

depends on the legal and tax framework being established. Advisors who work from inconsistent assumptions produce inconsistent documents.

- Advisory team coordination is the sponsor's responsibility. Each advisor performing their function correctly but independently is not the same as a coordinated team producing a coherent offering. Securities counsel should be managing the overall process and ensuring that each advisor's work is consistent with the others'.

## CHAPTER SEVEN

# Entity Structures Used in Real Estate Syndications and Funds

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Ask a real estate attorney what the most consequential decision in a syndication is, and the answer will rarely be the acquisition price, the loan terms, or the distribution waterfall. Those things matter, obviously. But the entity structure sets the rules under which everything else operates. It determines how investors hold their interests, who controls the investment, how liability is allocated, how income and losses flow for tax purposes, and, in a private securities offering, how the governing documents define the rights and obligations of every party for the full life of the investment.

Entity structure is not a formality that gets resolved after the important decisions are made. It is one of the important decisions. The entity type shapes what governing document applies and what default rules govern when the agreement is silent. The jurisdiction of formation determines the depth of the statutory framework and the quality of the case law. The tier structure, how the sponsor's management enterprise, the managing entity, and the investment vehicle are stacked, determines how liability is allocated across the platform and whether deal-specific claims can reach the sponsor's accumulated institutional assets.

Sponsors who approach entity structure as a checkbox, forming an LLC and sorting out the details later, consistently encounter problems that deliberate early structuring would have prevented. The fund formed in the wrong jurisdiction for the institutional investors who later wanted to participate. The operating agreement that did not define the manager's authority precisely enough to govern situations that actually arose. The platform built entirely within a single entity, with no liability wall between the sponsor's management enterprise and the individual deals.

This chapter works through the primary entity structures used in real estate syndications and funds: why the SPV model is the foundational architecture, what the LLC and LP offer and when each is appropriate, the two-tier structure that every serious platform requires, multi-tier fund architecture with property-level SPVs, the GP entity design distinctions between single-asset syndications and funds, REIT structures, institutional

joint ventures, jurisdiction selection, tenant-in-common arrangements, and Delaware Statutory Trusts. Throughout, the chapter identifies what governing documents must address and where template documents most predictably fail.

## Why the Choice of Entity Matters

Four dimensions of entity structure produce the most consequential consequences for sponsors and investors.

**Liability protection.** The entity form determines who bears personal liability for the entity's obligations. One of the primary purposes of using a legal entity is to limit the personal liability of those who organize and operate it. But the extent and reliability of that protection varies across entity types, across jurisdictions, and depending on how the entity is actually operated. Selecting the wrong entity, or operating the right entity incorrectly, can expose principals to personal liability they believed the structure protected them from.

**Tax treatment.** Different entity forms carry different default tax classifications. Pass-through taxation, in which the entity's income and losses are allocated to investors and taxed at the investor level, is almost universally preferred in real estate syndications because it preserves the tax benefits of real estate ownership: depreciation deductions, cost segregation, interest deductions. Getting the tax classification right at formation is important; restructuring it after investors have committed is expensive.

**Governance and documentation.** The entity's governing document is the contract that defines the sponsor-investor relationship for the life of the investment. The entity type shapes what that document can and cannot do, what default rules apply when the agreement is silent, and what state law governs in a dispute. In a private real estate offering where the hold period spans years and market conditions change, the governing document is tested in ways that are difficult to anticipate at formation, which is why drafting it with precision matters more than any other single legal task.

**Investor expectations.** Different investor categories have structural preferences. Institutional investors and family offices generally expect the Delaware LLC or LP framework. ERISA plan investors have their own regulatory requirements that affect entity structure. Retail investors have fewer structural preferences but deserve the protections that a properly structured, well-documented entity provides. Selecting an

entity structure without considering the investor base can create friction with the investors the offering is designed to attract.

## **The SPV Structure: Why the Investment Entity Cannot Hold Real Estate Directly**

Every professionally structured real estate syndication places a special purpose vehicle, typically a Delaware limited liability company, between the investor and the real estate asset. This architecture is not convention. It is a structural necessity that arises from the fundamental characteristics of how real property ownership works under U.S. law.

Real property in the United States is transferred through deeds recorded in county-level recording systems. Title insurance companies insure against title defects by examining those records. Mortgage lenders underwrite loans secured by liens recorded against the specific property. Local governments assess property taxes against identified legal owners. For every one of these systems, the counterparty is the legal owner of record, the entity whose name appears on the recorded deed.

In a real estate syndication, investors do not hold real property. They hold fractional ownership interests, membership interests in an LLC or limited partnership units, in the entity that holds the property. That membership interest is a personal property right, a contractual claim defined by the operating agreement, not a real property interest. Personal property rights transfer by contract, not by deed. They are not subject to recording requirements. They can be freely structured by the parties through the governing documents.

### **The Core Architecture: Who Owns What**

The SPV (LLC or LP) owns the real property.

Title is in the SPV's name. The SPV is the borrower under the mortgage. The SPV pays the property taxes and signs the leases.

Investors own membership interests (or limited partnership units) in the SPV.

Their economic rights, distributions, a share of appreciation, are defined by the operating agreement. Their interests are personal property, not real property.

The Manager/GP controls the SPV through the governing documents.

The manager executes the business plan, manages the lender relationship, controls distributions, and directs the disposition process.

This two-track architecture allows the entity to interact with the real property recording system while investor interests are governed by contract. A transfer of an investor's membership interest does not change who holds title to the property. The SPV always holds title. Only the SPV's membership composition changes.

### **What Investors Actually Own, and What They Do Not**

This distinction generates confusion with some regularity, particularly among investors who are new to the private real estate market and assume that participating in a syndication gives them some form of direct real property ownership.

A membership interest in the SPV is a contractual right: a right to receive distributions according to the waterfall defined in the operating agreement, to have certain governance rights as specified in the operating agreement, and to receive a share of the proceeds when the investment exits. The value of that contractual right depends on the performance of the real estate asset. But the investor does not own the real estate. The investor owns a membership interest in the LLC that owns the real estate.

What the investor does not have: ownership of the real property, a right to possess or occupy the property, a lien against the property, an interest that needs to be recorded in the county deed records, or any right that exists independently of the operating agreement. In a distressed scenario, whether lender foreclosure, casualty loss, or major litigation, the investor's position is determined by what the operating agreement says their membership interest entitles them to, not by any direct real property rights.

The PPM and subscription agreement should make this distinction explicit. Investors who are given the wrong impression, who believe they hold a real property interest rather than a contractual claim against an LLC, may have different and incorrect expectations about their rights in a stressed scenario. Those expectations, if uncorrected, become the basis for claims at the worst possible moment.

### **What the Membership Interest Actually Represents Must Be Disclosed**

The PPM must affirmatively explain what membership interests represent and, equally importantly, what they do not represent. A member who believes they hold a direct real property interest rather than a contractual claim against an LLC may have incorrect expectations about their rights in foreclosure, casualty, dissolution, or litigation. Those expectations, if wrong, become the basis for investor claims.



Clear disclosure at the offering stage is the most effective defense against investor misunderstanding downstream. The language in the PPM should be specific: investors hold membership interests in an entity that holds real property; they do not hold real property interests and their rights are defined entirely by the operating agreement.

## Limited Liability Companies

The limited liability company is the dominant entity form in private real estate syndication. Its combination of liability protection, tax flexibility, and governance adaptability makes it the right choice for most single-asset syndications and many fund structures. Understanding the LLC at the level of specificity that the syndication context requires, not as a generic business entity but as the instrument through which investor relationships are governed for years, is fundamental to building a properly structured offering.

### Manager-Managed vs. Member-Managed: Why the Choice Is Not Optional

Every LLC operating agreement makes a foundational governance choice: is the LLC managed by a designated manager, or is it managed collectively by its members? In a real estate syndication with passive investors, the answer is always manager-managed, and for reasons that run directly through the legal framework of the offering.

In a manager-managed LLC, a designated manager has exclusive authority to make operational and strategic decisions. Members participate in the economic returns but have no day-to-day management authority. The manager's authority is defined and limited by the operating agreement, which specifies what the manager can do unilaterally and what requires member consent.

In a member-managed LLC, the default structure under most state statutes if the operating agreement does not specify otherwise, all members participate in management. This default must be overridden in the operating agreement for every real estate syndication. The failure to do so is not a minor omission.

The manager-managed structure is essential for two reasons that operate in parallel. First, the securities law framework: passive investor protection under the Howey test

depends on investors genuinely being passive. A member-managed LLC in which every investor participates in management raises the question of whether the efforts-of-others element is satisfied. Courts have generally held that nominal management rights in a member-managed LLC do not satisfy active participation, but the analysis creates uncertainty that a manager-managed structure eliminates. Second, the tax treatment: investors in a manager-managed LLC are generally treated as passive participants for purposes of the passive activity rules, allowing them to use real estate-generated losses against other passive income. Investors in a member-managed LLC may be characterized as active, limiting their ability to use those losses.

### **Member-Managed LLCs Are the Wrong Default for Real Estate Syndications**

Most state LLC statutes default to member-managed governance if the operating agreement does not specify otherwise. In a real estate syndication, an LLC that inadvertently defaults to member-managed status has both a securities law problem and a tax problem.

The securities law problem: investors who participate in management are active, not passive, which complicates the Howey analysis and could affect the exemption compliance framework.

The tax problem: active investor status limits the investor's ability to use the real estate losses that are one of the primary tax benefits of the investment structure.

Every real estate LLC operating agreement must expressly designate manager-managed governance. This is not a drafting technicality. It is a foundational choice with direct legal and tax consequences.

### **What the Operating Agreement Must Address With Precision**

The operating agreement of a manager-managed LLC governing a real estate syndication must address the following provisions with specificity that generic templates consistently fail to provide:

- **Manager authority:** a precise list of what the manager can do unilaterally and what requires investor consent. The line between these categories is one of the most consequential drafting decisions in the document. Routine management should be unilateral; major decisions, sale of the property, major refinancing above specified thresholds, material changes to the business plan, related-party transactions, should require a defined investor approval threshold.

- **Distribution mechanics:** the complete waterfall, defined with enough precision that distributions can be calculated unambiguously in every scenario the investment might encounter, standard exit, below-projection exit, partial disposition, refinancing, and capital event during the hold period.
- **Capital account methodology:** how each investor's capital account is established and maintained, how income and loss allocations adjust it, and how pro-rata calculations are performed for distribution purposes.
- **Transfer restrictions:** the conditions under which a member may transfer their interest, what approvals are required, whether the LLC or other members hold a right of first refusal, and what happens when a member dies, becomes incapacitated, or faces a proceeding that could affect their ownership.
- **Manager removal:** the conditions under which investors may remove the manager, the vote threshold required, and the transition process to successor management including what happens to the removed manager's promoted interest in the existing portfolio.
- **Dissolution mechanics:** how the investment is wound down at exit, in what order remaining assets and proceeds are distributed, what filings and tax obligations accompany dissolution.

### **Template Operating Agreements Are Not Adequate for Real Estate Syndications**

Standard LLC operating agreement templates, whether from online document services, adapted from prior deals, or prepared by attorneys without specific real estate syndication experience, routinely fail to address the provisions that matter most in a real estate securities offering.

The distribution waterfall, the manager authority framework, and the transfer restriction provisions are the three areas where generic templates most commonly produce ambiguous or inadequate language. Ambiguity in any of these provisions is not a drafting inconvenience. It is a future dispute.

The operating agreement should be drafted specifically for the deal and investor base, by counsel with real estate syndication experience, and finalized before any investor is asked to commit capital.

## **Series LLCs: Genuine Capability, Real Limitations**

Approximately 24 states, most prominently Delaware, Texas, Illinois, Nevada, and Tennessee, permit the formation of a Series LLC: a single LLC that can contain multiple internal series, each with its own assets, liabilities, members, and management. Florida

enacted protected series legislation in June 2025 that takes effect July 1, 2026. The theoretical appeal for a real estate sponsor is meaningful: one master entity with multiple internal compartments, each isolated from the others, each capable of raising its own capital from its own investors, under the same umbrella.

The liability shield is the core promise. Under Delaware's statute, if a series separately accounts for its assets, the LLC agreement establishes the structure, and the certificate of formation contains the required notice, the debts and liabilities of a particular series are enforceable against the assets of that series only and not against the assets of any other series or the master LLC generally. That shield is conditional on operational discipline: separate accounting, separate bank accounts, and records that clearly identify which assets belong to which series. A sponsor who creates a Series LLC and runs the accounting through one combined ledger has not achieved the liability separation the statute describes.

Each series can conduct its own independent securities offering under Regulation D, with its own investors, its own Form D filing within 15 calendar days of first sale, and its own state blue sky compliance calendar. That capital-raising capability at the series level is the feature that makes the structure genuinely compelling for deal-by-deal sponsors who want investor-level separation without fund-level pooling.

The practical limitations are real and vary by platform. Cross-border recognition is not uniform: California, New York, and several other major real estate markets do not have domestic Series LLC legislation, and courts in those states may not honor the liability walls that Delaware's statute created. Institutional construction lenders and CMBS originators have historically been reluctant to lend directly to a series rather than to a conventional single-purpose entity. Title insurers may require additional endorsements or special underwriting for series interests. For tax purposes, IRS guidance under proposed regulations (issued in 2010, not yet finalized) treats each series as a separate entity with its own EIN and its own filing obligations, producing a compliance burden substantially equivalent to maintaining separate LLCs.

For high-volume sponsors operating primarily within a single Series LLC-friendly state, with relationship-oriented financing sources and sophisticated investors familiar with the structure, the Series LLC can be a well-designed platform vehicle. For most sponsors whose portfolios span multiple states, rely on institutional debt markets, or involve title-sensitive transactions, the administrative complexity and legal uncertainty of the Series

LLC outweigh its formation-cost advantages. Separate standalone LLCs for each deal, properly maintained, are simpler and more legally predictable.

### **Delaware LLC vs. State of Operations**

Delaware's LLC Act is the most developed and investor-tested LLC statute in the country. Its flexibility in structuring operating agreements, defining the manager's authority, the distribution waterfall, investor consent rights, transfer restrictions, and governance mechanisms, is unmatched. Delaware courts, particularly the Court of Chancery, have produced an extensive body of case law interpreting LLC agreements and manager authority in ways that provide predictability for sophisticated parties structuring complex transactions.

Delaware LLCs are also universally familiar to institutional investors, lenders, title companies, and counterparties across the country. A Delaware LLC holds property, arranges financing, and interacts with county recording systems in any state without jurisdictional friction. The lender making a mortgage loan on a Texas property to a Delaware LLC is a routine transaction. The same lender encountering an unfamiliar state's LLC statute may require additional diligence.

For smaller syndications with primarily individual high-net-worth investors, forming in the state where the sponsor is located or where the property sits is often a practical and cost-effective choice. For any platform with institutional capital in its near-term future, Delaware formation is almost always correct. Restructuring a Texas LLC to a Delaware LLC after the fact is procedurally awkward. Starting in Delaware and registering as a foreign entity in the operating state is the cleaner path.

## **Limited Partnerships**

The limited partnership has a longer history in real estate investment than the LLC. The LP structure predates the LLC by decades, and the private equity and institutional real estate industries standardized around it before LLC statutes had developed sufficiently to serve as alternatives. Understanding when LPs are appropriate and how their specific characteristics affect the legal framework of the investment is essential context for any sponsor building toward institutional scale.

### **The General Partner / Limited Partner Structure**

A limited partnership has two classes of partners with fundamentally different legal status. The general partner manages the partnership and bears unlimited personal liability for its obligations. Limited partners contribute capital and receive economic rights, but their liability is generally limited to their capital contribution. They do not bear personal liability for partnership obligations beyond what they have committed.

The general partner's unlimited liability creates an immediate structural problem: a natural person or conventional company serving as general partner is personally exposed to every claim against the partnership. The standard solution, used almost universally in institutional real estate funds, is to form a separate LLC to serve as the general partner. The sponsor controls the GP LLC, and the LLC's own liability protection insulates the sponsor's principals from the GP's unlimited liability exposure. The structure adds one entity but resolves the liability problem cleanly and is well understood by institutional investors.

### When LPs Are Preferred Over LLCs

For most single-asset syndications aimed primarily at individual high-net-worth investors, the LLC is the simpler and more commonly used structure. The LP comes into its own in specific contexts where its structural characteristics align with the investor base or the regulatory framework.

Institutional investors often have a preference for the LP structure, partly because their own legal and compliance teams are highly familiar with the limited partnership agreement framework and partly because the Delaware LP Act provides a governance structure that institutional investors' counsel has spent decades analyzing and negotiating. When a sponsor is raising capital from family offices, registered investment advisers who pool their clients' capital, or any form of institutional investor, the LP is frequently the structure those investors expect.

ERISA plan investors, including pension funds, profit-sharing plans, and certain other employee benefit plans, have specific structuring requirements arising from the plan asset rules under ERISA. The limited partnership framework, with its established body of ERISA guidance, is generally more navigable for those investors than the LLC equivalent.

Some state tax regimes treat LPs more favorably than LLCs. Texas imposes a franchise tax on LLCs but not on limited partnerships, which has historically made the LP

structure tax-advantaged for Texas-based platforms with significant volume. The specific tax analysis depends on the jurisdiction and should be verified with tax counsel.

### **Delaware LP: Governance and Flexibility**

The Delaware LP Act, like the Delaware LLC Act, is among the most flexible and best-developed in the country. The Act grants broad authority to the limited partnership agreement to modify default rules, including fiduciary duty obligations, subject to certain baseline protections for limited partners. Delaware courts have produced substantial case law interpreting LP agreement provisions.

One provision of Delaware LP law that deserves specific attention in the fund context is the ability to modify or eliminate default fiduciary duties by agreement. The Delaware LP Act permits limited partnership agreements to restrict or eliminate the general partner's duties of care and loyalty, subject to a baseline standard of good faith and fair dealing. Many institutional fund LPAs include such modifications, particularly with respect to the duty of loyalty in the context of the general partner's other business activities and competing investment opportunities. Investors reviewing fund documents need to understand how these modifications work and what protections remain in place after default duties are contractually reduced. Their counsel should address this in the due diligence process.

## **The Two-Tier Structure**

The two-tier structure is the most important structural concept in this chapter. It is also the concept most frequently absent, or inadequately implemented, in early-stage real estate syndication platforms.

### **The Operating Entity and the Manager/GP Entity: Why Both Are Required**

In a properly structured real estate syndication or fund, there are two distinct entities serving two distinct functions. The first is the operating entity: the LLC or LP that holds the property, is the borrower under the mortgage, and is the issuer of the securities offered to investors. The second is the management entity: a separate LLC or corporation controlled entirely by the sponsor, which serves as the managing member of the operating entity or as the general partner of the LP.

The operating entity is deal-specific. It is formed for a particular transaction, holds the investment through its lifecycle, and is dissolved at exit. Every deal has its own operating entity.

The management entity is the sponsor's platform. It is the ongoing business: the entity with the track record, the team, the relationships, and the brand. It is not dissolved when any individual deal exits. It exists independently of any specific investment and, if built properly, has genuine enterprise value that outlasts any individual deal. The management entity employs all staff, holds all intellectual property and licenses, enters all major vendor and service contracts, and owns or controls the GP entity that signs the offering documents.

### Protecting the Sponsor's Asset Management Enterprise

The two-tier structure solves a specific liability problem that single-entity structures create. In a single-entity structure where the sponsor is both the managing member of the operating entity and the seat of the management business, a claim against the operating entity can potentially reach the sponsor's management assets. A tenant injury lawsuit, an investor dispute over the management of a specific deal, a lender enforcement action: any of these can, in a poorly structured single-entity arrangement, create exposure that reaches the sponsor's other activities.

The two-tier structure places a legal wall between the deal and the platform. The operating entity carries the deal-specific liability. The management entity carries the platform: the team, the relationships, the compensation structure, the promoted interests from multiple deals. A successful claim against the operating entity in a well-maintained two-tier structure does not automatically reach the management entity's assets.

This protection is not absolute. Courts can pierce the veil between entities when they are operated as alter egos, when assets are treated interchangeably, when corporate formalities are ignored, or when the management entity funds operating entity losses without documentation. The protection works only if the separation is genuine and consistently maintained: separate bank accounts, separate books and records, documented intercompany arrangements, and clear delineation of which entity is performing which function.



### **The Two-Tier Structure in Practice**

#### **Tier 1: Management Entity (the sponsor's platform)**

- Controlled by the sponsor's principals.
- Serves as the managing member of each operating entity.
- Earns management fees and promoted interest from the portfolio.
- Persists across deals; not dissolved at any individual exit.
- The sponsor's long-term institutional asset.

#### **Tier 2: Operating Entity (deal-specific)**

- Formed specifically for the transaction.
- Holds title to the property; is the borrower under the mortgage.
- Issues membership interests (or LP units) to investors.
- Governed by the operating agreement negotiated for the specific deal.
- Dissolved at exit.

The legal wall between these two entities protects the sponsor's accumulated platform assets from deal-specific claims. It works only if the separation is genuine, documented, and consistently maintained.

### **The Management Entity Must Be Formed Before the First Deal Closes**

The most common structural error in emerging real estate syndication platforms is the absence of a management entity. The sponsor forms a single LLC for the deal, makes themselves the managing member, raises capital from investors, and operates without ever establishing the platform entity that should be the lasting home of the business.

This structure-exposes the sponsor's entire business to deal-specific claims. It also complicates every subsequent development: bringing in a co-sponsor, granting equity to a key hire, raising a fund, or attracting institutional capital are all materially more complex without a properly structured management entity.

The management entity should be formed before the first deal closes, with governance provisions that anticipate the platform's growth. If that step has not been taken, the conversation with securities counsel should happen soon.

## **Multi-Tier Fund Structures**

As real estate investment platforms grow from single-asset syndications to funds, the entity architecture becomes more sophisticated. Multi-tier structures manage that

complexity, isolate liability across different assets, and accommodate the operational requirements of a multi-investment program.

### **The Three-Tier Stack: Sponsor, Manager, and SPV**

The standard architecture for a properly structured real estate syndication involves three tiers, each serving a distinct purpose.

At the top sits the sponsor entity: the company that represents the sponsor's brand, employs the investment team, manages multiple deals across the platform, and earns the promoted interest from successful investments. The sponsor entity is typically an LLC owned by the individual principals. It exists independently of any specific deal.

At the middle sits the manager entity: the LLC or limited partnership that serves as the managing member of the investment vehicle for a specific deal or fund. The manager entity controls the operating entity, executes the operating agreement on behalf of the sponsor, and is the contractual party in the investment's governance documents. The manager entity is typically owned by the sponsor entity.

At the bottom sits the operating entity or SPV: the investment LLC that holds the real estate asset, issues membership interests to investors, raises the equity capital, and distributes returns. The SPV is the issuer in the securities offering.

#### **Standard Three-Tier Stack**

##### **Tier 1: Sponsor Entity**

The sponsor's operating company. Owns the manager entity. Earns the promote from successful deals. Disclosed to investors as an affiliate of the manager.

##### **Tier 2: Manager Entity**

The managing member of the SPV. Controls the SPV's operations and executes the business plan. Receives management fees directly. Disclosed fully in the PPM.

##### **Tier 3: SPV / Operating Entity**

The investment vehicle. Holds title to the property (or interests in a subsidiary property-owning LLC). Issues membership interests to investors. Governed by the operating agreement. The issuer of the securities offering.

Investors purchase membership interests in the SPV. They are governed by the SPV's operating agreement. They receive economic returns through the distribution waterfall. They have no direct role in property management.

### **The Fund Entity as the Investor-Facing Vehicle**

In a fund structure, the fund entity is what investors invest in. It is typically an LP (with the management entity or a GP LLC as general partner) or a manager-managed LLC. Investors contribute capital to the fund entity, hold their interests in the fund entity, and receive distributions from the fund entity. The fund entity does not own properties directly. It owns interests in the property-owning SPVs.

This separation is fundamental. It isolates asset-level liabilities within the respective SPV rather than at the fund level. It allows individual assets to be structured, financed, and ultimately sold without disrupting the fund structure. And it accommodates the lender-imposed requirement, standard in commercial real estate financing, that the borrowing entity be a single-purpose entity that owns only the specific property being financed.

### Special Purpose Vehicles at the Asset Level

Every asset owned by a real estate fund is typically held in its own SPV: a single-purpose LLC or LP formed specifically to hold that asset and nothing else. The SPV holds the deed, signs the mortgage, signs the leases, and is the party to all property-level contracts. The fund entity holds membership interests in the SPVs, not real property directly.

Single-purpose lender requirements are the primary driver of the SPV architecture. Commercial lenders want a clean borrower entity, one without other assets, other liabilities, or other business activities that would complicate a foreclosure or loan workout. Lenders frequently require bankruptcy-remote provisions in the SPV's organizational documents: representations and covenants that make it more difficult to put the SPV into bankruptcy without lender consent.

From the fund's perspective, the SPV structure achieves asset isolation: a problem at one asset, including a major liability claim, a catastrophic loss, or a lender enforcement action, is contained within that asset's SPV and does not directly contaminate the fund entity's interests in other SPVs. This isolation is one of the most important risk management features of the fund architecture.

#### Multi-Tier Fund Structure

##### Tier 1: Sponsor Entity

The sponsor's operating company; employs the team; earns the promote.

**Tier 2: Fund GP / Fund Manager LLC**

General partner or managing member of the fund entity. Controlled by the sponsor entity.

**Tier 3: Fund Entity (LP or LLC)**

The investor-facing vehicle. Holds committed capital. Calls capital for investments. Owns membership interests in the asset-level SPVs.

**Tier 4: Asset-Level SPVs (one per property)**

Each SPV holds a single real estate asset. Borrower under the property mortgage. Liability isolated at the asset level.

Investors commit to the Fund Entity. The Fund Entity owns the SPVs. Each SPV holds one property. The Fund GP controls the Fund Entity, which controls the SPVs.

## **The Syndication GP Entity vs. the Fund GP Entity: A Critical Distinction**

A GP entity designed for a single-asset syndication and one designed for a discretionary fund are not the same thing with different labels. They are built for fundamentally different jobs, and using a syndication-era GP entity for a fund, without redesigning the authority it holds, the governance mechanics it requires, or the disclosure framework it operates under, creates a structural mismatch between what investors are relying on and what the legal structure is actually built to do.

A single-asset GP is built around one investment thesis: it acquires one asset, executes one business plan, manages one set of lender relationships, and distributes proceeds from one exit. Its authority should be as narrow as the investment. The operating agreement or LP agreement for a syndication GP can be drafted tightly around those specific circumstances because the scope of what the GP is authorized to do corresponds directly to what investors underwrote when they committed capital.

A fund GP must have authority sized to a discretionary mandate. It must be able to make investment decisions across a portfolio, source and underwrite opportunities, call capital on the fund's schedule, handle multiple closings with new investors admitted over time, manage co-investments, allocate opportunities across vehicles, and govern a portfolio of assets with overlapping hold periods. That broader discretion creates broader responsibility. The fund GP's governing documents need conflict-management provisions that are substantive rather than nominal, investment allocation policies, LPAC authority provisions, and disclosure precision that reflect the scope of what investors are trusting the sponsor to do with their capital over an extended investment period.

Sponsors transitioning from syndications to funds should treat the GP entity redesign as a structural requirement, not an administrative upgrade. The entity that served as the GP for three successful single-asset deals does not become a fund GP by adding a new name and raising more capital. It becomes a fund GP when its authority, governance framework, and disclosure architecture are redesigned to match the actual demands of running a discretionary investment vehicle.

## The Operating Agreement and the Entity Stack

The governing documents at every tier of the entity stack must be designed as a coordinated system. The fund LPA defines investor rights, manager authority, the waterfall mechanics, and governance at the fund level. The SPV operating agreement defines the same matters at the asset level. The intercompany arrangements between the fund entity and the SPVs, including how capital flows down, how distributions flow up, and how the fund entity exercises its management authority over the SPVs, must be addressed in the documents and administered consistently.

The fund LPA's waterfall mechanics and the SPV operating agreement's waterfall mechanics must be internally consistent. If the fund LPA defines how sale proceeds are distributed to investors but the SPV operating agreement describes a different distribution priority, the documents are in conflict and the conflict will matter when a distribution is actually made. Securities counsel drafting the fund documents must ensure vertical consistency across the entity stack: not just that each document works in isolation, but that all of them work together as a system.

### **The Entity Stack Shapes Every Legal Document in the Offering**

The operating agreement, the PPM, the subscription agreement, and every intercompany arrangement reflect the entity structure. If the entity stack is designed correctly, with clear authority definitions at each tier, appropriate separation between the sponsor entity, manager entity, and SPV, and deliberate placement of liability isolation at the right level, the documentation flows logically from the structure.

If the entity stack is designed incorrectly, or not deliberately designed at all, the documents will be inconsistent, the authority definitions will be ambiguous, and the legal uncertainty will manifest when something goes wrong.

Entity structure decisions made before the first document is drafted set the ceiling for everything that follows.

## Master Fund / Feeder Fund Structures

Master-feeder structures are used in more complex fund platforms to accommodate different investor types with materially different tax profiles who need to access the same investment strategy through different legal vehicles. The master fund is the primary investment vehicle that deploys capital and owns the underlying assets. Feeder funds are separate entities designed for specific investor profiles that invest into the master fund.

A domestic feeder fund accepts U.S. taxable investors. An offshore feeder fund, typically organized in the Cayman Islands or British Virgin Islands, accommodates tax-exempt U.S. investors such as pension funds and endowments, and non-U.S. investors, both of whom have reasons to prefer an entity that does not pass through U.S. taxable income directly.

Master-feeder structures are relevant for fund sponsors accessing institutional capital from multiple investor categories with materially different tax profiles. For most emerging sponsors raising primarily from U.S. taxable individual investors, the complexity of a master-feeder structure is not warranted. Understanding what the structure is matters because institutional investors may ask whether the fund can accommodate their specific tax needs, and the answer may determine whether they can participate.

## Lender Consent and the Transfer Restriction Framework

Most commercial real estate acquisitions involve mortgage financing, and the loan documents for that financing routinely include provisions restricting the transfer of membership interests in the borrowing entity without lender consent. These provisions, sometimes called due-on-transfer clauses or membership interest transfer restrictions, exist to protect the lender's underwriting, which was based on the creditworthiness and competence of the borrowing entity's specific ownership.

The transfer restriction framework in the operating agreement must be designed in coordination with the loan documents' transfer restriction provisions. An operating agreement that describes investor transfer rights that the loan documents do not permit creates a documentation inconsistency that can trigger a loan default when an investor attempts to exercise the right the operating agreement appeared to grant.

The right approach is to review the loan documents specifically for their transfer restriction and change-of-control provisions before the operating agreement is finalized, and to ensure that the operating agreement's permitted transfer provisions are consistent with what the lender has agreed to allow. This review must be part of the offering structuring process, not discovered by a transferring investor after the offering has closed and capital has been deployed.

Lenders in commercial real estate have varying levels of receptiveness to investor transfers. Agency lenders through Fannie Mae and Freddie Mac have standard provisions governing membership interest transfers. Balance sheet lenders have more flexibility to negotiate. CMBS lenders, whose loans are securitized and cannot be easily renegotiated, may have the most restrictive transfer provisions. The financing discussion, specifically the negotiation of any consent to membership interest transfers, should involve both real estate counsel and securities counsel working together, not sequentially.

#### **Lender Consent Must Be Resolved Before the Offering Launches**

An offering that describes investor transfer rights that the loan documents prohibit has made a promise it cannot keep. Worse, membership interest transfers that execute without the required lender consent may constitute a loan default, creating a crisis for the entire investment that extends far beyond a securities compliance issue.

The lender consent analysis must be part of the financing negotiation, not an afterthought. Securities counsel and real estate counsel must coordinate on this issue. If lender consent cannot be obtained on acceptable terms, the operating agreement's transfer restriction provisions must reflect the actual constraints, with full disclosure to investors of the limits on transfer.

## **REIT Structures and When They Make Sense**

Real Estate Investment Trusts were created by Congress in 1960 to give individual investors access to large-scale, professionally managed real estate investments with the tax efficiency of pass-through treatment. A REIT that continuously qualifies under the relevant provisions of the Internal Revenue Code is allowed to deduct dividends paid to shareholders, effectively eliminating entity-level tax on distributed income.

Understanding both what REITs offer and when they are appropriate requires working through the specific qualification requirements.

## The REIT Qualification Requirements

To qualify as a REIT and maintain that qualification on an ongoing basis, an entity must continuously satisfy requirements across four categories:

- **Income tests:** At least 75% of gross income must come from qualifying real estate sources, including rents from real property, mortgage interest, and gains on real estate sales, and at least 95% of gross income must come from qualifying sources plus dividends and interest.
- **Asset tests:** At least 75% of total assets must consist of qualifying real estate assets, and specific concentration limits apply to holdings of securities in individual issuers.
- **Distribution requirement:** The REIT must distribute at least 90% of its taxable income to shareholders annually. This distribution requirement is the source of the REIT's pass-through tax treatment.
- **Organizational requirements:** The REIT must have at least 100 shareholders and no more than 50% of its shares may be held by five or fewer individuals, the five-or-fewer rule, or 5/50 rule. The entity must be organized as a domestic corporation, trust, or association taxable as a corporation.

The 5/50 rule creates a structural challenge for most private real estate syndications. If five or fewer investors hold more than half of the outstanding interests, REIT qualification fails, not just prospectively but potentially retroactively for the full year in which the violation occurred. Building and maintaining a shareholder base sufficiently dispersed to satisfy the 5/50 rule requires either a large investor base or specific structural provisions limiting concentration, both of which add complexity.

## Non-Traded REITs and Private REITs

Non-traded REITs are registered with the SEC but their shares do not trade on a national securities exchange. They raise capital from retail and accredited investors through broker-dealer networks and registered investment adviser platforms. The non-traded REIT structure has become more accessible for emerging managers through third-party fund administration and distribution platforms, but it requires substantial ongoing compliance infrastructure: satisfaction of REIT qualification requirements, SEC



registration of the offering and ongoing reporting obligations, and the governance expectations that institutional-grade investors bring.

Private REITs, those that qualify for the REIT election but do not register with the SEC, are used in specific institutional contexts where the REIT tax treatment provides particular value. Operating Partnership structures, in which the REIT holds interests in a limited partnership that actually owns the real estate, are used to accommodate tax-deferred contribution of properties in exchange for OP units. These structures require specialized and coordinated tax and securities counsel.

### **The Investment Company Act Issue**

Any real estate vehicle with a large investor base must be analyzed for potential investment company registration requirements under the Investment Company Act of 1940. An entity that is primarily engaged in investing in securities, which can include LLC membership interests in property-owning subsidiaries under some analyses, may be required to register as an investment company unless it qualifies for an exemption.

The most commonly used exemptions for private real estate funds are Section 3(c)(1), allowing no more than 100 beneficial owners, and Section 3(c)(7), requiring all investors to be qualified purchasers. As a fund's investor base grows, which happens faster than sponsors sometimes anticipate, particularly in platforms that use lower minimum investments, the Investment Company Act exposure requires analysis and monitoring. The 3(c)(1) investor count includes all beneficial owners, not just direct subscribers, and counts across the entire enterprise rather than individual fund vehicles.

REIT qualification, if properly maintained, provides an alternative path around Investment Company Act concerns. But REIT qualification imposes all of the requirements described above. The choice between REIT and non-REIT structure for a broadly subscribed offering requires coordinated analysis by tax counsel and securities counsel before the first investor subscribes. For most sponsors exploring fund formation for the first time, REIT structures add substantial ongoing compliance obligations without proportionate benefit.

## **Joint Ventures: When a Syndication Meets an Institutional Co-Investor**

In the context of real estate syndications and funds, a joint venture has a specific meaning: a deal structure in which the sponsor brings in a single institutional equity partner, rather than a pool of individual investors, who contributes a significant portion of the equity in exchange for a negotiated set of economic rights and governance protections. This arrangement is common in the institutional real estate market and represents a materially different legal and commercial dynamic than a retail syndication.

### **GP/LP Joint Ventures with Institutional Equity**

The most common joint venture structure in the institutional real estate market is the GP/LP joint venture, in which the sponsor serves as the general partner or managing member contributing operational expertise, and the institutional investor serves as the limited partner or non-managing member contributing most of the equity. The institutional investor typically contributes 80 to 95 percent of the equity; the sponsor contributes 5 to 20 percent.

The institutional investor in this structure is not passive in the way that individual syndication investors are passive. They have negotiated governance rights: approval rights over major decisions, budget approval rights, the right to replace the GP or manager for cause or with sufficient vote without cause, and often co-investment rights for future deals. The governing document in a joint venture with an institutional partner is a negotiated agreement, not a sponsor-favorable form. The sponsor's counsel and the institutional investor's counsel will negotiate the document, and the resulting instrument will reflect the balance of commercial leverage in the specific transaction.

Institutional investors bring documentation expectations that match their own fiduciary obligations: audited financial statements, formal quarterly reporting in formats their portfolio management teams use, specified insurance coverage requirements, representations and warranties about the sponsor's organization and legal proceedings, and key person provisions specifying what happens if the lead sponsor departs. These are standard requirements, not unreasonable demands, and sponsors who are not prepared to satisfy them will find institutional joint venture capital unavailable to them.

### **How Joint Venture Structures Differ from Traditional Syndications**

Several structural features distinguish an institutional joint venture from a retail syndication.

**The economic terms are negotiated.** A retail syndication uses a fairly standard waterfall with limited variation. An institutional joint venture LPA is negotiated: the preferred return rate, the hurdle structure, the carried interest percentage, the catch-up mechanics, the clawback provisions, the fee offset structure, and the formation fee arrangement are all potential negotiating points. A sponsor who enters these negotiations without experienced counsel who has worked on both sides of these documents is at a real disadvantage.

**The governance balance shifts.** In a retail syndication, the sponsor has broad management authority. In an institutional joint venture, the institutional investor frequently has approval rights over individual acquisition decisions, capital expenditure budgets, financing arrangements, and disposition timing. The sponsor's operational authority is narrower, the governance documentation is more detailed, and the consequences of acting outside that authority are more significant.

**The relationship is direct and active.** There is one investor, or a small group, with dedicated professional staff who monitor the investment, review the reporting, and communicate concerns directly. The investor relations management required is more intensive than with a retail investor pool, and the institutional investor's sophistication means that errors in reporting, governance, or documentation are identified and raised quickly.

For sponsors building toward institutional capital, the first institutional joint venture is often a turning point: not only because of the specific deal's economics, but because of what the relationship requires in terms of operational discipline, documentation quality, and governance process. The institutional partner's requirements tend to make the sponsor significantly better at everything they do across their entire platform.

## Jurisdiction Selection: Delaware, Texas, Nevada, and Others

The question of where to form the entity, which state's law will govern the entity's internal affairs, deserves deliberate analysis rather than default to whatever is cheapest or most familiar.

| Jurisdiction | Primary Advantages                           | Key Considerations                                | Best Suited For                                                    |
|--------------|----------------------------------------------|---------------------------------------------------|--------------------------------------------------------------------|
| Delaware     | Most developed LLC and LP case law; Court of | Registered agent required; franchise tax on LLCs; | Any offering where institutional capital is a near-term objective; |

|                            |                                                                                                                                                                     |                                                                                                                                                         |                                                                                                                                        |
|----------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------|
|                            | Chancery specialization; broadest institutional investor and lender familiarity; most flexible LLC and LP statutes; Delaware Business Court for non-LLC matters.    | foreign qualification required in operating state.                                                                                                      | fund formations; complex operating agreements; any transaction where sophisticated counterparties will review the governing documents. |
| <b>Texas</b>               | Strong LLC and LP statutes; no state income tax; Series LLC available; no franchise tax on LPs; Texas Business Court now operational for complex business disputes. | Less developed case law than Delaware; some institutional investors and their counsel prefer Delaware for fund vehicles.                                | Texas-based sponsors with primarily Texas-located properties and individual HNW investor bases; LP structures for tax efficiency.      |
| <b>Nevada</b>              | Strong asset protection statutes; no state income tax; charging order protection.                                                                                   | Thin case law; not recognized as a preferred jurisdiction by most institutional investors; rarely appropriate for investor-facing syndication vehicles. | Specific asset protection contexts; not recommended as primary vehicle for a securities offering.                                      |
| <b>Wyoming</b>             | Strong charging order protection; flexible LLC statute.                                                                                                             | Very limited case law; not recognized by institutional investors; not appropriate for private securities offerings.                                     | Asset protection contexts only; not appropriate for private securities offerings.                                                      |
| <b>State of Operations</b> | No foreign qualification required; lower formation costs in some cases.                                                                                             | Varying quality of LLC and LP statutes; limited case law in most states; typically less flexible than Delaware.                                         | Small, single-state syndications with individual HNW investors who do not require Delaware governance framework.                       |

Delaware's dominance is not marketing. It reflects genuine advantages in statutory flexibility, case law depth, and institutional familiarity that have real value for parties structuring complex, long-duration investment relationships. For any platform with institutional capital in its future, Delaware formation is almost always the right call. The incremental cost, a registered agent and a modest franchise tax, is trivial relative to the friction of having an institutional investor's counsel advise their investment committee that the fund is formed in a jurisdiction they are less familiar with.

### Jurisdiction Selection Based on General Research Is a Structuring Risk

A meaningful number of emerging real estate sponsors choose their entity structure and jurisdiction based on articles, general business formation services, or advice from people who are not securities and real estate attorneys. This produces predictable results: entities formed in supposedly favorable jurisdictions without the case law depth that sophisticated parties need, structured with inadequate governance provisions, without the two-tier structure that protects the sponsor's platform.

Entity structure decisions made at formation shape the investment's governance, liability exposure, and tax treatment for the full life of the investment. They are among the most difficult structural decisions to unwind after the fact. Undoing them through conversion, merger, or reformation is expensive and time-consuming, and some cannot be fully accomplished after investors have committed capital.

Form the entity correctly, with experienced counsel, before the offering launches.

## Entity Structure Summary: Matching Structure to the Offering

| Structure                                                  | Active Party                                          | Passive Party                                | Typical Use                                                                                | Key Legal Points                                                                                                                                               |
|------------------------------------------------------------|-------------------------------------------------------|----------------------------------------------|--------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Manager-Managed LLC (Delaware)</b>                      | Managing Member                                       | Non-Managing Members                         | Single-asset syndications; smaller funds                                                   | Most flexible OA; best case law on manager authority; must expressly designate manager-managed governance; must enumerate manager authorities specifically     |
| <b>Limited Partnership (Delaware LP + LLC as GP)</b>       | General Partner (GP LLC controlled by Management LLC) | Limited Partners                             | Institutional-grade funds; ERISA plan investors; platforms targeting institutional capital | GP must be an LLC to limit personal liability; LP control analysis required for governance rights; fiduciary duty modifications must be reviewed by LP counsel |
| <b>Two-Tier Structure (Management LLC + Operating LLC)</b> | Management Entity controls Operating Entity           | Investors hold interests in Operating Entity | All professional real estate platforms                                                     | Liability isolation requires genuine operational separation; corporate formalities must be maintained; management                                              |

|                                                            |                                                     |                                         |                                                   |                                                                                                                                                                                                                                                            |
|------------------------------------------------------------|-----------------------------------------------------|-----------------------------------------|---------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                            |                                                     |                                         |                                                   | entity should be formed before first deal                                                                                                                                                                                                                  |
| <b>Multi-Tier Fund (Sponsor / GP / Fund Entity / SPVs)</b> | Sponsor Entity controls GP; GP controls Fund Entity | Investors hold interests in Fund Entity | Multi-asset funds; institutional platforms        | Each SPV is single-purpose and property-specific; liability isolated at asset level; vertical consistency required across all governing documents; fund GP must be designed for discretionary mandate                                                      |
| <b>Non-Traded REIT</b>                                     | REIT Board/Manager                                  | REIT Shareholders                       | Broad retail distribution; 1031 exchange programs | REIT qualification ongoing; SEC registration required; 100 shareholder minimum; 5/50 rule; 90% distribution requirement; Investment Company Act analysis required                                                                                          |
| <b>Series LLC</b>                                          | Designated Series Manager                           | Series Members                          | High-volume single-state platforms (limited use)  | Available in approximately 24 jurisdictions as of 2025; each series raises its own capital independently; administrative discipline required for liability isolation; lender and title company acceptance inconsistent; not recommended for most platforms |

## What the Operating Agreement Must Address, and What Most Templates Miss

The operating agreement is not a formality. It is the governing legal instrument for the full life of the investment. Every material governance question, every economic term, every dispute about investor rights will be evaluated against what it says. A document that does not address the situations that arise in real estate syndications is not a legally adequate governing document. It is a document that will be argued about when the relationship between the sponsor and investors is already under stress.

### Manager Authority: The Specificity Standard

The scope of manager authority must be defined with precision: what the manager can do unilaterally, what requires investor consent, and what the procedural requirements are in each category. Generic grants of authority, the manager may take any action it deems necessary or appropriate in managing the company, are not adequate. They create ambiguity about whether specific categories of action were authorized, and in litigation, ambiguous authority is challenged authority.

The line between unilateral manager authority and required investor consent should reflect the actual risk profile of the investment. Routine management decisions, including minor capital expenditures within approved budgets and lease renewals within specified parameters, should be manager prerogatives. Significant decisions, including sale of the property, major refinancing, taking on additional debt above specified thresholds, material changes to the business plan, and related-party transactions above specified amounts, should require investor approval at a defined threshold.

Manager removal provisions require particular care. The conditions for removal, the vote threshold, the transition process, and the treatment of the removed manager's promoted interest in the existing portfolio all need to be specifically addressed. A removal provision that terminates the management relationship without specifying how the transition works fails investors at exactly the moment they most need the provision to function.

### **Transfer Restrictions: Coordination with Loan Documents**

The transfer restriction provisions of the operating agreement must match the transfer restriction provisions of the loan documents, not as a matter of convenience, but as a legal requirement. An investor who attempts to transfer their interest in reliance on the operating agreement's permissions, and whose transfer is blocked or constitutes a loan default because the loan documents say something different, has a valid grievance about the quality of the offering's legal documentation.

Securities counsel must review the loan documents as part of the operating agreement drafting process, specifically to identify transfer restriction and change-of-control provisions that affect how the operating agreement should be written. This review should occur before the offering is launched, not after an investor's transfer attempt reveals the inconsistency.

### **Dissolution Mechanics and Final Distribution**

The dissolution provisions of the operating agreement govern what happens at exit: how the wind-down is managed, in what order remaining assets and proceeds are distributed, how the final waterfall calculation is performed, what filings are required, and who is responsible for them. These provisions are frequently neglected in early-stage offerings because they deal with outcomes that seem distant at formation. They become urgently relevant at the moment of exit, when accuracy in the final distribution calculation is directly tied to legal exposure if investors believe they were shortchanged.

#### **A Note on Operating Agreement Drafting**

The operating agreement is the most important document in a real estate syndication. It is also the document most commonly prepared inadequately, using templates drafted for different deal types, by attorneys without specific real estate syndication experience, or by sponsors who believe the deal matters more than the documents.

An operating agreement that is ambiguous about the distribution waterfall, the manager's authority, the transfer restriction framework, or the dissolution mechanics is not a document that protects anyone. It is a document that will be argued about when the relationship is already strained.

The operating agreement should be drafted specifically for the deal, reviewed by experienced securities counsel, and finalized before any investor is asked to commit capital. Sponsors who want to discuss what a properly tailored operating agreement requires for a specific deal or fund structure are welcome to reach out at [crowdfundlawyer.com](http://crowdfundlawyer.com).

## **Tenant-in-Common Structures and Delaware Statutory Trusts**

Two additional ownership structures appear regularly in the private real estate investment market and require specific treatment in any comprehensive discussion of entity architecture: tenant-in-common arrangements and Delaware Statutory Trusts. Both are used primarily in the context of Internal Revenue Code Section 1031 like-kind exchange transactions, and both carry legal and regulatory characteristics that distinguish them sharply from the LLC and LP structures discussed elsewhere in this chapter.

### **Tenant-in-Common Structures**



A tenancy in common is a form of concurrent real property ownership in which two or more individuals or entities each hold an undivided fractional interest in the same property. Each co-owner holds a direct real property interest, a specific fractional share of the fee title to the property, rather than a membership interest in an entity that holds the property. Unlike a joint tenancy, each TIC owner's interest is freely transferable and passes to their estate rather than to the surviving co-owners upon death.

TIC structures became prominent in the early 2000s as a vehicle for 1031 exchange investors seeking replacement property interests. Revenue Procedure 2002-22 established the IRS's safe harbor conditions under which a tenancy in common interest would be treated as a direct real property interest qualifying as like-kind exchange replacement property rather than as an interest in a business entity that would disqualify the exchange. For 1031 exchange investors who need replacement property in a short timeframe, participation in a TIC offering as a co-owner of a larger institutional-quality asset addresses both the exchange timeline and the scale problem.

### **Revenue Procedure 2002-22: The Safe Harbor Conditions**

The IRS's safe harbor in Revenue Procedure 2002-22 imposes fifteen conditions that a TIC arrangement must satisfy to avoid being characterized as a partnership or other entity for federal tax purposes, a characterization that would disqualify the interest as 1031 replacement property. The most significant conditions for structuring purposes:

- The number of co-owners may not exceed 35. This limit is directly relevant to capital raising: a TIC sponsor cannot raise from more than 35 co-investors, which constrains the offering's total capital capacity unless the individual co-owner interests are large.
- Each co-owner must hold title in their own name or through a disregarded entity. The disregarded entity option, typically a single-member LLC or a grantor trust, allows co-owners to obtain liability protection without interposing an entity that would defeat the direct ownership analysis.
- The co-owners may not file a partnership or corporate tax return or hold themselves out as conducting business as a partnership or corporation.
- The co-owners must retain the right to approve specified major decisions unanimously or by a defined supermajority. Leases with a term exceeding one year, the creation of liens, material alterations to the property, and the sale or exchange of the property are specifically listed.

- A co-owner's interest may only be encumbered by the co-owner themselves, and all co-owners must execute any blanket mortgage uniformly applicable to the entire property.
- A co-owner may not be required to sell their interest and must be permitted to sell, transfer, or gift their undivided interest without the approval of the other co-owners, subject to rights of first refusal that comply with specific conditions.

### **TIC Structures Are Securities Offerings Despite the Direct Ownership Form**

The direct real property ownership characteristic of a TIC interest has led some sponsors to conclude that TIC offerings are not subject to the federal securities laws. That conclusion is wrong in virtually every case where there is a sponsor managing the property on behalf of passive co-owners.

The SEC has taken the position, and courts have consistently agreed, that TIC interests sold to passive co-owners who rely on a sponsor's management efforts to generate their returns satisfy the Howey test, specifically the common enterprise and efforts-of-others elements, regardless of the direct ownership form. The investors' returns derive primarily from the sponsor's management of the property, not from the investors' own efforts.

A TIC offering that involves passive co-investors relying on sponsor management is a securities offering and must be conducted under a valid securities exemption with adequate offering documents. The 1031-qualifying ownership form does not create an exemption from the securities laws.

## **The Decline of TIC Structures and the Rise of DSTs**

TIC offerings were significantly more common in the early-to-mid 2000s than they are today. The 35-investor cap limits scale. The unanimous or supermajority consent requirements for major decisions create genuine governance friction in a property with multiple co-owners who may have different views about the appropriate exit timing. The requirement that each co-owner execute any blanket mortgage creates closing complications. And the 2008 financial crisis exposed the structural fragility of TIC arrangements when multiple co-owners were simultaneously in financial distress with divergent views about whether and how to restructure.

The Delaware Statutory Trust emerged as the dominant 1031-compatible real estate investment structure in the years following the financial crisis and has largely displaced TIC structures in the institutional 1031 exchange market.

## **Delaware Statutory Trusts**

A Delaware Statutory Trust is a trust formed under the Delaware Statutory Trust Act (12 Del. C. Section 3801 et seq.) that holds real property for the benefit of its beneficial interest holders. Revenue Ruling 2004-86 established the IRS's position that a DST interest that meets specified conditions constitutes a direct interest in real property for purposes of Section 1031, qualifying as like-kind replacement property just as a TIC interest does, but without most of TIC's structural disadvantages.

The DST's central legal characteristic is that beneficial interest holders have no management authority over the trust's assets. The trustee, a professional trustee company that is the named legal owner of the trust's real property, manages the property under a trust agreement. The beneficial interest holders receive their pro-rata share of income and proceeds but have no ability to direct management decisions, vote on operational matters, or encumber the property.

This structure achieves 1031 compatibility without the governance complications of a TIC. Because the DST is a trust rather than a business entity under federal tax law, the beneficial interests can qualify as direct real property interests for 1031 purposes despite the absence of any actual management control by the beneficial interest holders.

### **The Revenue Ruling 2004-86 Conditions**

Revenue Ruling 2004-86 identifies the conditions under which a DST interest will be respected as a real property interest for 1031 purposes rather than as an interest in a business entity. These conditions, collectively known as the seven deadly sins of DST structure because any one of them, if violated, can jeopardize the DST's 1031-compatible status, significantly constrain the trustee's management flexibility:

- Once the offering is closed, there can be no capital contributions to the DST by existing or new investors.
- The trustee may not renegotiate the terms of any loans secured by the DST's real property, except in the case of a workout necessitated by a default or imminent default.
- The trustee may not reinvest the proceeds of a sale of the DST's real property. Upon disposition, proceeds must be distributed to the beneficial interest holders.
- The trustee may not enter into new leases or renegotiate existing leases except in the case of a tenant default or imminent default.

- The trustee may not make capital expenditures on the trust property other than those required for normal maintenance and repair, minor non-structural capital improvements, and expenditures required by law.
- Any cash flow not distributed to beneficial interest holders must be held in short-term debt instruments.
- The trustee may not accept any additional contributions of property from any person, including existing beneficial owners, after the initial offering closes.

A DST structure is fundamentally a fixed-income real estate structure: the asset, the financing, and the lease terms are essentially locked at closing, and the trustee's operational role is to maintain the asset, collect the income, and make the required distributions.

### **TIC vs. DST: Key Structural Comparison**

#### **Tenancy in Common (TIC)**

Ownership form: Direct co-ownership of real property (fractional undivided interest)

Co-owner limit: 35 (per Revenue Procedure 2002-22)

Management: Co-owners retain approval rights over major decisions (unanimous/supermajority)

Financing: All co-owners must execute blanket mortgage

Capital calls: Permissible

Lease renegotiation: Permissible with co-owner approval

1031 authority: Revenue Procedure 2002-22

Governance friction: Significant with multiple co-owners

#### **Delaware Statutory Trust (DST)**

Ownership form: Beneficial interest in a trust that holds real property

Investor limit: No statutory cap (limited by offering structure)

Management: Trustee manages; beneficial interest holders have no management rights

Financing: Cannot be renegotiated (except in default workout)

Capital calls: Not permitted after initial closing

Lease renegotiation: Not permitted except in default workout

1031 authority: Revenue Ruling 2004-86

Governance friction: Minimal; investors have no governance role

## **DSTs as Securities Offerings**

DST beneficial interests are securities. The Howey analysis is straightforward: investors contribute money to acquire beneficial interests in a trust, the trust is a common enterprise in which all investors participate, investors expect profits from the income generated by the property, and those profits derive entirely from the trustee's management of the property rather than from investors' own efforts. All four Howey elements are satisfied. DST offerings are conducted as private securities offerings, almost exclusively under Regulation D.

The regulatory profile of DST offerings has one significant distinction from typical Regulation D LLC syndications: DST beneficial interests are frequently sold through broker-dealer networks rather than directly to investors. Because DSTs are commonly used by 1031 exchange investors working with financial advisors to identify replacement property, the distribution channel often runs through registered broker-dealers who earn commissions for placing investors into DST offerings. The firms distributing DST interests must be FINRA-registered, and the DST sponsor must ensure that no unregistered persons are receiving transaction-based compensation in connection with the offering.

### **The '721 Exchange' Exit Path for DST Investors**

One feature of the DST structure that has contributed to its popularity among sophisticated 1031 exchange investors is the 721 exchange exit mechanism. Section 721 of the Internal Revenue Code allows a tax-deferred exchange of DST beneficial interests for operating partnership units in a REIT operating partnership when the REIT acquires the DST's property at disposition.

This creates a potential two-step tax deferral path: the investor first uses a 1031 exchange to acquire a DST interest, then uses a 721 exchange when the DST's property is acquired by a REIT to convert their DST interest into OP units, deferring the gain that would otherwise be recognized at disposition. The OP units provide ongoing economic participation in the REIT's portfolio and eventually may be converted to REIT shares or liquidated.

The 721 exchange exit is not guaranteed. It depends on a REIT being willing to acquire the specific property on terms acceptable to the DST trustee, which cannot be promised to DST investors at the time of their initial investment. Disclosing the 721 exchange as a potential liquidity mechanism without overstating the probability or the terms under which it would occur is an important PPM drafting consideration for DST offerings.

## Practical Considerations for Sponsors Considering TIC or DST Structures

For sponsors whose investor base includes 1031 exchange investors, TIC and DST structures offer genuine value: they provide a 1031-compatible investment vehicle that allows exchange investors to defer capital gains while participating in a professionally managed real estate opportunity.

- DST structures are appropriate primarily for stabilized, income-producing assets with predictable cash flows and fixed financing. The Revenue Ruling 2004-86 constraints make DSTs unsuitable for value-add strategies that require operational flexibility. A DST with a value-add business plan is either violating its 1031-qualifying structure or not executing its intended strategy.
- TIC structures retain utility in situations where co-owners want direct fractional title ownership and where the 35-person limit is not a binding constraint.
- Both structures require specific legal expertise: securities counsel who understands the Regulation D framework for these offerings, tax counsel who understands Revenue Procedure 2002-22 and Revenue Ruling 2004-86, and real estate counsel who understands the title and financing implications of co-ownership and trust structures.
- DST offerings distributed through broker-dealer networks require specific attention to the broker-dealer regulatory framework: registered firms only, FINRA-compliant compensation arrangements, and appropriate supervision of the distribution process. The distribution cost structure of DST offerings, commissions to placing broker-dealers, must be fully disclosed in the PPM and reflected in the economics that investors actually receive.
- The disclosure obligations in both TIC and DST PPMs must specifically address the 1031-qualifying conditions and the risks associated with failing to maintain those conditions. An investor who acquires a TIC or DST interest for 1031 purposes and later discovers that the structure failed to maintain its qualifying conditions has a rescission claim directly proportional to the tax liability they were seeking to defer.

### **A Note on TIC, DST, and Qualified Opportunity Zone Structures**

TIC structures, Delaware Statutory Trusts, and Qualified Opportunity Zone funds each represent specialized intersection points between federal tax law and the private real estate securities framework. Each requires securities counsel with specific experience in

both the tax structure and the private placement compliance requirements, not just one or the other.

The legal analysis for a DST offering requires simultaneous competence in Revenue Ruling 2004-86's structural conditions, the Regulation D exemption framework, the broker-dealer requirements applicable to the distribution channel, and the real estate due diligence that supports adequate PPM disclosure. These requirements interact in ways that produce offering-specific compliance questions requiring integrated legal analysis.

Sponsors considering TIC or DST structures for the first time, or seeking to add these structures to an existing syndication platform, are welcome to reach out at [crowdfundlawyer.com](http://crowdfundlawyer.com) to discuss what a specific offering would require.

## Practical Takeaways

- Entity structure is a foundational decision that shapes the investment's governance, liability exposure, and tax treatment for the full life of the investment. It deserves deliberate analysis before the offering launches, not a default to whatever template is cheapest or most familiar.
- The SPV structure is architecturally necessary, not merely conventional. The LLC holds property title; investors hold membership interests in the LLC; those interests are contractual claims defined by the operating agreement. Investors do not hold real property, and the PPM should say so explicitly.
- Manager-managed governance is essential in every real estate LLC syndication, for securities law compliance, for the tax treatment of investor losses, and for operational efficiency. The manager-managed designation must be expressly stated in the operating agreement, not assumed as a default.
- The two-tier structure, a separate management entity that manages the deal-specific operating entity, is one of the most important structural protections in the private real estate toolkit. It separates the sponsor's accumulated platform assets from deal-specific liability. It should be implemented before the first deal closes.
- The GP entity must match the job it is doing. A syndication GP built for a narrow, disclosed mandate is not the same legal instrument as a fund GP exercising broad discretionary authority over pooled capital. Sponsors transitioning from syndications to funds must redesign the GP entity's authority provisions,

governance framework, and disclosure architecture to match the actual demands of a discretionary investment program.

- Delaware LLC or LP is the correct default for any platform with institutional capital in its near-term future. The case law depth, statutory flexibility, and institutional familiarity that Delaware provides have genuine value. The incremental formation cost is trivial relative to the friction of having an institutional investor's counsel flag an unfamiliar formation jurisdiction.
- Multi-tier fund structures, a fund entity owning asset-level SPVs, are standard architecture for real estate funds. They achieve asset isolation, accommodate single-purpose lender requirements, and simplify individual asset management and disposition. The governing documents across all tiers must be vertically consistent.
- Lender consent to membership interest transfers must be analyzed and resolved during the financing negotiation, not discovered after the offering has launched. The transfer restriction provisions in the operating agreement must match what the lender has agreed to permit.
- REIT structures add substantial ongoing compliance obligations, including a 100-shareholder minimum, the 5/50 rule, a 90% distribution requirement, and an Investment Company Act analysis, that are not justified for most private platforms below significant scale.
- Institutional joint ventures require a different documentation framework and governance posture than retail syndications. The governing agreement is negotiated, not sponsor-drafted. Sponsors entering their first institutional joint venture negotiation need experienced securities counsel who has been on both sides of these transactions.
- The operating agreement is the most important document in the syndication. Template documents not adapted to the specific deal, jurisdiction, and investor base fail the parties they are supposed to govern. Get it right, with experienced counsel, before anyone invests.
- Tenant-in-common structures and Delaware Statutory Trusts are 1031 exchange-compatible real estate investment structures that serve investors seeking like-kind replacement property. Both are securities offerings subject to the full Regulation D compliance framework. DSTs have largely displaced TICs in the institutional 1031 market due to their simpler governance structure, but the Revenue Ruling 2004-86 conditions, the seven deadly sins, constrain the



trustee's operational flexibility and make DSTs unsuitable for value-add strategies.

CHAPTER EIGHT

# The Capital Stack

Every commercial real estate investment is financed with some combination of debt and equity. The arrangement of that debt and equity, including who contributes the capital, in what proportion, with what priority of payment, and with what rights if the deal goes sideways, is what practitioners mean when they talk about the capital stack.

For a real estate sponsor or investor, the capital stack is not a peripheral concept. It is central to how the investment generates returns, how risk is distributed, and how the legal documents that govern the syndication or fund relate to the underlying financing. The waterfall investors care about, the preferred return mechanics, the bad boy carveout provisions in the loan guaranty: each is a downstream consequence of capital stack decisions that were made before the offering documents were ever drafted.

This chapter works through the capital stack from bottom to top, beginning with the senior debt that anchors most commercial acquisitions and ending with the common equity that investors in a syndication typically hold. It addresses how lenders underwrite real estate deals and what those underwriting requirements mean for deal structure; the specific characteristics of agency financing, CMBS, bridge debt, and construction lending; the legal and economic distinctions between preferred equity and mezzanine debt; and the equity cushion question that underlies every leveraged real estate investment. Throughout, the discussion focuses on the legal implications of each capital stack decision for the offering documents, for the investor relationship, and for the sponsor’s personal exposure.

## Understanding the Capital Stack

The capital stack is the hierarchy of financial claims against a real estate asset. Each layer has a defined position, a defined payment priority, and a defined set of rights both in the ordinary operation of the investment and in a distressed scenario. The ordering is consistent. Senior obligations are paid first. Subordinate obligations are paid next. Equity is paid last. The lower a position sits in the stack, the more risk it absorbs and the higher the return it requires.

| Layer       | Position                 | Description                                                                                                                                           |
|-------------|--------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------|
| Senior Debt | Top of stack (last loss) | First mortgage loan secured by a first position lien on the real property. Lowest risk to the lender, lowest cost to the borrower. Foreclosure is the |

| Layer            | Position                                   | Description                                                                                                                                                                                                                       |
|------------------|--------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                  |                                            | primary remedy. Paid before every subordinate claim.                                                                                                                                                                              |
| Mezzanine Debt   | Senior to equity, junior to first mortgage | Subordinate loan secured by a pledge of the equity interests in the property owning entity. Enforced through UCC Article 9, not real property foreclosure. Senior to all equity classes.                                          |
| Preferred Equity | Senior to common equity, junior to debt    | Priority return over common equity. No lien on the real property. Remedies derive from the operating agreement, including the right to remove the common equity manager or force a sale. Debt like priority documented as equity. |
| Common Equity    | Bottom of stack (first loss)               | Residual interest after all other claims are satisfied. Investors in a syndication typically hold this position. Highest risk and highest potential return. Last to be paid in every scenario.                                    |

## Senior Debt: The First Mortgage

Senior debt occupies the top of the capital stack from a priority standpoint. It is the last to lose and the first to be repaid. A first mortgage loan is secured by a first position lien directly on the real property. The lender's primary enforcement remedy in a default is foreclosure, which is the legal process through which the lender takes title to the property, or causes it to be sold, to satisfy the outstanding loan balance.

Because the senior lender holds a first position lien on the property itself, it bears less risk than any other party in the capital stack. That lower risk is reflected in a lower interest rate. Senior debt typically finances 50% to 80% of a property's value depending on the asset class, the lender type, and the property's cash flow characteristics. Equity contributed by the sponsor and investors, together with any subordinate debt, fills the remaining gap between the senior loan and the total transaction cost.

In a real estate syndication, the senior mortgage is typically the most significant single document in the transaction after the purchase contract. Its terms have direct implications for investor rights and the sponsor's operating authority. Loan covenants restrict operational decisions. Transfer restriction provisions constrain investor transfers. Bad boy carveout provisions create personal recourse exposure for the sponsor in specified circumstances. These provisions are not negotiated by investors, but they directly affect what investors are actually buying. Material loan terms must be disclosed in the PPM.

## Mezzanine Debt: Subordinated Secured Lending

Mezzanine debt sits between the first mortgage and equity in the capital stack. It is a loan, not an equity interest, but its security is not a lien on the real property. Instead, a mezzanine loan is secured by a pledge of the equity interests in the entity that owns the property. The mezzanine lender's enforcement remedy is a UCC Article 9 foreclosure on those pledged equity interests, which can transfer ownership of the property owning entity more rapidly than a real property foreclosure.

Mezzanine lending fills gaps in the capital stack that senior lenders are unwilling to fill. When a senior lender will finance 65% of a \$20 million acquisition, but the sponsor's equity raise is only sufficient to cover 20% of the cost, a mezzanine loan covering 15% of the acquisition price can close the gap. The mezzanine lender accepts higher risk than the senior lender, since its claim is subordinate to the entire first mortgage, and it charges a higher interest rate to compensate for that position.

The legal relationship between the senior lender and the mezzanine lender is governed by an intercreditor agreement. That document, negotiated between the two lenders, defines the senior lender's priority, the mezzanine lender's enforcement rights, the standstill periods that restrict the mezzanine lender from acting while the senior lender pursues its own remedies, and the conditions under which the mezzanine lender may cure a default in the senior loan to protect its equity position. Negotiating the intercreditor agreement is often the most time consuming aspect of a deal that includes mezzanine financing, and its terms can significantly affect the sponsor's flexibility in a distressed scenario.

## Preferred Equity: Hybrid Debt and Equity Structures

Preferred equity occupies the same general position in the capital stack as mezzanine debt. It is subordinate to the first mortgage and senior to common equity. The key difference is that preferred equity is documented as an equity interest rather than as a loan. The preferred equity investor holds a membership interest in the property owning entity, or in an entity that owns the property owning entity, with contractual rights to a specified return before the common equity participates.

The economic profile of preferred equity is debt like. There is a fixed or minimum return, priority over common equity in distributions and on liquidation, and limited (or no) participation in appreciation above the preferred return threshold. But because it is documented as equity, there are implications for lender consent, enforcement mechanics, and tax treatment that differ from true debt. The preferred equity investor's enforcement remedy in a default is typically a contractual right to remove the common equity manager or to force a sale. Those remedies derive from the operating agreement, not from the debt enforcement statutes.

Many commercial mortgage loans include restrictions on the placement of preferred equity between the senior loan and the common equity without lender consent. A sponsor who layers preferred equity on top of a property owning entity without reviewing the senior loan's preferred equity restriction provisions may inadvertently trigger a loan default. That analysis, namely whether the loan documents permit the proposed preferred equity structure, must occur before the preferred equity is offered to investors, not after.

### Common Equity: The Residual Interest

Common equity occupies the bottom of the capital stack. It is the position that absorbs losses first and receives returns last. In a real estate syndication, the investors whose interests are governed by the operating agreement typically hold common equity. After the senior debt is serviced, after any mezzanine debt or preferred equity is paid, and after all operating expenses and reserve requirements are satisfied, the remaining cash flow is distributed to the common equity holders through the waterfall defined in the operating agreement.

The common equity position is the highest risk position in the capital stack. It is the first position to be impaired if the property generates less income than projected, if renovation costs exceed budget, if market conditions deteriorate, or if the exit fails to achieve the projected price. It is also the position with the greatest upside. All appreciation above the total debt and subordinate claims accrues to common equity.

That risk profile (last paid, first impaired, with full upside participation) is the profile that most syndication investors accept when they commit capital. Understanding it clearly, in concrete terms tied to the specific investment rather than as an abstract description, is the foundation of an informed investment decision. The PPM's disclosure of the capital stack and its implications for investor risk is a material disclosure obligation, not boilerplate.

## How Lenders Underwrite Real Estate Syndications

A lender's underwriting of a real estate acquisition is a risk assessment. Given this property, in this market, with this sponsor, what is the probability that the loan will be repaid in full and on time? The three primary metrics lenders use to answer that question are loan to value (LTV), debt service coverage ratio (DSCR), and debt yield. Together they govern how much debt any given transaction can support. Understanding these metrics is essential for sponsors structuring a deal and for investors evaluating the risk profile of the financing.

### Loan to Value: The Asset Coverage Metric

Loan to value is the ratio of the loan amount to the property's appraised value. An 80% LTV loan on a \$10 million property is an \$8 million loan. The equity cushion is \$2 million, which is 20% of value. LTV is the lender's measure of how much collateral coverage exists relative to the

loan. The lower the LTV, the more value the property could lose before the lender's principal is impaired.

LTV limits vary substantially across asset classes and lender types. Agency lenders such as Fannie Mae and Freddie Mac will lend up to 80% LTV on qualifying multifamily properties in normal market conditions. CMBS lenders for commercial assets may lend 65% to 75% LTV depending on property type and cash flow stability. Bridge lenders for transitional assets may lend 70% to 80% of cost, with the higher leverage offset by the loan's short term and higher interest rate. Construction lenders typically underwrite to projected stabilized value rather than current value, with loan to cost ratios of 60% to 70%.

LTV is a static measure. It reflects the ratio at the time of origination based on an appraisal. The actual risk profile, however, is dynamic. If the property's value declines after origination, the LTV rises even though the loan terms remain unchanged. Loans that were well within LTV limits at origination can become technically over levered if the market moves against the investment, without any change in the loan terms or the sponsor's conduct.

### **Debt Service Coverage: The Cash Flow Metric**

Debt service coverage ratio (DSCR) measures the property's ability to pay its debt from operating income. DSCR is calculated as net operating income (NOI) divided by annual debt service (principal and interest payments). A DSCR of 1.25x means the property generates \$1.25 in NOI for every \$1.00 of debt service, which is a 25% cushion above the minimum required to cover the loan payments.

Minimum DSCR requirements vary by lender and asset class. Agency multifamily lenders typically require a minimum 1.25x DSCR. Institutional CMBS lenders for office and retail assets may require 1.30x or higher, reflecting the greater income volatility of those asset classes. Bridge lenders for transitional assets may underwrite to a stabilized DSCR, that is, what the property is projected to generate after the value add business plan is executed, rather than the current DSCR on a property in the middle of a renovation.

DSCR matters to investors because it determines the property's margin of safety on debt service. A property with a 1.05x DSCR at origination has very little buffer. Any decline in occupancy, any increase in operating expenses, or any disruption to rent collection could make debt service coverage inadequate. The risk of a cash flow shortfall that requires equity to cover debt service, or worse, a technical default that triggers lender remedies, is directly related to the DSCR at origination and the trajectory of the business plan.

### **Debt Yield: The Risk Adjusted Coverage Metric**

Debt yield is NOI divided by the total loan amount, expressed as a percentage. A \$5 million loan against a property generating \$400,000 in NOI has a debt yield of 8%, calculated as \$400,000 divided by \$5,000,000. Debt yield is the lender's assessment of the return it would earn if it owned the property outright at the loan amount. It is a measure of how well the property's income supports the loan balance independent of appraised value or the interest rate.

Debt yield became increasingly important to institutional lenders after the 2008 financial crisis because it is less susceptible to appraisal manipulation than LTV. An appraiser can be influenced to support a higher property value, which produces a lower LTV on the same loan amount. Debt yield, by contrast, is calculated from actual income, not an opinion of value, which makes it harder to optimize. Many institutional lenders now have minimum debt yield requirements, often 7% to 9% depending on asset class, that serve as independent constraints on loan sizing alongside LTV and DSCR requirements.

## **Lender Consent and Transfer Restriction Provisions**

Most commercial real estate loans restrict the transfer of ownership interests in the borrower entity without lender consent. These provisions, sometimes called due on transfer clauses or membership interest transfer restrictions, protect the lender's underwriting, which was based on the specific ownership and management team at origination. If the property changes hands without the lender's knowledge, the lender loses the ability to assess whether the new owner has the capability to manage the asset and service the debt.

For real estate syndications, lender consent provisions create a direct legal constraint on investor rights. An operating agreement that promises investors the ability to transfer their membership interests, whether on a secondary market or to a qualified transferee, may make a promise the loan documents do not permit. The analysis of what the loan documents allow, and how the operating agreement's transfer provisions must be drafted to be consistent with those permissions, is one of the most important coordination points between the sponsor's securities counsel and real estate counsel.

Sponsors who plan to offer investors secondary market access to their membership interests, whether through informal transfer arrangements or a formal secondary trading platform, must resolve the lender consent issue before the offering is launched. A secondary transfer that executes without the required lender consent may constitute a loan default, which is a far more serious problem than a securities compliance issue.

## **Recourse, Nonrecourse, and Bad Boy Carveouts**

Commercial real estate loans in the institutional market are almost always documented as nonrecourse. If the borrower defaults, the lender's remedy is limited to foreclosing on the property. The lender cannot pursue the sponsor or the principals personally for any deficiency

between the loan balance and the foreclosure sale proceeds. Nonrecourse is the standard that institutional sponsors and institutional lenders expect in commercial real estate transactions.

Nonrecourse, however, is never absolute. Every institutional nonrecourse loan includes carveout provisions, often called bad boy carveouts, that convert specified categories of conduct by the sponsor from nonrecourse to full personal recourse. The carveout operates at the guarantee level. A carveout guarantor, typically the sponsor's management entity or the individual principals, becomes personally liable for the full loan amount if any of the enumerated bad acts occurs.

| Trigger Category       | Common Trigger Events                                                                                                                                                                                                                                                                                                               | Scope of Liability                                                   |
|------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------|
| Full Recourse Triggers | Voluntary bankruptcy filing by the borrower entity; collusive involuntary bankruptcy filing facilitated by the sponsor; transfer of the property or ownership interests in violation of loan restrictions; fraudulent misrepresentation in the loan application or ongoing reporting; intentional physical waste of the collateral. | Personal liability for the entire outstanding loan balance.          |
| Loss Recourse Triggers | Misappropriation of rents or security deposits after default; failure to maintain required insurance coverage; failure to pay property taxes resulting in a tax lien; environmental violations caused by the sponsor; interference with the lender's foreclosure rights.                                                            | Personal liability for actual lender losses attributable to the act. |

### **⚠ Bad Boy Carveouts Create Personal Liability for the Sponsor's Principals**

*In most institutional nonrecourse loans, the carveout guarantee is signed personally by the sponsor's principals or by the sponsor's management entity, not by the borrower LLC. If the borrower LLC triggers a carveout event, the guarantee creates personal liability against the individual principals who signed it.*

*Voluntary bankruptcy is the carveout that most frequently surprises sponsors. In a distressed scenario where the property is losing value and the loan is deeply out of the money, a sponsor's instinct may be to file bankruptcy to stop a foreclosure and preserve options. But if voluntary bankruptcy is a carveout event, and it almost always is, the bankruptcy filing itself triggers full personal recourse on the loan. The sponsor's attempt to protect the investment by filing bankruptcy can personally eliminate the nonrecourse protection that was the foundation of the loan structure.*



*Carveout guarantee terms should be reviewed carefully by the sponsor's legal counsel before the loan is executed and disclosed specifically in the offering documents. Investors who commit capital to a deal do not bear the carveout guarantee liability personally, but they are affected if the sponsor's financial exposure from a triggered carveout impairs the sponsor's ability to manage the investment.*

## Agency Financing: Fannie Mae, Freddie Mac, FHA, and HUD

Agency financing, meaning loans originated, guaranteed, or insured by government sponsored enterprises and federal agencies, is the dominant debt source for multifamily real estate in the United States. Fannie Mae (Federal National Mortgage Association), Freddie Mac (Federal Home Loan Mortgage Corporation), FHA (Federal Housing Administration), and HUD (Department of Housing and Urban Development) collectively finance the majority of institutional multifamily debt in the country. Understanding how agency financing works, and how its specific requirements affect the structure of a multifamily syndication, is essential for any sponsor operating in the multifamily market.

### Fannie Mae and Freddie Mac: The Conventional Agency Market

Fannie Mae and Freddie Mac purchase mortgage loans from approved lenders. These are the Delegated Underwriting and Servicing (DUS) lenders for Fannie Mae and the Optigo lenders (formerly Program Plus) for Freddie Mac. These approved lenders originate loans under agency guidelines and typically retain approximately one third of the credit risk on every DUS loan as a condition of origination authority. That risk retention aligns their incentives with loan quality. The purchased loans are then securitized and sold to investors in the secondary mortgage market.

Agency multifamily financing offers meaningful advantages. These include competitive interest rates, high leverage (up to 80% LTV for qualifying assets), nonrecourse structure with standard bad boy carveouts, and long loan terms (typically 5, 7, or 10 years) with fixed rates. For multifamily syndications targeting institutional quality assets with stabilized occupancy, agency financing is almost always the lowest cost, most sponsor favorable debt option available.

Agency financing also imposes specific requirements that affect the syndication structure. Borrower entity requirements include single purpose entity structures, specified organizational document provisions (single purpose entity covenants and clean bankruptcy covenants), and limitations on transfers of ownership interests in the borrower. Agency loan documents typically restrict ownership transfers without lender consent, and the consent process involves substantive review of the proposed transferee's creditworthiness and real estate experience.

Sponsors who plan to offer secondary market access to investors in agency financed deals need to understand the agency transfer consent framework before making any liquidity representations to investors.

The agency approval process also has specific borrower and principal eligibility requirements, including background checks, financial strength requirements, and experience criteria. These can determine whether a first time or less established sponsor qualifies for agency financing at all. Sponsors who assume agency financing is available for their deal without going through the qualification process early in the transaction may find themselves scrambling for alternative financing at the last moment.

### **FHA and HUD: The Affordable and Construction Programs**

FHA and HUD financing programs serve specific market segments that Fannie Mae and Freddie Mac do not, namely new construction, substantial rehabilitation, and affordable housing projects. The HUD 221(d)(4) program finances the construction or substantial rehabilitation of multifamily properties with high leverage (up to 85% loan to cost for market rate projects, with higher levels available for affordable and rental assistance properties), fixed interest rates, and a 40 year amortization following an interest only construction period. The HUD 223(f) program refinances or acquires existing multifamily properties with similar long term, fixed rate features.

HUD financing provides access to some of the highest leverage and longest terms available in the institutional multifamily market. The tradeoff is a lengthy approval and processing timeline. FHA and HUD loan processing can take 6 to 12 months or longer, which significantly affects deal timing. The regulatory requirements associated with HUD loans, including Davis Bacon prevailing wage requirements for construction, accessibility standards, and tenant protection provisions, also add complexity to projects that pursue this financing.

For multifamily syndication sponsors pursuing ground up development or workforce housing strategies, HUD financing can be a genuinely attractive option that conventional agency financing does not provide. But the timeline and process complexity must be incorporated into the offering's capitalization plan, and investors must understand that the development loan may not close on the same timeline as a conventional financing.

### **CMBS and Conduit Lending**

Commercial Mortgage Backed Securities (CMBS) financing, sometimes called conduit lending, is the primary institutional debt source for commercial real estate asset classes that agency financing does not serve. These include office, retail, hospitality, self-storage, and other commercial property types. CMBS loans are originated by banks and other lenders and immediately securitized. They are pooled with other loans and sold as bonds to institutional

investors. The securitization process has significant implications for how CMBS loans are structured and administered.

## How CMBS Loans Work

CMBS loans are fixed rate, nonrecourse (with standard bad boy carveouts), and typically carry 10 year terms with 25 or 30 year amortization schedules. Interest rates are typically based on U.S. Treasury yields plus a credit spread. The proceeds from the securitization are used to fund the loan; the loan then sits in a securitized trust managed by a servicer for routine administration and a special servicer for default and workout situations.

The securitization of a CMBS loan has a fundamental consequence for the borrower. Once the loan is securitized, the original lender has no ongoing relationship with the borrower. The loan is administered by a servicer whose authority is defined by the pooling and servicing agreement (PSA), which is a document the borrower is not a party to and typically cannot see.

Modifications to loan terms, consent to ownership transfers, and workout negotiations all run through the servicer, whose authority to approve modifications is often more limited than the authority a balance sheet lender would have.

## CMBS Loan Restrictions That Affect Syndications

CMBS loans typically impose the most restrictive ownership transfer provisions of any commercial real estate financing. The borrower entity must be a single purpose, bankruptcy remote entity. Any transfer of more than a specified percentage of the ownership interests (often 49%) triggers a lender consent requirement, and the CMBS servicer's ability to consent to transfers is typically more constrained than a balance sheet lender's.

CMBS loans also contain cash management provisions that activate upon a trigger event, typically when the DSCR falls below a specified floor. Under a hard lockbox structure, all property revenues are directed to a lender controlled account before any operating expenses are paid. Under a soft lockbox, revenues flow to the borrower but are swept to a lender controlled account if a trigger event occurs. These provisions can significantly affect the sponsor's operating flexibility and the timing of investor distributions in a stressed scenario.

Perhaps the single most important thing for syndication sponsors and investors to understand about CMBS financing is that prepayment is typically extremely expensive. CMBS loans include defeasance provisions, requiring the borrower to substitute government securities for the collateral in order to release the property from the lien, or yield maintenance provisions, requiring payment of a premium that compensates the bondholders for the lost interest income. The cost of these provisions can make early exit economically unattractive and constrains the sponsor's ability to respond opportunistically to favorable market conditions.

### **⚠ CMBS Loan Terms Constrain Investment Flexibility. Disclose This to Investors.**

*Investors in a real estate syndication backed by CMBS financing are investing in a structure with materially less operational flexibility than a deal financed by a balance sheet lender or an agency lender. The servicer's limited modification authority, the cash management triggers, and the prepayment penalty structure all affect the sponsor's ability to respond to market conditions. They can also affect the ability to sell at a time that would otherwise be optimal for investors.*

*These constraints are material information that must be specifically disclosed in the PPM. They should not be buried in a list of general real estate financing risks. They should be specifically described in terms of how the CMBS structure affects the investment's operational profile and exit optionality.*

*Sponsors who do not read their CMBS loan documents carefully before preparing the PPM risk preparing disclosures that do not accurately describe the actual constraints investors have accepted.*

## **Bridge and Construction Lending**

Value add and development transactions, which are the investment strategies that generate the highest returns but also carry the highest execution risk, require financing structures that conventional permanent lenders are not designed to provide. Bridge loans and construction loans finance the transitional period, meaning the period during which a property is being repositioned, renovated, or developed, and during which it does not yet generate the stable income that permanent lenders require.

### **Bridge Loans: Financing the Transitional Asset**

A bridge loan finances the acquisition and initial repositioning of a transitional asset, that is, a property with below market occupancy, significant deferred maintenance, or an operational profile that does not qualify for permanent financing. The bridge loan provides capital while the sponsor executes the value add business plan. Once the property is stabilized and qualifies for permanent financing, the sponsor refinances the bridge loan with a permanent mortgage.

Bridge loans are typically short term, often 1 to 3 years with extension options for 6 to 12 additional months. They carry floating interest rates, typically indexed to SOFR (the Secured Overnight Financing Rate, which replaced LIBOR as the primary U.S. benchmark rate). SOFR indexed bridge loans were a significant source of unexpected stress for value add multifamily

sponsors during 2022 and 2023, when SOFR rose by approximately 500 basis points in roughly 18 months. That move dramatically increased debt service costs for floating rate loans that had been underwritten in a near zero rate environment. Business plans projecting refinancing into a fixed rate permanent loan within 18 months found themselves in a market where the permanent loan market had also tightened, leaving bridge loans that could not be economically refinanced.

The floating rate risk of bridge loans is a material risk that must be specifically disclosed in the PPM for any value add syndication using bridge financing. The disclosure should specifically address the current rate environment, the cap or other interest rate protection in place, the rate scenarios under which the investment's financial performance would be stressed, and the business plan's timeline for transitioning to permanent financing. A business plan projection that shows returns under a flat interest rate assumption, without stress testing the floating rate risk, is an incomplete disclosure.

| Underwriting Factor            | What the Lender Evaluates                                                                                                                                                                                                              |
|--------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Exit Strategy (primary)        | How will the bridge loan be repaid? Is refinancing into permanent financing achievable at the projected stabilized NOI and in the current rate environment? Is sale at the projected price achievable given current market conditions? |
| Loan to Cost (LTC)             | Bridge lenders typically underwrite to 70% to 80% of total project cost (purchase price plus renovation budget), not to appraised value.                                                                                               |
| Debt Service Reserve           | Many bridge lenders require an interest reserve funded at closing covering 12 to 18 months of projected debt service, held in a lender controlled account.                                                                             |
| Renovation Budget and Timeline | Bridge lenders require detailed renovation scopes with contractor bids. Budget disbursements are typically controlled through a draw process with inspections required before each draw.                                               |
| Sponsor Experience             | Bridge lenders underwrite the sponsor's ability to execute the business plan. First time sponsors may face tighter underwriting or higher rates.                                                                                       |

## Construction Loans: Financing Ground Up Development

A construction loan finances the development of a new property from the ground up. That includes land acquisition, entitlement, construction, and pre-leasing. The loan is structured as a commitment to lend up to a specified amount, drawn in stages as construction progresses, with disbursements controlled by an inspector or construction monitor who certifies that the work has been completed before each draw is funded.

Construction loans carry the highest risk of any commercial real estate debt because the collateral does not yet exist at origination. The lender is relying on the sponsor's ability to

execute a multi-year development process. That process involves obtaining permits, managing contractors, controlling costs, pre-leasing or pre-selling units, and completing construction on schedule. Any of these milestones can go wrong in ways that delay the project, increase costs, or impair the exit.

Construction loan underwriting focuses heavily on two categories of analysis. The first is the sponsor's track record and financial strength. The second is the project's feasibility and market support. First time developers face substantially higher barriers to construction financing than experienced sponsors with documented track records of completed projects. The personal guaranty requirement for construction loans is typically more-extensive than for bridge or permanent financing. Construction lenders almost always require a completion guaranty that makes the sponsor personally liable for completing the project and repaying the loan, regardless of what causes the delay or cost overrun.

### **The Completion Guaranty: A Material Exposure Disclosure**

A completion guaranty is a guarantee signed by the sponsor's principals that the project will be completed and that the construction loan will be repaid in full. Unlike a bad boy carveout guaranty, which is triggered only by specified bad acts, a completion guaranty typically creates full recourse on the loan without any fault requirement. If the project does not complete, for any reason, including general contractor failure, force majeure, or market conditions that make the project economically unviable, the completion guaranty creates personal liability against the guarantors.

The completion guaranty is a material fact about the sponsor's personal financial exposure that must be disclosed in the PPM. Investors evaluating a development syndication are evaluating the sponsor's personal financial commitment to the project. The completion guaranty demonstrates that commitment and also quantifies the personal financial risk the sponsor has accepted. A PPM that describes a development project without disclosing the existence and terms of the completion guaranty is providing incomplete disclosure of a material risk to the investment.

## **Preferred Equity Compared with Mezzanine Debt**

Preferred equity and mezzanine debt serve similar economic functions. Both fill the gap between the senior mortgage and the common equity in the capital stack. They have meaningful legal, structural, and tax differences, however, that affect how they are documented, how they are enforced in a distressed scenario, and how they interact with the senior lender's rights. Understanding the distinction matters for sponsors who use these instruments and for investors who hold interests in a structure that layers them.

| Dimension                  | Preferred Equity                                                                                | Mezzanine Debt                                                                                                |
|----------------------------|-------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------|
| Legal form                 | Equity interest in the property owning entity or its parent.                                    | Loan documented by promissory note and pledge agreement.                                                      |
| Security                   | Contractual rights under the operating agreement. No lien on the real property.                 | Pledge of equity interests in the property owning entity, enforced under UCC Article 9.                       |
| Enforcement remedy         | Contractual removal of common equity manager; forced sale rights under the operating agreement. | UCC Article 9 foreclosure on the pledged equity interests.                                                    |
| Senior lender relationship | May require lender consent. Intercreditor or recognition agreement is often negotiated.         | Intercreditor agreement required. Standstill period applies during senior lender enforcement.                 |
| Return structure           | Preferred return (fixed or variable), sometimes plus equity upside participation.               | Fixed interest. No equity upside absent convertibility or warrants.                                           |
| Tax treatment              | Equity. Returns treated as distributions. No interest deduction for the issuer.                 | Debt. Interest payments are deductible by the borrower.                                                       |
| Default timeline           | Contractual. Manager removal process must follow the operating agreement.                       | UCC foreclosure. Faster than real property foreclosure in many states.                                        |
| Bankruptcy treatment       | Equity. Subordinate to all debt claims.                                                         | Debt claim. Subordinate to senior mortgage but senior to all equity.                                          |
| Typical cost               | Higher than mezzanine debt. Returns often 10% to 15% or more.                                   | Lower than preferred equity. Interest rates often 8% to 14% in the current market.                            |
| Typical use case           | When the senior lender prohibits mezzanine debt or when equity documentation is preferred.      | When the senior lender permits mezzanine debt and when interest deductibility benefits the capital structure. |

## Why the Distinction Matters in a Distressed Scenario

In a performing investment, the distinction between preferred equity and mezzanine debt is primarily a documentation and tax matter. In a distressed investment, however, where the property is not generating sufficient cash flow to service all claims and the sponsor and lenders are negotiating over workout options, the distinction becomes legally critical.



A mezzanine lender can foreclose on the pledged equity interests through a UCC Article 9 process that can transfer ownership of the property owning entity in a matter of weeks, depending on applicable law and notice requirements. That speed is both the mezzanine lender's primary enforcement advantage and the primary risk for common equity holders in a distressed scenario. Common equity can be wiped out quickly, without the extended timeline of a real property foreclosure.

A preferred equity investor's enforcement remedy, namely contractual removal of the common equity manager and forced sale rights, must follow the operating agreement's procedural requirements. It may also be subject to equitable defenses that a court applies in a partnership dispute. The process is generally slower than a UCC foreclosure, which can actually be advantageous for the common equity holders if the extended timeline creates additional opportunities to cure the default or find alternative capital.

Sponsors structuring the capital stack for a syndication need to understand these enforcement dynamics and their implications for common equity investors. The risk profile of a deal with a mezzanine lender is materially different from a deal with only senior debt. The PPM must specifically disclose the mezzanine lender's rights and the timeline under which those rights could eliminate investor equity in a distressed scenario.

## The Equity Cushion: How Much Equity Is Enough?

The equity cushion is the buffer between the property's current value and the outstanding debt. It is the amount by which the property's value could decline before the debt becomes unsecured. In a \$10 million property financed with \$7 million in debt, the equity cushion is \$3 million, or 30% of value. If the property's value falls to \$7 million, the equity cushion is zero. The debt equals the property value and the equity holders have no residual value.

The equity cushion is both an underwriting metric (lenders use LTV to ensure the cushion meets their requirements at origination) and a risk indicator for equity investors (who understand that the cushion is what stands between their investment and a scenario in which the debt cannot be refinanced or the equity is wiped out in a distressed sale).

## How Leverage Amplifies Returns and Losses

Leverage amplifies equity returns by allowing equity investors to control a larger asset than their capital alone could acquire. A \$3 million equity investment in a \$10 million property means that a 20% increase in property value, which is \$2 million, represents a roughly 67% return on the equity investment (\$2 million divided by \$3 million). Without leverage, the same 20% property appreciation on a \$3 million direct investment represents a 20% return.



The same amplification applies to losses. A 20% decline in property value eliminates approximately 67% of the equity cushion in the example above. A 30% decline eliminates the entire cushion, leaving equity holders with no residual value even before considering the costs of disposition. The risk and return tradeoff of leverage is symmetric in theory but asymmetric in practice. The upside is bounded by the property's appreciation potential, while the downside is bounded by zero. Equity investors cannot lose more than they invested, but they can lose all of it.

The appropriate level of leverage for a real estate syndication depends on the asset type, the investment strategy, the property's cash flow stability, the market environment, and the investor's risk tolerance. A stabilized multifamily property with predictable income and an agency loan at 65% LTV is a very different risk profile from a ground up development with a construction loan at 70% of cost and a floating rate. Both may be appropriate investments, but the disclosure of the leverage structure and its implications for investor risk must match the actual structure.

## Stress Testing the Capital Stack

A complete analysis of the capital stack's adequacy requires stress testing the structure against adverse scenarios. It is not enough to confirm that the numbers work under the base case. The scenarios that matter most are those in which the investment's performance falls short of projections, requiring the capital stack to absorb losses.

The stress test questions worth asking before any leveraged real estate investment:

- If the property generates 20% less NOI than projected, whether through higher vacancy, lower rents, or higher expenses, can the debt service still be covered from property income? If not, what is the source of coverage?
- If the floating rate debt increases by 200 basis points, a scenario that was unthinkable in 2021 and routine in 2023, what happens to the DSCR and the investor distribution capacity?
- If the exit cap rate is 50 basis points higher than the entry underwriting assumes, a realistic scenario in a rising rate environment, how does that affect the exit price and the equity remaining after debt repayment?
- If renovation costs exceed budget by 15% and the timeline extends by 6 months, is there sufficient interest reserve and liquidity to carry the project through stabilization without requiring an emergency capital call?
- If the asset needs to be sold in a distressed scenario, quickly, without the benefit of a full marketing process, what is the probable recovery for common equity holders after senior debt repayment and transaction costs?

These stress tests do not need to appear verbatim in the PPM's financial projections, but the risk factors section of the PPM should address each of these scenarios specifically in terms of what would happen to investor returns under the identified adverse conditions. Generic risk factor language stating that real estate investments are subject to market fluctuations does not satisfy the materiality standard for a specific leveraged deal.

## Capital Stack Disclosure in the Offering Documents

The capital stack of the specific investment is material information that must be disclosed in the PPM. At a minimum, the disclosure should address the total acquisition cost and the sources of capital; the amount, type, lender, and material terms of each debt tranche; the LTV and DSCR at origination; the fixed or floating rate structure; the loan term and extension options; the prepayment provisions; the bad boy carveout provisions and the parties who have executed the guaranty; and any mezzanine debt or preferred equity together with the rights of those capital providers in a distressed scenario.

A PPM that describes the investment in terms of the equity economics, including the preferred return, the waterfall, and the promote, without adequately disclosing the debt structure that sits above the equity in the capital stack has provided an incomplete picture of what investors are actually buying into. The equity return depends on the debt structure performing as expected. The risk of the equity investment is shaped by the debt structure's characteristics. Both dimensions belong in the disclosure.

### A Note on Capital Stack Structuring Legal Work

*The capital stack of a real estate syndication is not simply a financing decision. It is a legal structure with implications for the offering documents, the investor relationship, the operating agreement's transfer restrictions, the bad boy carveout disclosures, and the risk factor analysis. Each of these downstream implications requires securities counsel who understands the capital stack and who has reviewed the loan documents before the offering documents are finalized.*

*The sequencing that produces the best outcomes is straightforward. Financing terms should be negotiated and loan documents reviewed before the PPM is prepared. Not after, and not simultaneously. A PPM prepared without the loan documents in hand will not accurately describe the constraints that the debt structure imposes on the equity investors' rights.*

*Sponsors who want to discuss how the capital stack of a specific deal should be reflected in the offering documents are welcome to reach out at [crowdfundlawyer.com](http://crowdfundlawyer.com).*

## Practical Takeaways

- The capital stack is the hierarchy of financial claims against a real estate asset, consisting of senior debt, mezzanine debt or preferred equity, and common equity. Each layer has a defined payment priority, defined rights in a distressed scenario, and a risk and return profile that reflects its position. Investors in a syndication typically hold common equity, meaning last paid, first impaired, with full upside participation above all debt claims.
- LTV, DSCR, and debt yield are the three primary metrics lenders use to underwrite commercial real estate loans. LTV measures asset coverage, DSCR measures cash flow coverage, and debt yield measures income based loan support independent of appraised value. Understanding these metrics, and how the specific deal's metrics compare to lender requirements, is essential for any sponsor structuring a capital stack and for any investor evaluating it.
- Lender consent provisions in commercial real estate loan documents restrict ownership transfers. The operating agreement's transfer permission framework must be consistent with what the loan documents actually permit. Promising investors secondary market access without resolving the lender consent question creates legal exposure for the sponsor when investors attempt to exercise that right.
- Bad boy carveout provisions convert nonrecourse commercial real estate loans to full personal recourse for specified acts. Voluntary bankruptcy filing is the most significant carveout, and the most frequently triggered in distressed scenarios. The carveout guaranty terms are a material disclosure obligation in the offering documents.
- Agency financing (Fannie Mae, Freddie Mac, FHA, and HUD) provides the most competitive terms for multifamily assets, including high leverage, nonrecourse, and competitive rates. It imposes specific borrower entity requirements and transfer restriction frameworks that must be incorporated into the syndication structure. Agency financing is not available for most commercial asset classes.
- CMBS loans are flexible in their coverage of commercial property types but impose significant operational constraints. These include limited servicer modification authority, cash management trigger provisions, and expensive prepayment structures. These constraints affect investment flexibility and must be specifically disclosed in the PPM.
- Bridge loans and construction loans finance transitional and development assets. Both typically carry floating rates, and floating rate risk must be specifically disclosed in light of the 2022 and 2023 rate environment, which demonstrated how severely SOFR movements can stress value add business plans. Completion guaranty terms in construction loans create personal recourse for the sponsor's principals and are a material disclosure obligation.

- Preferred equity and mezzanine debt serve similar economic functions but have important legal differences in enforcement remedy timing, bankruptcy treatment, and tax treatment. In a distressed scenario, mezzanine lenders can foreclose on equity interests rapidly through UCC Article 9, wiping out common equity quickly. The presence of mezzanine debt or preferred equity in the capital stack must be specifically disclosed with an explanation of those parties' rights.
- The equity cushion, meaning the buffer between the property's value and the outstanding debt, determines how much value the property can lose before debt impairment. Stress testing the capital stack against adverse scenarios (lower NOI, higher rates, wider exit cap rates) is essential analysis that should inform the PPM's risk factor disclosure.
- The offering documents must specifically disclose the deal's complete capital stack, including sources of capital, debt terms, LTV, DSCR, floating rate risk, prepayment provisions, bad boy carveouts, and the rights of any subordinate capital providers. Generic real estate financing risk factors do not satisfy this obligation for a specific leveraged deal.

## CHAPTER NINE

# Key Investment Terms in Real Estate Syndications and Funds

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Investment terms in a real estate syndication do one thing. They define how money moves: how it comes in, how it is accounted for, how it accrues, and eventually how it flows back out. Every other aspect of the deal, including property operations, marketing, and asset management, ultimately resolves into these terms at the moment of distribution.

The preferred return, the distribution waterfall, the promote, the catch-up: these are not primarily concepts of financial analysis or real estate underwriting. They are legal terms. They live in the operating agreement. Their meaning, their calculation methodology, and the remedies available when they are not honored are all determined by the specific language of that document. In well drafted governing documents, these terms are defined with enough precision that both parties can calculate the outcome of any distribution event without ambiguity. In poorly drafted documents, they generate the disputes that end up in arbitration and litigation.

This chapter provides a comprehensive treatment of the key economic, structural, and governance terms that appear in real estate syndication and fund offering documents. Part A covers the economic terms, meaning the provisions that define how money is earned and distributed. Part B covers the fund governance terms, meaning the provisions that define how the investment is managed and how the relationship between sponsor and investors is governed across the investment's full life.

The goal is not merely to define these terms but to explain how they work in practice, where the most consequential drafting decisions are made, and where ambiguity most reliably produces disputes. Both sponsors building offering documents for the first time and investors evaluating whether the terms of a specific offering are reasonable and clearly expressed should find this material directly relevant.

### **PART A** **Economic Terms**

## Ownership Interests and Capital Contributions

In a conventional real estate syndication, an investor's ownership interest is documented in the operating agreement, reflected in the fund administrator's capital account records, and

evidenced by whatever records the LLC maintains. The cap table, meaning the record of who owns what, lives in a spreadsheet or in an administrator's system. Before any distribution can be calculated, the operating agreement must establish who owns what and in what proportion.

## **Membership Interests, Units, and Ownership Percentages**

In a manager managed LLC, investors hold membership interests. Those interests can be expressed as ownership percentages, for example Investor A holds a 12.5% non-managing membership interest, or as units, where the total outstanding units across all holders equals 100% of the membership.

Unit based structures have a practical advantage for deals with irregular investment amounts. If Investor A contributes \$250,000 and Investor B contributes \$375,000 in a \$1,000,000 raise, expressing their interests as 250,000 and 375,000 units out of 1,000,000 total units is mathematically cleaner than carrying six decimal ownership percentages across every distribution calculation. Either approach is legally sound. What matters is that the operating agreement defines the methodology clearly and applies it consistently.

Whatever form the interests take, the operating agreement must define the total number of interests or units authorized for issuance, the percentage each holder represents, and how pro rata calculations are performed at each tier of the waterfall. Ambiguity in any of these foundational definitions propagates through every downstream calculation.

## **Capital Accounts: The Accounting Record That Governs Everything**

The capital account is the running accounting record of each investor's economic position in the entity. It starts at the investor's initial capital contribution and is adjusted over the life of the investment by allocations of income and loss, additional contributions, and distributions received. At any point in time, each investor's capital account reflects their economic stake in the fund after all adjustments.

Capital accounts matter for three independent reasons. First, the distribution waterfall is typically calculated by reference to capital account balances, not the original contribution amount, particularly for preferred return calculations and return of capital determinations. Second, capital accounts are the basis for tax allocations: the entity's income, loss, and deductions are allocated to investors' capital accounts and reported on their Schedule K-1s. Third, on dissolution, each investor typically receives distributions equal to their positive capital account balance after all other claims are satisfied.

The capital account is maintained by the fund administrator and must be updated accurately at every distribution event and allocation cycle. Capital accounts that are maintained incorrectly, whether because the fund administrator is not applying the operating agreement's allocation

methodology correctly or because distributions are being recorded against the wrong investor accounts, produce incorrect K-1s and incorrect waterfall calculations at exit. Both outcomes are far more-expensive to correct after the fact than to prevent through competent fund administration from the beginning.

## Capital Account, Book Value, and Fair Market Value

These three measures describe different things, and the operating agreement should be specific about which measure governs which calculation.

**Capital account balance** tracks the accounting position of each investor's interest, adjusted for allocations and distributions. It is used for waterfall calculations and K-1 preparation. It is not a market value and does not reflect unrealized appreciation in the underlying property.

**Book value** is the accounting value of the entity's assets, typically cost basis reduced by accumulated depreciation. Real estate book value diverges substantially from fair market value over time as depreciation reduces the book basis while the property appreciates. A property with a \$2 million book value may have a fair market value of \$8 million after several years of appreciation.

**Fair market value** is what a willing buyer would pay a willing seller in an arm's length transaction. It is used for buying out departing investors, triggering buy sell mechanisms, determining the price in a forced sale, and calculating NAV in open end fund structures. It requires an appraisal or another objective valuation methodology when it governs a legally binding calculation.

Using the wrong measure in a calculation governed by the operating agreement produces incorrect results. An operating agreement that uses book value to determine a departing investor's buyout price in an LLC holding appreciated real estate will systematically underpay the departing investor. These errors are not always intentional. They typically arise from drafting that was insufficiently specific about which measure governs which calculation.

## Preferred Returns

The preferred return, often called the "pref," is the annualized return that investors are entitled to receive on their invested capital before the sponsor participates in profits. It is expressed as a percentage of invested capital. An 8% preferred return means investors receive an 8% annualized return on their capital before the sponsor earns any carried interest. It is the first hurdle in the distribution waterfall, the gating mechanism that ensures investors receive a minimum specified return before the sponsor earns any promoted interest.

The legal mechanics, including accrual, calculation, and payment, are defined in the operating agreement and applied by the fund administrator. Getting the mechanics right requires precision that many template operating agreements do not provide.

## Cumulative and Non-cumulative Preferred Returns

A cumulative preferred return means that unpaid preferred return accrues. If a deal generates insufficient cash flow to pay the full preferred return in a given year, the unpaid amount carries forward and continues to accrue. Investors must receive all cumulative accrued preferred return before the sponsor participates in profits.

A non-cumulative preferred return means unpaid amounts do not carry forward. If the deal does not generate enough cash flow to pay the preferred return in a given year, that year's shortfall is simply lost to investors. It does not accrue or compound. The vast majority of private real estate syndications use a cumulative preferred return, and investors should be alert to any structure that uses a non-cumulative preferred return without clear disclosure and a compelling justification.

### Non-cumulative Preferred Returns Require Specific Disclosure

*Most investors who see an “8% preferred return” in offering materials assume cumulative accrual. If the operating agreement implements a non-cumulative preferred return, that divergence from market standard must be specifically disclosed in the PPM. It should not be embedded in the operating agreement’s definition section where most investors will not read it carefully.*

*A sponsor who presents an “8% preferred return” in marketing materials and implements a non-cumulative structure in the governing documents has created a disclosure gap that can constitute a material omission under the antifraud standard. The economic value of a cumulative preferred return over a multi-year hold is substantially greater than a non-cumulative return. Investors who would have required different terms or declined the investment had they understood the distinction have a valid basis for a rescission claim.*

## Simple and Compounding Accrual

For cumulative preferred returns, the operating agreement must specify whether the accrual is simple or compounding. The distinction is economically significant over multi-year hold periods and must be addressed in the operating agreement, not left implicit.

Simple accrual applies the preferred return to the outstanding invested capital balance only, always the same base amount. An 8% simple preferred return on a \$1,000,000 investment accrues \$80,000 per year regardless of whether distributions have been made.



Compounding accrual applies the preferred return to the outstanding accrued balance, so accrued but unpaid preferred return itself earns the preferred return rate in subsequent periods. The economic difference compounds significantly over longer hold periods. A \$1,000,000 investment with an 8% cumulative preferred return accrues \$400,000 in simple preferred return over a five year hold with no interim distributions. Under annual compounding at 8%, the same investment generates approximately \$469,000 in accrued preferred return, a difference of about \$69,000, or roughly 17% more than the simple calculation.

Most private real estate syndications use simple accrual because it is easier to calculate and explain. Operating agreements that specify a preferred return rate without identifying simple or compounding accrual leave open a question whose answer matters economically, and ambiguity in that answer tends to be resolved in favor of whoever has more leverage in the dispute.

### Tracking Preferred Return Accrual

The fund administrator tracks each investor's preferred return accrual in the capital account system. The accounting system must capture each investor's contribution date, contribution amount, and any interim distributions received, and must apply the operating agreement's preferred return formula to calculate the accrual correctly for each investor, particularly for investors who contributed capital at different times.

Investors who contributed in a first closing and investors who contributed in a subsequent closing may have different accrual start dates, different accrual base amounts, and different cumulative pref balances at any given distribution date. The fund administrator's capital account system, not a single shared calculation, must track each investor's position individually. The capital account is the accounting record that governs what each investor actually receives. Errors in that record compound into incorrect distributions at exit.

### Preferred Return Structures in Common Use

Several preferred return structures appear in real estate offering documents, each with slightly different accounting implications.

- Non compounding preferred return. Accrues annually on invested capital at the stated rate. Unpaid amounts do not themselves earn the preferred return. Simplest for the fund administrator to track and easiest for investors to understand. The most common structure in private real estate syndications.
- Compounding preferred return. Unpaid accrued amounts compound at the stated rate, so the investor's pref balance grows faster in periods of limited distributions. Requires the fund administrator to maintain the compounding calculation period by period. More favorable to investors over extended holds with limited interim distributions.

- **IRR based preferred return.** The sponsor does not earn any promote unless investors achieve a specified annualized IRR on their actual invested capital over the actual hold period. More technically precise than a simple preferred return rate because it accounts for the timing of all cash flows, not just their amount. More common in institutional fund structures and increasingly expected by sophisticated LPs.

## Distribution Waterfalls

The distribution waterfall is the sequencing mechanism that determines who gets paid, in what order, and in what proportion. It is the most economically significant provision in the operating agreement, and the provision that generates the most disputes when it is ambiguous, internally inconsistent, or inadequately explained to investors before they commit capital.

The waterfall lives in the operating agreement. The fund administrator calculates the amounts at each tier. The actual payment, whether by wire transfer, ACH, or any other distribution mechanism, delivers those amounts to investors. Getting the calculation right requires a fund administrator who understands the waterfall formula and can apply it accurately to the specific facts of each distribution event, including interim distributions that occurred during the hold period.

### The Standard Four Tier Structure

**Tier 1, Return of Invested Capital.** Investors receive distributions equal to their original contributed capital. The operating agreement must specify whether “return of capital” means the original contribution, the current capital account balance, or some other defined amount, and whether interim operating distributions during the hold period reduce this obligation at exit.

**Tier 2, Preferred Return.** Investors receive the accrued and unpaid preferred return on their capital, meaning the amount earned over the hold period at the agreed rate, reduced by any preferred return distributions already made during the hold period. This calculation must be performed with precision. The contribution date of each investor’s capital, the accrual start date, and the amount of any interim preferred return payments all affect the final calculation.

**Tier 3, Catch Up (if present).** The sponsor receives distributions until reaching a defined proportion of total distributions made, typically structured so the sponsor reaches its target percentage of profits (excluding return of capital). Discussed in detail in the next section.

**Tier 4, Residual Profit Split.** Remaining profits are divided between investors and sponsor according to the agreed promote ratio, commonly 80/20, 75/25, or 70/30 in favor of investors.

## Worked Example: Standard Four Tier Waterfall on a \$10 Million Exit

### Assumptions

Investor equity contributed: \$4,000,000

Preferred return: 8% simple cumulative

Hold period: 4 years

Operating distributions paid to investors during the hold: \$800,000

Promote: 80/20 with a full sponsor catch up

Net sale proceeds available at exit (in addition to interim distributions): \$10,000,000

### Tier 1, Return of Capital

Investors receive their \$4,000,000 of contributed capital.

Investors: \$4,000,000 | Sponsor: \$0

### Tier 2, Preferred Return

Accrued preferred return:  $8\% \times \$4,000,000 \times 4 \text{ years} = \$1,280,000$

Less amounts already paid during the hold: \$800,000

Remaining preferred return paid at exit: \$480,000 to investors.

Investors: \$4,480,000 | Sponsor: \$0

### Tier 3, Sponsor Catch Up (Full Catch Up)

A full catch up is calibrated so the sponsor reaches 20% of all distributions excluding return of capital.

Investors have received \$1,280,000 of preferred return. That is the “80% side” of the catch up.

Grossed up basis for the catch up:  $\$1,280,000 / 0.80 = \$1,600,000$ .

Sponsor catch up:  $20\% \times \$1,600,000 = \$320,000$ .

Investors: \$4,480,000 | Sponsor: \$320,000

### Tier 4, Residual 80/20 Split

Remaining proceeds: \$10,000,000 minus \$4,000,000 minus \$480,000 minus \$320,000 = \$5,200,000.

80% to investors: \$4,160,000. 20% to sponsor: \$1,040,000.

Investors: \$8,640,000 | Sponsor: \$1,360,000

### Totals (Including Hold Period Distributions)

Total to investors: \$4,000,000 (ROC) + \$1,280,000 (pref, including \$800,000 paid during hold) + \$4,160,000 (residual) = \$9,440,000.

Total to sponsor: \$320,000 (catch up) + \$1,040,000 (residual) = \$1,360,000.

Combined: \$10,800,000, which equals \$10,000,000 of exit proceeds plus \$800,000 of interim operating distributions already paid.

### Profit Share Check

Total profit (all distributions other than return of capital):  $\$1,280,000 + \$320,000 + \$5,200,000 = \$6,800,000$ .

Sponsor share of profit:  $\$1,360,000 / \$6,800,000 = \text{exactly } 20\%$ .

Investor share of profit:  $\$5,440,000 / \$6,800,000 = \text{exactly } 80\%$ .

This is the design objective of a full catch up: the sponsor reaches the stated 20% promote on all non-return of capital distributions, no more and no less. Variations such as half catch up, no catch up, or a catch up calibrated on total distributions (including return of capital) produce materially different splits and must be modeled before the offering documents are finalized.

## Waterfall Calculation: The Fund Administrator's Function

Even in structures with automated distribution mechanics, the waterfall calculation is performed by the fund administrator, not automatically. The fund administrator determines how much each tier of the waterfall amounts to, which investors have satisfied their preferred return threshold, what the cumulative accrued preferred return balance is for each investor, and what the residual profit split should produce. These are accounting and legal determinations that require human judgment applied to the operating agreement's specific language.

The value of having a competent, experienced fund administrator, one who has administered real estate fund waterfalls before and understands both the accounting mechanics and the legal document governing them, cannot be overstated. A fund administrator who applies the waterfall formula incorrectly produces incorrect distributions. If those errors favor the sponsor, they create investor claims. If they favor investors, they create a clawback obligation. Neither outcome is acceptable.

### ⚠ Waterfall Ambiguity Is a Future Dispute

*Every ambiguous provision in the distribution waterfall is a future dispute that will be resolved either through negotiation between the parties (where the sponsor holds more operational information and leverage) or through litigation, which is expensive for everyone.*

*The most common waterfall ambiguities are the interaction between interim operating distributions and the preferred return calculation at exit; the treatment of investors who contributed capital at different times and therefore have different accrual periods; whether the catch up applies to operating distributions or only to exit proceeds; and the calculation methodology when multiple investors have different capital balances at different tiers.*

*These are predictable scenarios that arise in most multi-year syndications. An operating agreement that does not address them specifically is not a well drafted governing document.*

## The Promote (Carried Interest)

The promote, also called carried interest, is the mechanism by which the sponsor participates in the investment's upside disproportionate to any capital they have contributed. It is the primary economic incentive that aligns the sponsor's interests with investors' interests, and it is the reason sponsors continue working to maximize property performance after their preferred return is satisfied.

Twenty percent is the most common market convention. Sponsors receive 20% of profits above the preferred return and investors receive 80%. Sponsors with strong track records and investor demand for their deals may maintain this percentage. Sponsors with thinner track records may offer 15% or lower to attract capital. Ground up development deals and higher risk strategies sometimes feature 25% to 30% promotes in exchange for the elevated execution risk the sponsor is accepting.

### What the Promote Is and How It Aligns Interests

The promote aligns sponsor and investor interests by making the sponsor's primary economic upside contingent on investor performance. A sponsor whose promoted interest is worth nothing unless investors first receive their capital back and their preferred return has a direct financial incentive to maximize investment performance, not because they are ethically obligated to, but because their own economics depend on it. This is the alignment mechanism at the heart of the syndication model.

The alignment is real but imperfect. Affiliated fees, including acquisition fees, asset management fees, property management fees, and disposition fees, are earned regardless of investment performance. A sponsor who generates most of their income from fees rather than from promoted interest has weaker performance alignment than one whose economics are primarily promote dependent. The ratio of fee income to promote income in a sponsor's overall economics is a legitimate analytical question for sophisticated investors evaluating a manager's true incentive structure.

### Hurdle Rates: The Preferred Return as the Gating Mechanism

The hurdle rate is the performance threshold the investment must clear before the sponsor begins participating in profits. In most real estate syndications, the hurdle rate is expressed as a preferred return percentage. Investors must receive their 8% preferred return before the sponsor earns any promote. The preferred return is not just a return calculation mechanism. It is the sponsor's gating condition, and it should be understood as such.

An IRR hurdle, more common in institutional fund structures, is more technically precise than a simple preferred return rate because it accounts for the timing of cash flows rather than only their amount. An 8% IRR hurdle means investors must achieve an 8% annualized return on their actual invested capital over the actual investment period before the sponsor participates. IRR hurdles are more investor favorable when investors commit capital early and receive distributions late, because the time value analysis captures that benefit. They also require more sophisticated calculation by the fund administrator.

The choice between a preferred return hurdle and an IRR hurdle has meaningful economic implications. For individual investors in single asset syndications, the preferred return hurdle is more intuitive and more common. For fund structures with institutional investors, the IRR hurdle is increasingly expected. Whichever structure is used, the calculation methodology must be specified with precision sufficient to produce an unambiguous answer at every distribution event.

### **Tiered Waterfalls: Multiple Hurdle Structures**

A tiered waterfall adds additional performance thresholds and promote percentages above the base preferred return. A common structure might have three tiers. Investors receive their pref. The sponsor receives a 20% promote up to a 12% IRR. The sponsor receives a 25% promote up to an 18% IRR. The sponsor receives a 30% promote on returns above 18% IRR. Each tier provides incremental upside to the sponsor as performance improves, aligning interests across a wider range of return outcomes.

Tiered waterfalls add significant complexity to the waterfall calculation, which must be performed with precision by the fund administrator at each distribution event. Each tier boundary requires a precise definition of how the threshold is measured, how prior distributions are treated at the boundary, and how the catch up (if any) works at each tier. Tiered waterfall operating agreements that define the thresholds without specifying the calculation methodology at each boundary create multiple potential ambiguity points, each one a future dispute.

### **Catch Up Provisions: Accelerating Sponsor Distributions**

A catch up provision accelerates the sponsor's economics after the preferred return threshold is satisfied. Under a full catch up, once investors have received their preferred return, the sponsor receives 100% of subsequent distributions until the sponsor has reached its target promote

percentage of all distributions other than return of capital. The catch up brings the sponsor up to where it would have been if the promote had applied from the first dollar of profit.

From an investor perspective, the catch up means that a meaningful portion of post pref distributions flows to the sponsor in a short window after the preferred return is satisfied. The worked example above illustrates this. With a properly calibrated full catch up to a 20% target, the sponsor's total share of non-return of capital distributions is exactly 20%. Sponsors and investors should understand which formulation their operating agreement uses, because two structures both called a "full catch up" can produce different results: a catch up calibrated to 20% of all distributions other than return of capital is the institutional standard; a catch up calibrated to 20% of all distributions including return of capital is materially more sponsor favorable and is unusual in the institutional market.

Whether and how to structure the catch up is a legitimate negotiating point. Investors focused on total return often prefer a full catch up because it gives the sponsor a strong incentive to maximize performance beyond the preferred return threshold. Investors focused on the timing of cash flows may prefer a partial catch up, where the sponsor receives a portion greater than the promote but less than 100% during the catch up tier, or no catch up at all, with the promote applied proportionally from the first dollar of profit above the preferred return.

### **Clawback Provisions: Protecting Investors from Over Distribution**

A clawback provision requires the sponsor to return previously received carried interest if, on a cumulative basis at the end of the fund's life, the sponsor has received more than the promote percentage it was entitled to earn. Clawback provisions are most relevant in fund structures with deal by deal (American style) waterfalls, where carry is paid on profitable early exits before the fund's overall performance is established. They can also apply in structures where interim distributions resulted in the sponsor receiving carry before final accounting confirmed entitlement.

A well drafted clawback provision addresses four specific questions that generic clawback language typically leaves open.

- Calculation methodology. Is the clawback calculated on a deal by deal basis, comparing each deal's actual promote to what would have been earned under a whole fund waterfall? Or is it calculated only at final fund wind down, comparing total carry received to total carry earned on the cumulative portfolio? The answer produces very different clawback obligations and should be specified in the operating agreement before any carry is distributed.
- Pre-tax or post-tax calculation. Is the clawback calculated before or after the manager's income taxes on the previously received amounts? A sponsor who received \$1 million in



carry, paid \$350,000 in taxes, and retains \$650,000 faces very different financial hardship depending on whether the clawback obligation is \$1 million (Pre-tax) or \$650,000 (post-tax). Most institutional fund clawbacks are calculated on a net after tax basis.

- **Timing of the obligation.** Is the clawback owed at fund wind down? Or is it triggered on a rolling basis as individual deals are realized and the comparison between actual carry and earned carry is made? Rolling calculations impose more frequent obligations but prevent the sponsor from retaining carry on strong early performers if later assets underperform significantly.
- **Security for the obligation.** Is the sponsor required to maintain a funded reserve, meaning a portion of received carry held in escrow, to secure the clawback? Or is the clawback simply a contractual promise the sponsor is expected to honor from personal assets? Institutional investors increasingly require funded reserves or other security, particularly for sponsors whose principals may not have sufficient personal liquidity to fund a significant clawback obligation at wind down.

## IRR Hurdles and Equity Multiples

The two most commonly used performance metrics in private real estate, the internal rate of return and the equity multiple, measure different dimensions of investment performance. Both are used as benchmarks in offering materials and as hurdle rate triggers in tiered waterfall structures. Understanding what each measures and what each misses is essential for sponsors presenting returns and investors evaluating them.

### Internal Rate of Return: The Time Weighted Metric

IRR is the annualized discount rate at which the present value of all investment cash flows (contributions in, distributions out) equals zero. In plain language, it is the annualized rate of return that accounts for both the magnitude and the timing of every dollar invested and received. A dollar received in year two is worth more than the same dollar received in year five, and IRR captures that distinction.

IRR's time sensitivity is both its strength and its principal limitation. A deal that returns 2x equity in two years has a dramatically higher IRR than the same 2x return achieved over six years, even though the total profit is identical. IRR rewards speed of return and penalizes extended hold periods with back loaded distributions. This can create misaligned incentives. A sponsor focused primarily on maximizing IRR might prefer an early exit at a lower total return over a longer hold at higher total return if the IRR calculus favors the earlier exit.

In tiered waterfall structures with IRR based thresholds, the fund administrator needs to calculate the IRR at each distribution event to determine which promote tier applies to the



current payment. The timing precision of those calculations requires accurate records of the exact dates of each capital contribution and each distribution for every investor.

## Equity Multiple: The Total Return Metric

The equity multiple, sometimes called the investment multiple, is total distributions received divided by total equity invested. A \$1,000,000 investment that generates \$2,100,000 in total distributions has a 2.1x equity multiple. The equity multiple does not account for time, which makes it a complement to IRR rather than a substitute.

The equity multiple's simplicity is also its limitation. A 2.0x multiple achieved over two years is dramatically more attractive than the same 2.0x over ten years, and the equity multiple presents both identically. For individual investors who are less accustomed to IRR analysis, the equity multiple is often the more meaningful primary communication tool, supplemented by the expected hold period rather than an IRR calculation.

Using both metrics together, by reporting projected IRR alongside the projected equity multiple and the expected hold period, provides investors with the most complete return picture. Presenting IRR alone without the equity multiple, or the equity multiple without the expected hold period, is incomplete disclosure that favors whichever metric makes the specific deal look best.

| Dimension                | IRR (Internal Rate of Return)                                             | Equity Multiple                                                |
|--------------------------|---------------------------------------------------------------------------|----------------------------------------------------------------|
| What it measures         | Annualized return that accounts for the precise timing of all cash flows. | Total capital returned divided by total capital invested.      |
| Time sensitivity         | Very high. Same total profit produces a higher IRR when received sooner.  | None. 2.0x in 3 years looks identical to 2.0x in 10 years.     |
| Typical use              | Institutional comparisons; tiered waterfall trigger points.               | Individual investor communications; total return storytelling. |
| Key limitation           | Can incentivize early exit over total value maximization.                 | Provides no information about the timing of returns.           |
| Typical value add target | 13% to 18% net IRR is a common market benchmark.                          | 1.8x to 2.2x net equity multiple over a 4 to 6 year hold.      |

## Capital Contributions, Capital Calls, and Pro Rata Rights

Capital contributions are the funds investors pay into the SPV in exchange for their membership interests. In a single asset syndication where all equity is funded at closing, capital contributions

occur once and the capital structure is fixed. In a fund with unfunded commitments, capital calls are the central mechanism through which the investment relationship operates throughout the investment period.

### **Mandatory Capital Calls and the Commitment Obligation**

A mandatory capital call is a legal obligation. Investors who have committed to the fund must contribute the called amount within the notice period (typically ten business days) or face the consequences specified in the operating agreement's defaulting investor provisions. The capital call notice must specify the amount being called, the purpose of the call, the deadline by which investors must fund, and the wiring instructions.

Investors who commit to a fund and fail to maintain sufficient liquidity to fund capital calls when issued are creating a real governance problem for the fund. A fund that is counting on committed capital to close an acquisition, and has investors who cannot fund on time, faces a failed acquisition, a damaged broker relationship, and potential liability to the seller. Capital call commitments should be understood as genuine financial obligations, not statements of intention.

### **Defaulting Investor Provisions: The Teeth Behind the Obligation**

The commitment to fund capital calls is only as meaningful as the consequences for not funding them. Common defaulting investor provisions include the following.

- **Forfeiture.** Some or all of the defaulting investor's existing interest is forfeited as a penalty for the default.
- **Dilution.** The defaulting investor's ownership percentage is reduced by formula, with the diluted portion allocated to the investors who fund the call at a price favorable to the funding investors.
- **Forced loan.** The fund borrows the defaulting investor's portion from other investors, at an interest rate specified in the operating agreement, and the defaulting investor is obligated to repay the advance with interest.
- **Interest and fees.** The defaulting investor pays interest on the unfunded amount at a specified rate (often the preferred return rate plus a margin) from the date the call was due until the date it is funded.
- **Exclusion from future investments.** The defaulting investor loses the right to participate in future capital calls, and their interest is limited to their existing funded position.

The appropriate severity of defaulting investor provisions depends on the fund's capital needs and investor base. Whatever the specific terms, they must be disclosed in the PPM. Investors who do not understand the consequences of failing to fund a capital call before they commit are

investors who may be surprised by those consequences, and surprised investors become litigious investors.

## Pro Rata Rights and Preemptive Rights

Pro rata rights give existing investors the right to participate in future capital calls or additional investment opportunities in proportion to their current ownership percentage. In a fund context, pro rata participation in each capital call preserves each investor's proportional ownership. They contribute their proportionate share of each new investment on the same economic terms as the initial closing.

Pro rata rights become most important when the fund raises additional capital for new investments or when the fund has the option to increase its stake in an existing investment. An investor who exercises pro rata rights maintains their ownership percentage. An investor who cannot or does not exercise loses ownership percentage to the investors who fund the additional capital.

The operating agreement must specify the notice period for exercising pro rata rights, the mechanics of how the right is exercised, and what happens to the pro rata allocation of an investor who does not participate. Provisions that describe pro rata rights in general terms without specifying the operational procedures are provisions that will be litigated when the specific scenario arises.

## Voting Rights and Major Decision Thresholds

Voting rights in a real estate syndication define the decisions that require investor approval rather than manager unilateral action. In a manager managed LLC, the manager has broad authority to make most operating decisions without investor consent. But certain fundamental decisions are reserved for investor approval. These include selling the primary asset, extending the fund term, amending the operating agreement's economic terms, removing the manager, and similar major decisions.

## What Decisions Require Investor Approval

The specific list of major decisions varies across deals, but common categories include the following.

- Sale or disposition of the primary asset. The most significant decision, which ultimately determines investor returns and is irreversible once completed.
- Refinancing that materially changes the debt structure, particularly refinancing that increases leverage above the investment's underwritten level or extends the loan term beyond the fund's originally planned hold period.

- Amendments to the operating agreement that adversely affect investor economic rights, such as changes to the waterfall mechanics, preferred return rate, or promote percentage.
- Capital calls beyond the original committed amount, requiring investors to contribute more than the amount they originally committed.
- Related party transactions above specified thresholds, including transactions between the fund and entities affiliated with the manager, where the manager has a direct conflict of interest.
- Removal of the manager. Discussed in detail in Part B of this chapter.
- Dissolution of the entity other than in accordance with the fund's normal wind down provisions.

## Approval Thresholds

The threshold required for investor approval, whether simple majority (a majority of votes cast), supermajority (often 66.67% or 75%), or unanimous consent, should match the significance of the decision. Material economic changes warrant supermajority protection. Decisions that affect specific investors differently from others, such as amendments that reduce the preferred return for some investors while maintaining it for others, typically require unanimous consent of the affected investors, regardless of the general approval threshold for other major decisions.

Operating agreement provisions governing economic terms should specifically require that any amendment to the waterfall mechanics, preferred return rate, or promote percentage receive supermajority approval by investors, with the sponsor's own ownership interests excluded from the vote. An operating agreement that allows the sponsor's interests to count toward the approval threshold for amendments to the sponsor's own compensation creates an obvious conflict that sophisticated investors will not accept and that courts have been skeptical of.

## Written Consents and Meeting Procedures

The operating agreement should specify the procedures for calling and conducting investor votes. These include how much advance notice investors receive, what information must accompany the notice, what constitutes a quorum for a valid vote, how proxies are handled, and whether written consent without a formal meeting is permitted. Procedural requirements that are not met can render a vote invalid even if the substantive decision was otherwise appropriate.

In a fund with a large investor base spread across multiple states and time zones, written consent mechanisms (circulating a proposed resolution with a defined response deadline) are the standard approach. The operating agreement should authorize written consents explicitly and specify the procedures for executing, collecting, and tabulating them.

## **PART B**

# **Fund Governance Terms**

The terms in Part A apply to both single asset syndications and fund structures. The terms in Part B apply primarily to multi asset fund structures, meaning closed end funds raising capital for a portfolio of properties rather than for a single acquisition. Sponsors building a fund platform rather than executing individual deals need to understand these terms as well as the economic terms in Part A. These are the provisions where institutional investors spend most of their negotiating time, and where the quality of the legal documentation most directly signals the sponsor's institutional maturity.

## **Management Fees**

The management fee is the recurring annual fee paid to the sponsor for managing the fund. It is the ongoing compensation for the investment management function separate from the carried interest. Management fees are what keep the lights on at the sponsor's operation while the fund is assembling its portfolio and managing assets toward disposition.

### **How Management Fees Are Structured**

Management fees are most commonly expressed as a percentage of committed capital during the investment period, transitioning to a percentage of invested capital or net asset value after the investment period ends. A typical structure might be 1.5% to 2.0% of committed capital during the investment period, stepping down to 1.0% to 1.5% of invested capital or net asset value thereafter.

The distinction between committed capital and invested capital matters economically. During the investment period, committed capital includes both deployed and undeployed amounts, so the manager earns the full management fee even on capital not yet invested. This is standard market practice because the manager is actively sourcing and underwriting deals during the investment period even before capital is deployed. After the investment period, the fee transitions to invested capital to reflect that the manager is no longer expanding the portfolio.

### **Management Fee Offsets**

One of the most important and most frequently negotiated aspects of the management fee is the offset provision. Management fee offsets reduce the annual management fee by some percentage of the affiliated fees that the manager or its affiliates earn from the fund's portfolio during the year.

The logic is straightforward. Management fees are designed to cover the sponsor's operating costs. If the sponsor is also earning acquisition fees, asset management fees, and property management fees from the same assets, charging the full management fee on top of those fee streams means the sponsor is being compensated multiple times for overlapping services. The offset prevents this by requiring the sponsor to credit a portion of those other fees against the management fee.

Fee offset structures are among the most actively negotiated provisions in institutional fund documents. Sponsors want offsets limited to specific deal fees calculated at 50 cents on the dollar, where a \$100,000 acquisition fee generates a \$50,000 offset against the management fee. Institutional investors want broader offsets at 100 cents on the dollar. The negotiated result determines how much of the management fee the sponsor actually retains after offsetting.

### Fee Disclosure: A Legal Obligation, Not a Marketing Choice

The management fee, along with every other fee the sponsor or its affiliates may earn in connection with the fund, is material information that must be fully disclosed in the PPM. Fee disclosure needs to go beyond listing the fees. It must explain the calculation methodology, the payment timing, the offset structure, and how each fee interacts with the distribution waterfall.

A PPM that lists management fees without explaining how they are calculated, what services they compensate for, and how they interact with other fees and the management fee offset does not satisfy the disclosure standard. Investors who cannot understand the fee structure from the PPM alone cannot meaningfully evaluate the investment's net economics, and a PPM that obscures rather than clarifies the fee structure creates antifraud exposure for the sponsor.

## Other Affiliated Fees

Beyond the management fee, sponsors commonly earn additional fees in connection with specific transactions or activities within the fund. These affiliated fees are a legitimate component of sponsor compensation, but they create alignment concerns that must be addressed through disclosure, reasonableness, and in some cases LPAC oversight.

### The Common Affiliated Fee Categories

**Acquisition fees** are paid at the time a property is acquired, typically ranging from 0.5% to 2.0% of the acquisition price. They compensate the sponsor for deal sourcing, underwriting, and closing work.

**Asset management fees** are ongoing fees paid to the sponsor or an affiliate for managing the portfolio. In a fund context, the management fee is often intended to cover asset management functions, so a separate asset management fee can represent double compensation unless

offset against the management fee. The relationship between the management fee and any separate asset management fee must be clearly explained in the PPM.

**Property management fees** are paid to the sponsor or an affiliate for managing day to day property operations. If the sponsor self manages properties, this fee should be competitive with what a third party manager would charge for the same services. Sponsors who charge above market property management fees while simultaneously earning a management fee on the same assets create alignment concerns that sophisticated investors will scrutinize.

**Construction and renovation management fees** compensate the sponsor for overseeing capital improvement programs, typically expressed as a percentage of the renovation budget. In value add strategies where renovation is central to the investment thesis, this fee can be substantial. It should be disclosed with specificity about what services it covers and how it is calculated relative to the scope of the renovation program.

**Financing and refinancing fees** are sometimes charged at loan origination or refinancing. These fees are among the more difficult to justify to sophisticated investors, particularly when the sponsor is not performing specialized financing services beyond what a broker would provide. Their disclosure requires clear explanation of the services rendered in exchange for the fee.

**Disposition fees** are paid upon the sale of a property, typically ranging from 0.5% to 1.0% of the sale price. They compensate the sponsor for the disposition process. Because disposition fees and promoted interest are both paid at disposition, the sponsor receives two forms of compensation simultaneously at the moment of maximum fund liquidity, a structure worth examining carefully in the PPM's fee disclosure.

## The Alignment Problem with Affiliated Fees

The fundamental concern with affiliated fees is alignment. The sponsor's promoted interest aligns sponsor and investor interests by making the sponsor's primary upside contingent on superior performance. Affiliated fees (acquisition fees, asset management fees, property management fees, and disposition fees) are paid regardless of performance. They create income streams for the sponsor that do not depend on whether the investment succeeds.

This does not make affiliated fees impermissible. It does mean they need to be transparent, reasonable, and properly offset against the management fee where appropriate. A sophisticated investor, fully informed of the complete fee structure, should be able to conclude that each fee represents reasonable compensation for genuine services and that the total fee load, taken together with the promoted interest, creates appropriate alignment. If the total fee load is so high that the sponsor captures most of the economics regardless of performance, the promote structure has lost its alignment function.

## Fund Term and Investment Period

The fund term and investment period are the temporal boundaries within which the fund operates. They have significant practical and legal implications for both the sponsor and the investors.

### The Fund Term

The fund term is the total operating life of the fund, from the initial close of capital commitments to the final distribution and dissolution. For closed end real estate funds, the standard term is eight to twelve years, which is long enough to acquire properties, execute value add programs, and sell at favorable market timing. Most fund documents provide for one or two one year extensions of the fund term at the manager's election, with investor consent or LPAC approval required for extensions beyond that.

The fund term matters to investors because it defines how long their capital is committed. An investor in a ten year fund with two one year extensions is potentially committing capital for twelve years. That duration needs to be disclosed clearly and understood before the commitment is made.

### The Investment Period

The investment period is the window during which the fund may make new investments, acquire new properties, and call capital for those acquisitions. It typically spans the first half of the fund term. A ten year fund might have a five year investment period during which new acquisitions are made, followed by five years of asset management and disposition.

The investment period matters for several reasons. First, it constrains the manager's discretion. The manager cannot make new acquisitions or call capital for new investments after the investment period expires without investor consent. Second, it defines the period during which the management fee is calculated on committed capital rather than invested capital. Third, a key person event during the investment period triggers suspension of the investment period. The fund cannot call capital or close new deals until investors vote on whether to continue or wind down.

### When the Investment Period Ends: Practical Implications

Once the investment period expires, the fund enters a mode where it can manage and improve existing assets but cannot make new acquisitions or call new capital for investment purposes. Capital calls after this point can be made only for follow on investments in properties already owned (if the operating agreement permits) or to cover fund level expenses.



For sponsors, the expiration of the investment period marks the beginning of the harvest phase, the period where execution on existing assets and eventual disposition become the primary management priorities. The ongoing compliance obligations of the fund, including quarterly reporting, annual audits, K-1 preparation, and state blue sky compliance, do not diminish because the investment period has expired.

## Subsequent Closings

Most real estate funds raise capital in a series of closings rather than a single closing. The initial closing, which is the first point at which the manager accepts investor commitments and begins deploying capital, is followed by one or more subsequent closings that admit additional investors to the fund.

The mechanics of subsequent closings need to address a fairness problem. Investors who committed at the initial closing have their capital at risk from the moment investments are made and are therefore entitled to preferred return accrual from that date. Investors who join at a subsequent closing benefit from the initial closing investors' earlier deployment without having had their capital at risk for the same period.

The standard solution is an interest charge on late investors, often called a subscription equalizer or true up. Investors who participate in a subsequent closing typically pay interest on their committed capital from the date of the initial closing (or the date of the first investment) through the date of their actual subscription. This equalizes the economic position between early and late investors and prevents late investors from free riding on the appreciation generated before they joined.

Whatever equalization mechanism is used, the operating agreement must specify it clearly enough that the fund administrator can calculate each late investor's adjusted capital account with precision. Subsequent closing mechanics that are described in general terms without a specific calculation methodology create ambiguity about how early and late investors are treated economically, and that ambiguity will be noticed when the first distribution is made.

## Fund Expenses

The allocation of expenses between the fund (borne by investors) and the manager (borne by the sponsor from the management fee) is one of the most frequently negotiated provisions in fund documents and a common source of LP and GP friction.

### Expenses Typically Borne by the Fund

Fund level expenses properly charged to the fund and borne by investors include legal fees for fund formation, offering, and ongoing compliance; audit and accounting fees; fund administration fees; organizational expenses; transaction related legal and due diligence costs; taxes; and insurance. The PPM must identify which expenses are borne by the fund, because these costs reduce the capital available for investment and therefore reduce investor returns.

### Expenses Typically Borne by the Manager

The manager pays from its management fee the following types of costs: salaries and benefits for the management team; office rent and overhead; equipment and technology for the manager's operations; general administrative costs; and the marketing costs of fundraising. The operating agreement must be specific enough to resolve gray areas without requiring negotiation every time an expense arises. Examples include travel costs for investor relations visits, the cost of attending conferences where deal flow is generated, and the cost of the manager's accounting systems that generate the fund's financial statements.

## GP Commitment

The GP commitment, meaning the amount of capital the manager or its principals invest alongside investors in the fund, is one of the most important alignment signals available to investors evaluating whether to commit to a fund.

### Market Standards and What They Signal

The institutional market standard for GP commitment is typically 1% to 5% of total fund commitments. A \$50 million fund might require a \$500,000 to \$2,500,000 GP commitment. The sponsor invests that amount alongside LPs on the same economic terms and with the same exposure to loss.

A nominal GP commitment, such as \$50,000 in a \$50 million fund, sends a different signal than a meaningful one. It suggests that the manager does not have strong personal conviction in the fund's performance, or that the principals do not have sufficient capital to make a meaningful co-investment. Neither inference is favorable. For emerging managers who may not have sufficient liquid capital for a large GP commitment, the appropriate response is transparency. Investors can evaluate a smaller commitment in the context of the sponsor's stage of development. What they cannot easily forgive is a commitment described as meaningful in the PPM that turns out to be nominal in practice.

### How the GP Commitment Is Funded

The GP commitment is typically funded in the same proportion as LP capital calls. As deals are acquired and capital is called, the manager funds its pro rata share alongside investors. This

means the GP commitment is not a lump sum paid at the initial closing but a proportional contribution made over the investment period, which subjects the manager's capital to the same deployment risk as investor capital rather than allowing it to sit safely invested in other assets while LP capital is at risk.

Some managers allow principals of the management team to individually co invest in the fund as a way of satisfying the GP commitment. Individual principal co-investments require clear disclosure of which specific individuals are contributing, in what amounts, and on what economic terms.

## GP Removal

GP removal provisions give investors the ability to remove the fund manager and replace the fund's management in specified circumstances. They are the ultimate investor protection in a fund relationship and are among the most actively negotiated provisions in institutional fund documents.

### For Cause and No Fault Removal

For cause removal allows investors to remove the manager for specified bad acts: fraud, willful misconduct, gross negligence, criminal conviction, or breach of material obligations under the fund documents. For cause removal typically requires a majority or supermajority vote and takes effect upon the vote without the manager's consent. It is a baseline investor protection that institutional investors treat as non-negotiable.

No fault removal, sometimes called no cause removal, allows investors to remove the manager without any specific wrongdoing, simply because the investors have lost confidence in the manager's ability to execute the strategy. No fault removal typically requires a higher vote threshold (often 75% to 80% of investors by ownership percentage) and may include a carried interest tail. The removed manager retains some participation in the profits generated from investments made prior to removal, though no further carry accrues after removal.

The presence or absence of a no fault removal right, and the vote threshold required to exercise it, is a major negotiating point. Institutional investors expect the ability to remove an underperforming manager without having to prove fraud or gross negligence. Sponsors resist no fault removal provisions because they create governance risk. The compromise typically lands at a high threshold no fault removal right that is theoretically available but practically difficult to exercise without broad investor consensus.

### Post Removal Transition Mechanics

The mechanics of what happens after removal, including who manages the fund during the transition, how successor management is selected, how the removed manager's carried interest in the existing portfolio is treated, and what documentation the departing manager is required to provide, need to be defined clearly in the fund documents. A removal provision that terminates the management relationship without specifying the transition process creates a governance vacuum that harms investors more than the manager being removed.

In most well drafted fund documents, removal triggers an LPAC supervised transition process in which the LPAC coordinates successor management selection, the departing manager cooperates with transition documentation, and the fund's assets are protected during the gap period. The departing manager's right to receive carried interest on investments made prior to removal continues, but it is limited to the existing portfolio. No new investments enter the carry calculation after removal.

## Key Person Events

A key person event occurs when one or more of the individuals identified as key persons in the fund documents fail to satisfy the time commitment requirements for managing the fund, or when a key person departs the management team entirely.

### Why Key Person Provisions Exist

Investors in a real estate fund are investing in a team as much as a strategy. When an investor commits capital to a fund managed by a specific sponsor, they are doing so in reliance on the specific individuals who will source deals, make investment decisions, manage assets, and execute dispositions. Key person provisions address this concern by giving investors a defined remedy when the individuals who were the basis of their commitment are no longer running the fund.

### What Triggers a Key Person Event

The specific trigger conditions vary across funds but typically involve some combination of the following: a named key person departing the management team; a key person dedicating less than a specified percentage of their professional time to the fund's management (commonly 50% or more is required for the principals); or a key person becoming unable to perform their duties due to disability or other incapacity. The key persons should be named individuals, typically the principals of the sponsor who personally source and manage the fund's investments, not generic roles or institutional positions.

### What Happens After a Key Person Event

Upon a key person event, the investment period is suspended. No new investments and no new capital calls during the suspension. Investors are given a period (typically 180 days) to vote on whether to resume the investment period under the remaining management team, find a replacement for the departed key person and cure the event, or begin an orderly wind down of the existing portfolio. During the suspension period, the manager can continue managing existing assets and making follow on investments in properties already owned.

The investor vote mechanics, including who can vote, what threshold is required for each outcome, and what the default is if no threshold is reached, must be specified with precision. A key person provision that creates a suspension without defining how the suspension resolves creates a governance problem that can leave the fund in limbo, benefiting no one.

## Investment Limitations

Investment limitations are the contractual constraints on what the fund may invest in. They are the boundaries of the manager's discretion that investors relied upon when making their commitments. They define the investment mandate that was marketed to investors. Violations of investment limitations are not merely bad investment decisions. They are breaches of the fund's governing documents with legal consequences.

### Types of Investment Limitations

- **Asset class restrictions.** The fund may only invest in a specified asset class or must invest a minimum percentage in the primary asset class with limited deviation permitted.
- **Geographic restrictions.** Investments must be in specified states, metropolitan areas, or regions. Investments outside the defined geography require LPAC consent.
- **Concentration limits.** No single investment may exceed a specified percentage of total committed capital (often 20% to 25%), preventing the fund from becoming effectively a single asset vehicle.
- **Leverage limits.** Maximum leverage at the asset level and at the portfolio level. Prevents the manager from taking on debt that materially exceeds what investors underwrote when evaluating the strategy.
- **Investment size limits.** Minimum and maximum investment sizes, preventing investments that are either too small to justify the overhead or too large to maintain meaningful portfolio diversification.
- **Strategy restrictions.** The fund may only pursue value add investments, or may not undertake ground up development without LPAC consent.
- **Ethical or ESG exclusions.** Investments in specified sectors are prohibited if the fund's mandate or investor base requires such restrictions.

## The Consequences of Violating Investment Limitations

An investment that violates the fund's investment limitations is not simply one that investors might not like. It is a breach of the governing documents. Investors may have claims including indemnification claims against the manager, the right to require disposition of the non-conforming investment, and in some cases removal rights triggered by the material breach. Sponsors must maintain careful tracking of concentration limits, geographic exposure, and leverage levels across the portfolio to ensure ongoing compliance with the investment parameters investors committed to.

### Leverage

Leverage provisions in fund documents define the maximum amount of debt the fund may employ, at both the asset level and the portfolio level. They are a fundamental risk management parameter that investors rely on when assessing the risk profile of the fund.

Fund level leverage limits typically specify maximum loan to value ratios or debt to equity ratios at the aggregate portfolio level. A fund that limits leverage to 65% of portfolio value is operating a materially different risk profile than one that permits 80% LTV. Portfolio level limits can constrain aggregate leverage even if individual asset leverage is higher, providing a portfolio level risk management backstop.

Asset level leverage limits may be more or less permissive than portfolio level limits depending on the fund's strategy. A value add fund might permit 75% LTV on individual transitional acquisitions while maintaining a 65% portfolio level average, allowing higher asset leverage on specific opportunities while constraining overall portfolio leverage exposure.

Exceeding the leverage limits in the fund documents without appropriate consent is a breach of the governing documents. More practically, it represents a fundamental departure from the risk profile investors accepted when making their commitment. Changing the risk profile of the investment without investor consent is exactly the kind of conduct that key person and GP removal provisions are designed to address.

### Co-investments

Co-investment rights allow investors in the fund to invest additional capital alongside the fund in specific deals, participating beyond their pro rata fund ownership in opportunities that the manager identifies as particularly attractive.

## Why Co-investments Are Offered

Co-investments serve several purposes. They allow the fund to pursue deals that are larger than the fund's remaining uninvested capital can support on its own, by supplementing fund capital with co-investment capital from existing investors. They give investors with strong conviction about specific opportunities the ability to concentrate additional capital in those deals. They also serve as a relationship building tool. Investors who receive co-investment opportunities develop deeper engagement with the sponsor's platform.

In the institutional LP market, co-investment rights have become an expected feature of large fund commitments. LPs who commit significant capital to a fund often negotiate for priority co-investment allocation, which is the right to be offered co-investment opportunities before the broader LP base, as a condition of their anchor commitment.

### Co-investment Economics

Co-investments are typically offered at reduced economics relative to the fund. No management fee and no carry is the most LP favorable structure. Whatever economics apply to co-investments need to be clearly defined in both the fund documents and in the specific co-investment agreement for each transaction. Informal co-investment arrangements without a documented legal framework create the ambiguity that generates disputes when the specific deal does not perform as projected.

The co-investment allocation policy, meaning who gets offered how much of each co-investment opportunity, must be disclosed in the PPM and applied consistently. Selective allocation of co-investment opportunities, systematically favoring certain investors over others without disclosed criteria, raises fiduciary duty concerns and creates investor relations problems when the pattern is discovered.

## Successor Funds

Successor fund restrictions limit the manager's ability to raise a new, competing fund while the current fund is still in its investment period. They protect investors by ensuring that the manager's attention and deal flow remain focused on the current fund during the period when investment decisions are being made.

The standard successor fund restriction prohibits the manager from beginning to market a new fund with a similar investment mandate until a specified percentage of the current fund's committed capital has been invested or committed (typically 60% to 75%). Once that threshold is crossed, the manager may begin marketing the successor fund.

Successor fund restrictions also address the deal flow conflict that arises when a manager is simultaneously managing an existing fund and investing a new fund with a similar strategy. Fund documents typically require a written allocation policy that addresses how deals are

allocated between overlapping funds, and LPAC approval of that policy. A manager who consistently routes better deals to the newer fund at the expense of the older one has breached both the allocation policy and the fiduciary duty owed to the older fund's investors.

## **LP Withdrawal Rights and In Kind Distributions**

### **LP Withdrawal Rights**

In closed end funds, investors generally cannot withdraw their capital before the fund term ends. This illiquidity is a fundamental feature of the private real estate fund model. The fund holds illiquid real estate assets, and redemptions cannot be funded without selling properties, which may not be possible or advisable at any given moment.

Some closed end funds provide limited secondary transfer rights, allowing an LP to sell their interest to a third party buyer subject to manager consent and a right of first refusal by the manager or other LPs. These secondary transfers require coordination between the operating agreement's transfer restriction framework and the senior loan documents' membership interest transfer restrictions. An interest transfer that is permitted by the operating agreement but violates the loan documents' transfer restrictions can constitute a loan default.

Open end funds, by contrast, are designed with periodic redemption rights. These are quarterly or semi-annual windows during which investors can request redemptions at NAV, subject to gate provisions that limit total redemptions in any given period. For sponsors, the key disclosure obligation is to be precise and honest about what liquidity rights investors actually have, and specifically to avoid characterizing limited secondary transfer rights as equivalent to open end fund redemption rights.

### **In Kind Distributions**

An in kind distribution is a distribution of a non-cash asset, typically ownership interests in a property or a portfolio of properties, rather than cash. In kind distributions are uncommon in most real estate fund structures but arise in specific circumstances, most commonly during fund wind downs when properties cannot be sold at acceptable values.

In kind distributions raise valuation questions (how is the distributed asset valued for distribution calculation purposes?), tax questions (in kind distributions may have different tax treatment than cash distributions), and practical questions (how do individual investors take title to their fractional interest?). Fund documents should address the conditions under which in kind distributions may be made, the valuation methodology, and the mechanics of transferring the underlying property interests to investors.



## The Limited Partner Advisory Committee (LPAC)

The LPAC is one of the most important governance mechanisms in a real estate fund, and one of the provisions that distinguishes a professionally structured institutional fund from a less formally governed capital raise. Sponsors building funds with institutional investor participation will encounter LPAC requirements.

### What the LPAC Is

The LPAC is a committee composed of representatives from a subset of the fund's limited partners, typically the largest investors or those who specifically negotiated for LPAC representation. It is an advisory and oversight body, not a management body. The LPAC does not make investment decisions. It reviews and approves certain conflict of interest transactions, oversees compliance with investment limitations, and acts on key person events and removal situations.

The LPAC typically has three to seven members, with membership tied to investment size or participation at a specified closing. Institutional anchor investors who commit at or above a threshold amount often negotiate for guaranteed LPAC representation as a condition of their fund commitment.

### What the LPAC Does

The LPAC's primary functions fall into three categories. First, it reviews and approves conflicts of interest, specifically transactions between the fund and affiliated parties of the manager that would otherwise create conflicts. These include acquiring properties from affiliates, hiring affiliated service providers at above market rates, or allocating fund resources to related parties. These approvals protect the manager from later claims of self-dealing and give investors comfort that an independent body reviewed the arrangement.

Second, the LPAC approves specified departures from the fund's standard investment parameters: investments outside the geographic mandate, investments above the concentration limits, investments in asset classes not expressly within the investment strategy. These approvals protect the manager from later claims that it exceeded its authority.

Third, the LPAC acts on key person events and removal situations. Upon a key person event, the LPAC supervises the transition process. In a removal scenario, the LPAC typically coordinates the succession planning and serves as the governance counterparty in the transition documentation.

### What the LPAC Does Not Do

The LPAC does not manage the fund. It does not make investment decisions, approve individual acquisitions (unless an acquisition implicates an investment limitation), or oversee day to day operations. A sponsor who treats the LPAC as a co management body, seeking its input on ordinary investment decisions or using its approvals as cover for decisions the sponsor should be making independently, has misunderstood the LPAC's function and potentially created a governance problem.

An LPAC that functions properly protects both investors and the manager. It protects investors by providing structured oversight of conflicts and policy compliance. It protects the manager by providing documented, independent approval of transactions that might otherwise be challenged as self-dealing. This mutual protection function is why professionally structured funds view the LPAC as a feature rather than a constraint.

## Fund Governance Terms: Quick Reference

The following table summarizes the key fund governance terms covered in Part B, meaning the provisions that matter most in institutional fund documents and that distinguish a professionally structured fund from a less formally governed capital raise.

| Term              | What It Means                                                                         | Key Drafting and Negotiating Points                                                                                                                                           |
|-------------------|---------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| GP Commitment     | Manager's co-investment alongside LPs on the same economic terms.                     | 1% to 5% of total fund commitments is the institutional standard. Nominal amounts signal weak alignment. Disclosure must be specific about amount and funding mechanics.      |
| For Cause Removal | Removal for specified bad acts (fraud, misconduct, breach).                           | Baseline investor protection. Must include clear triggering events and post removal transition mechanics, including treatment of any carried interest tail.                   |
| No Fault Removal  | Removal by supermajority vote without specific wrongdoing.                            | 75% to 80% threshold is typical. May include a carried interest tail for existing investments. One of the most heavily negotiated provisions in institutional fund documents. |
| Key Person Event  | Named individual leaves or reduces time commitment, suspending the investment period. | Key persons should be named individuals, not generic roles. Suspension must have defined resolution mechanics. A 180 day investor vote period is standard.                    |

| Term                       | What It Means                                                            | Key Drafting and Negotiating Points                                                                                                                                                                |
|----------------------------|--------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Investment Limitations     | Contractual constraints on what the fund may acquire.                    | Violations are legal breaches, not strategy adjustments. LPAC approval is required for any departure. The fund must maintain tracking of concentration and leverage limits.                        |
| Leverage Limits            | Maximum debt at the asset and portfolio level.                           | Asset level and portfolio level limits may differ. Exceeding the limits without consent is a breach. Interacts with the lender consent framework.                                                  |
| Co-investment              | Right to invest additional capital alongside the fund in specific deals. | Allocation policy must be disclosed and applied consistently. Economics are typically reduced relative to the fund (no fee and no carry is common). Each co-investment requires its own agreement. |
| Successor Fund Restriction | Prohibits raising a competing fund during the investment period.         | A 60% to 75% deployment trigger is typical. Allocation policy is required for overlapping periods. LPAC approval of the allocation methodology is standard.                                        |
| LPAC                       | Committee of select LPs overseeing conflicts and policy compliance.      | Three to seven members. Membership tied to investment size. Approves conflict transactions, investment limitation departures, key person events, and removal transitions.                          |
| Administrative Amendment   | Minor corrections. No investor vote required.                            | Must be defined narrowly. LPAC should confirm characterization to prevent the manager from classifying material changes as administrative.                                                         |
| Material Amendment         | Requires investor vote at a specified threshold.                         | Economic term amendments should require supermajority of non-sponsor interests. Sponsor interests should be excluded from votes on sponsor compensation provisions.                                |

## Reports to Investors and Amendments

### Investor Reporting Obligations

The reporting obligations of a real estate fund manager are both a legal requirement under the fund documents and a critical component of the investor relations function. Standard reporting obligations include the following.

- Quarterly financial statements. Unaudited balance sheets and income statements for each portfolio asset and at the fund level, typically due 30 to 45 days after each quarter end.
- Annual audited financial statements. Prepared in accordance with GAAP, audited by an independent accounting firm, typically due 90 to 120 days after each fiscal year end.
- Annual fund reports. Narrative discussion of fund performance, portfolio status, market conditions, and the manager's outlook, typically accompanying the annual financial statements.
- K-1 tax reporting. Partnership K-1s for each investor, typically delivered by the Form 1065 due date (March 15 for calendar year partnerships, or the next business day if that date falls on a weekend or legal holiday) or by the extended due date (September 15) if the partnership has filed for an extension. Investors who transferred their interests during the year require pro rated K-1s reflecting income allocations for the portion of the year they held each position.
- Capital call notices. Advance notice (typically 10 business days) before each capital call, with the call amount, purpose, and wire instructions.
- Distribution notices. Notice accompanying each distribution, including total amount, per interest allocation, and the portion representing return of capital versus income.

These reporting obligations are contractual commitments that the manager must meet regardless of fund performance. A manager who is slow to produce financial statements during a difficult period, which is precisely when investors most want information, damages the relationship in ways that strong subsequent performance may not fully repair.

## **Amendments to Fund Documents**

Amendment provisions typically divide potential changes into categories based on their significance. Administrative amendments (corrections of typographical errors, updates to notice addresses, clarifications that do not affect substantive rights) can typically be made by the manager alone. Substantive amendments (modifications to economic terms, investment limitations, governance rights, or other material provisions) require investor approval at a specified threshold, often a majority or supermajority vote.

The most common amendment disputes arise from the manager's attempt to characterize a material change as an administrative amendment to avoid the LP vote requirement. LPAC oversight of the amendment process, requiring LPAC approval of the manager's

characterization of a proposed amendment as administrative, provides an important check. Provisions that modify the economic terms of the operating agreement should require supermajority approval by investors, with the sponsor's interests excluded from the vote.

## Alignment of Interests

Every investor who reads a real estate offering document is looking for the same thing behind all the defined terms and percentage calculations: evidence that the sponsor's interests are genuinely aligned with theirs. The preferred return, the promote, the catch up, the GP commitment, the key person provisions, and the removal rights are all structural mechanisms designed to answer the investor's fundamental question. Will the sponsor work as hard when the investment is struggling as when it is succeeding?

The same tools (meaningful preferred returns, sponsor co-investment, clawback provisions, key person protections, removal rights, and LPAC oversight) create alignment in a well-structured offering and fail to create it in a poorly structured one. Structure matters. Documentation matters. The precision of the language in the operating agreement matters. None of these structural tools works as intended if the language implementing them is ambiguous or incomplete.

### When Alignment Breaks Down

Alignment failures in real estate syndications typically involve one of three patterns. The first is a fee structure so heavy that the sponsor captures most of the economics regardless of performance. The promote becomes almost irrelevant to the sponsor's income because fee income is sufficient regardless of how the investment performs.

The second is a promote structure so sponsor favorable (low preferred return, high promote percentage, minimal co-investment) that the sponsor participates disproportionately in upside while investors bear most of the downside. This is an economic term negotiation problem. The appropriate response is for investors to negotiate better terms or decline the investment.

The third, and most legally consequential, is a governing document that does not accurately implement the economic terms the sponsor represented to investors. A PPM that describes an 8% cumulative preferred return with an 80/20 promote, paired with an operating agreement that implements something different, or that is ambiguous enough to be interpreted differently, is the alignment failure that creates the most serious legal exposure. It is also the one that experienced securities counsel reviewing the documents before they are distributed would most readily identify and correct.

### A Note on Counsel's Role in Document Review

*The terms covered in this chapter (preferred return, waterfall, promote, catch up, clawback, capital calls, defaulting investor provisions, LPAC, key person provisions, GP removal) are not concepts that have standard implementations. Every operating agreement makes specific drafting choices about each one. Those choices have economic consequences, legal consequences, and investor relations consequences that compound over multi-year hold periods.*

*Sponsors who review these terms in isolation, by reading a PPM but not the operating agreement, or by reading the operating agreement but not comparing it to the PPM, miss the inconsistencies that create the most serious problems. The documents must be reviewed as a system, by counsel who has seen enough of these transactions to know where the ambiguities tend to hide.*

*Investors evaluating a specific offering benefit from the same review. The relevant question is not just whether the headline terms are attractive, but whether the governing documents implement those terms with the precision required to produce the outcomes both parties expect. Sponsors and investors who want to discuss what that review involves for a specific offering or investment are welcome to reach out at [crowdfundlawyer.com](https://crowdfundlawyer.com).*

## Practical Takeaways

- Investment terms (preferred return, waterfall, promote, catch up, IRR hurdles, equity multiples) are legal terms that live in the operating agreement and are calculated by the fund administrator. They define how money moves. Ambiguity in any of them is a future dispute.
- The capital account is the accounting record that governs distribution calculations, tax allocations, and dissolution economics. It must be maintained accurately by a fund administrator who understands both the accounting mechanics and the specific operating agreement language that governs them.
- The preferred return is almost always cumulative in private real estate. Non-cumulative structures must be specifically and prominently disclosed. Simple or compounding accrual must be specified. The economic difference is material over a multi-year hold and will be calculated differently by the fund administrator depending on which approach is specified.
- The distribution waterfall is the most economically significant provision in the operating agreement. Work through the actual calculation with realistic assumptions, including interim distributions and investors with different contribution dates, before the offering

documents are distributed. The numbers often surprise sponsors who have not done the arithmetic.

- Catch up provisions come in several variations. A properly calibrated full catch up to the institutional standard brings the sponsor to exactly its stated promote percentage of all non-return of capital distributions. Variations such as half catch up, no catch up, or a catch up calibrated to total distributions including return of capital produce materially different splits. Investors should understand which variant their deal uses, and sponsors should disclose it specifically rather than allowing investors to discover it at exit.
- Clawback provisions require specific drafting on four questions: calculation methodology, Pre-tax or post-tax treatment, timing of the obligation, and security for the obligation. Generic clawback language that leaves these questions open is a litigation risk, not an investor protection.
- IRR and equity multiple should be presented together in offering materials. Each captures something the other misses. Presenting only the metric that favors the specific deal is incomplete disclosure.
- Management fees and affiliated fees are legitimate components of sponsor compensation. They create alignment problems when total fee load is so high that the sponsor captures most of the economics regardless of performance, or when they are inadequately disclosed in the PPM. Fee disclosure is a legal obligation, not a marketing choice.
- The fund term and investment period define the temporal boundaries of the fund's operation. The investment period's expiration constrains the manager's acquisition authority and triggers changes to the management fee calculation base. Key person events during the investment period trigger suspension mechanics that must be precisely defined.
- Key person provisions, GP removal rights, and investment limitations are the primary investor protections in a fund structure. Violations of investment limitations are legal breaches, not strategic adjustments. Removal mechanics must include post removal transition procedures, not just the right to remove.
- The LPAC protects both investors and the manager. It provides structured oversight of conflicts and policy compliance without managing the fund's investments. Amendment processes should require LPAC confirmation before the manager characterizes a change as administrative.
- Alignment between the sponsor and investors is achieved through structure and documentation. The preferred return, the promote, the co-investment, the clawback, and the key person provisions create alignment only when the documents implementing them are drafted with precision. Structure without precision is aspiration, not contract.





**CHAPTER TEN**

# How Sponsors Make Money

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Sponsor compensation is one of the most scrutinized aspects of any private real estate offering. Investors want to understand it completely before they write a check. Regulators want it disclosed in full before investors see the opportunity. And experienced deal lawyers know that fee structures drafted without care, including terms that seem reasonable in isolation but produce perverse incentives in combination, are a recurring source of investor disputes.

The fee categories, the disclosure obligations, and the alignment of interest analysis in a real estate syndication are specific and consequential. Every fee the sponsor earns, and every mechanism through which the sponsor participates in profits, must be fully and accurately described in the private placement memorandum, precisely documented in the operating agreement, and correctly reflected in the waterfall mechanics that govern how cash flows through the investment.

This chapter covers the full spectrum of sponsor compensation in a real estate syndication or fund, from the fees earned at formation through the final distribution at disposition. For each fee category, it addresses what the fee compensates, what market practice looks like, what the disclosure obligations require, and how the fee structure affects the alignment of sponsor and investor interests.

Sponsor compensation is also a legal compliance matter, not just a business negotiation. Fee disclosure failures are antifraud violations under Rule 10b-5, not merely technical omissions. The practical implication is simple. Every fee the sponsor receives must be in the documents, and the documents must match reality. The gap between what the PPM says and what actually happens is where investor claims begin.

## Organization and Formation Fees

Organization fees, sometimes called formation fees or offering expenses, compensate the sponsor for the time, resources, and out of pocket costs associated with structuring the investment, preparing the offering, and launching the capital raise. These activities include entity formation, legal drafting, accounting engagement, PPM preparation, and the administrative work of onboarding investors and managing the subscription process.

### What Organization Fees Cover

The organization fee compensates the sponsor for genuine pre-launch work that must be done before any investor capital is committed. That work includes evaluating the deal structure,

retaining and coordinating the legal team, reviewing and negotiating the purchase agreement, organizing the entity structure, supervising the preparation of the operating agreement and subscription documents, and managing the investor outreach and subscription process.

Organization fees are typically structured either as a flat dollar amount (commonly \$50,000 to \$150,000 depending on deal complexity) or as a percentage of the total equity raise (commonly 0.5% to 1.5%). In fund structures, organization fees may also include the costs of preparing the fund's LPA, PPM, and subscription agreement, which are typically more complex and more-expensive to produce than single asset offering documents.

Whether these costs are treated as organization fees paid to the sponsor (and reimbursed from offering proceeds), as offering expenses borne directly by the SPV, or as part of the use of proceeds calculation, they must be disclosed in the PPM. The disclosure must be specific enough that investors can evaluate what they are paying for and determine whether the costs are reasonable relative to the deal being offered.

### The Organization Fee in the Use of Proceeds Disclosure

A common structuring mistake is to bury formation costs in a broad organization fee without itemizing the components. Investors evaluating a \$9 million equity raise with a \$250,000 organization fee have very different reactions depending on whether that amount covers legal fees, accounting fees, entity formation, and PPM preparation, or whether it includes large categories of sponsor overhead that are less clearly related to deal specific costs.

The use of proceeds section of the PPM must account for all costs of the offering with sufficient specificity that investors can evaluate the total fee burden. Organization fees should be itemized where material: legal fees for offering document preparation, entity formation costs, accounting engagement, offering administration, and any other material components. Sponsors who aggregate all costs without itemization are taking a disclosure shortcut that creates investor relations problems and legal exposure.

#### **⚠ Use of Proceeds Disclosure Must Be Specific**

*The use of proceeds section of the PPM must account for all costs of the offering. A general "organization and offering expenses" category without meaningful itemization does not satisfy the disclosure obligation for a complex offering with multiple cost components.*

*Investors who commit capital to an offering are entitled to understand specifically what happens to their money from the moment it is funded. Organization fees that represent genuine deal related costs are legitimate and defensible. Undisclosed or inadequately*

*described fees are antifraud violations under Rule 10b-5 regardless of whether they represent reasonable compensation for genuine work.*

## Acquisition and Due Diligence Fees

The acquisition fee compensates the sponsor for identifying the investment opportunity, performing due diligence, negotiating the purchase agreement, arranging financing, and managing the closing process. It is the primary compensation mechanism for the deal sourcing and transaction execution function, the work that converts an opportunity into a closed investment.

### Structure and Market Rates

Acquisition fees are typically calculated as a percentage of the purchase price (commonly 0.5% to 2.0%, with some smaller deals or less established sponsors going higher) and are paid at or around the time the acquisition closes. On a \$20 million acquisition, a 1% acquisition fee is \$200,000. That is a meaningful sum that investors are entitled to understand and evaluate before committing capital.

Due diligence fees, where charged separately from acquisition fees, compensate the sponsor for the analytical and investigative work performed before the purchase agreement is signed: financial analysis, physical inspections, market studies, lease reviews, environmental assessments, and lender coordination. In practice, many sponsors combine these functions under a single acquisition fee. Others charge separate fees for deals where due diligence is unusually extensive or time consuming.

Market practice on acquisition fees varies by deal type and investor base. Institutional investors in fund structures are generally more skeptical of acquisition fees and may push for reduced rates or full offset against the management fee. High net worth individual investors in single asset syndications are generally more accepting of standard market acquisition fees, provided they are clearly disclosed and the services they compensate are clearly described.

### Disclosure Obligations for Acquisition Fees

Acquisition fees must be fully disclosed in the PPM. The disclosure should specify the calculation basis (percentage of purchase price, percentage of total project cost, or flat amount); the timing of payment; the party to which the fee is payable (typically the manager entity, not the SPV); whether the fee is subject to any cap; and whether the fee is deductible from or offset against the promote.

The dollar amount of the acquisition fee, not just the percentage, should appear in the PPM where it can be calculated at the time of disclosure. A 1% acquisition fee on a \$20 million purchase is \$200,000. Investors benefit from seeing that number alongside the percentage. The combination of percentage rate and dollar amount gives investors the information they need to evaluate the fee without requiring them to do arithmetic from incomplete information.

## Asset Management Fees

Once the property is acquired, the sponsor earns ongoing compensation for managing and overseeing the investment. Asset management fees are the primary form of that compensation. They represent payment for the sponsor's continuing work of monitoring property performance, implementing the business plan, reviewing financial reports, overseeing capital expenditure programs, managing the lender relationship, and making strategic decisions about the investment's direction.

### Calculation Basis: Equity or Asset Value

Asset management fees are calculated using one of two bases, and the choice between them has meaningful economic implications that must be disclosed and understood.

**Percentage of invested equity** (commonly 1% to 2% annually) ties the fee directly to the capital investors have committed to the investment. The fee base is fixed at the time of the offering and does not fluctuate with property performance or appreciation. A 1.5% annual asset management fee on \$5,000,000 of invested equity is \$75,000 per year regardless of what happens to the property's value.

**Percentage of gross asset value** (commonly 0.5% to 1% annually) ties the fee to the current appraised or estimated value of the property. If the property appreciates, the fee base increases, and the sponsor earns more. If the property value declines, the fee decreases. This structure can create alignment benefits, since the sponsor has an incentive to grow the asset's value, but it also creates volatility in fee income and can produce higher fees than investors anticipated when the asset appreciates significantly.

The operating agreement must specify the calculation basis, the payment frequency (quarterly or monthly is most common), and whether the fee is paid from operating cash flow before or after investor distributions. Most structures treat the asset management fee as an operating expense of the SPV that is paid before any waterfall distribution is made to investors or the sponsor. The distinction between the asset management fee (an operating expense) and the promoted interest (a distribution waterfall item) should be clearly established in both the PPM and the operating agreement.

## Market Rate Ranges by Deal Type

Asset management fee rates vary across deal types based on the intensity of management required and the conventions of the relevant market segment.

- Multifamily value add syndications. 1% to 2% of equity raised annually is the most common range. More complex renovation programs or larger portfolios tend toward the higher end.
- Stabilized commercial properties with net leases. 0.5% to 1% of equity, or 0.25% to 0.5% of asset value annually, is typical, reflecting the lower ongoing management intensity of a triple net investment.
- Ground up development projects. 1.5% to 2.5% of total project cost during the development period, reflecting the intensive management of a construction program. This rate typically transitions to a lower rate once the property is stabilized.
- Real estate funds. 1% to 2% of committed capital during the investment period, stepping down to 1% to 1.5% of invested capital or net asset value after the investment period ends.

These ranges reflect market convention, not regulatory limits. Sponsors who charge above market rates without a compelling justification create investor relations problems and potential legal exposure. Above market fees that are inadequately disclosed represent the kind of conflict of interest that the antifraud provisions target.

## Fee Subordination and Cash Flow Adequacy

One structural question the operating agreement must address specifically is whether the asset management fee is subordinated to investor distributions, meaning whether it is paid only when cash flow is available or whether it accrues as an obligation of the SPV even during periods when cash flow is insufficient to pay it currently. Most operating agreements for single asset syndications require current payment of asset management fees from operating cash flow. Most fund structures allow the fee to accrue during periods of insufficient cash flow, with the accrued amount payable when cash is available.

Subordination matters for investors who are evaluating cash flow projections. A \$75,000 annual asset management fee that is guaranteed to be paid regardless of property cash flow affects the investor distribution calculation differently than a fee that is only paid if cash flow is sufficient after covering operating expenses and debt service. The treatment must be disclosed, and the projections must reflect it accurately.

## Property Management Fees

If the sponsor or a sponsor affiliated entity provides property management services, handling leasing, rent collection, tenant relations, maintenance coordination, and on site staffing, the sponsor may earn a property management fee in addition to the asset management fee. This fee reflects a genuinely separate function. Asset management oversees the investment at the strategic level. Property management handles the daily operational reality.

Property management fees are typically calculated as a percentage of gross rental revenue (commonly 4% to 8% depending on property type and market, sometimes higher on smaller or operationally intensive properties). Multifamily residential properties generally fall at the higher end of that range due to the higher turnover and operational intensity of managing many individual lease relationships. Single tenant net lease commercial properties fall at the lower end, reflecting the limited operational demands of an asset where the tenant handles most maintenance obligations directly.

Where the sponsor uses a third party property manager (which is common and often preferred by investors because it separates strategic oversight from day to day operations and provides a market rate benchmark), the property management fee goes to the third party rather than to the sponsor. In that case, the fee still appears in the PPM as an operating expense, but it does not represent sponsor compensation. The PPM should clearly distinguish between affiliated and unaffiliated property management arrangements.

### **Affiliated Property Management: Conflict Disclosure**

When the sponsor or a sponsor related entity provides property management, the arrangement creates a conflict of interest that must be disclosed in the PPM. The sponsor is earning revenue from a service contract with an entity it controls, namely the SPV, which creates an incentive to overpay for property management services relative to what an arm's length market transaction would produce. The operating agreement should require that any affiliated property management agreement be on terms no less favorable to the SPV than would be available from an unaffiliated third party. The PPM should disclose the affiliation, the fee rate, and the basis for concluding that the arrangement is commercially reasonable.

Affiliated property management arrangements should specifically address the term of the management agreement and the conditions under which it can be terminated (including termination by investors upon a manager default or removal); the standard of services required; any markup on expenses passed through to the SPV; and the process for verifying that the fee is within market range. An affiliated property management arrangement that cannot be terminated for any reason short of fraud is an arrangement that institutional investors will not accept and that creates legal exposure even in deals with more permissive investor bases.

## Construction Management and Renovation Fees

For value add and ground up development projects, the sponsor typically earns a construction oversight or development management fee for supervising the renovation, redevelopment, or construction program. This fee compensates the sponsor for coordinating architects, engineers, and contractors; managing construction timelines and budgets; overseeing quality control; handling regulatory approvals associated with physical improvements; and managing the draw process with lenders who control construction loan disbursements.

### Structure and Market Rates

Construction and development management fees are typically calculated as a percentage of total construction or renovation costs (commonly 3% to 5%) and are paid in installments over the course of the construction program rather than in a single lump sum. Payment schedules are often tied to construction milestones: a portion upon commencement, periodic draws as specific stages are completed, and a final payment upon substantial completion. Milestone based payment schedules are more aligned with investor interests than front loaded fee structures that pay the full fee before construction is complete.

The operating agreement should specify the calculation basis (percentage of construction budget, percentage of actual costs, or both); the payment schedule, including any milestone conditions; whether the fee applies to the original budget only or extends to change orders and cost overruns; and the maximum dollar amount of the fee if expressed as a percentage of a variable cost base.

### Presenting the Dollar Amount, Not Just the Percentage

Construction management fees should be disclosed in the PPM with the expected dollar amount, not just the percentage. A 4% construction management fee on a \$4 million renovation budget is \$160,000, a meaningful number that investors should evaluate as part of the total fee structure. On a \$500,000 renovation on a \$15 million asset, the same rate produces \$20,000, which is also reasonable but requires no separate disclosure emphasis. Context matters, and presenting the dollar amount alongside the percentage provides that context.

Investors should also understand the total construction management fee as a percentage of the total investment, not just as a percentage of construction costs. A \$160,000 construction management fee on a \$2,000,000 equity raise represents 8% of equity. That perspective, the fee as a percentage of investor capital rather than as a percentage of the construction budget, is often more informative for the alignment analysis investors are performing.

## Financing and Refinancing Fees



## Loan Origination and Debt Placement Fees

Sponsors who arrange the debt financing for an acquisition, including negotiating with lenders, structuring the loan terms, preparing loan packages, and managing the loan closing process, sometimes receive a loan origination fee or debt placement fee as compensation for that work. These fees are typically calculated as a percentage of the loan amount, commonly 0.25% to 1.0%, and are paid at closing.

Debt placement fees create a conflict of interest that must be disclosed. The sponsor is being compensated to arrange financing, which creates an incentive to maximize the loan amount or to select the lender who provides the most favorable economics to the sponsor rather than the lender offering the best terms for investors. The PPM must disclose whether the sponsor receives any compensation from the lender in connection with the financing arrangement, since some lenders pay origination fees directly to intermediaries who bring them business, and must make clear that the lender arrangement was negotiated with the investors' interests in mind.

## Refinance Fee

A refinance fee compensates the sponsor for arranging a refinancing of the investment property during the hold period. Refinancing may reduce the interest rate, extend the loan term, access equity created by appreciation to return capital to investors, or reposition the financing structure in anticipation of a sale. The refinance fee is typically calculated as a percentage of the new loan amount, commonly 0.5% to 1.0%, and is paid at the refinancing close.

The justification for a refinance fee depends on whether the sponsor is providing genuine financing services in connection with the refinancing (sourcing the new lender, negotiating terms, coordinating the closing process), or whether the refinancing is a routine renewal with an existing lender that requires minimal sponsor effort. A refinance fee on a complex recapitalization that requires sourcing new financing and negotiating with multiple lenders is more defensible than a refinance fee on a simple rate reset with the existing lender. The PPM should be clear about what services the refinance fee compensates and the conditions under which it would be triggered.

## Disposition Fees

The disposition fee compensates the sponsor for managing the sale of the property: identifying potential buyers, running the marketing process, negotiating the purchase agreement, coordinating buyer due diligence, managing the lender payoff, and overseeing the closing. Disposition fees are typically calculated as a percentage of the gross sale price, commonly 0.5% to 2.0%, and are paid at closing.



The disposition fee is distinctive because it coincides with the payment of the promoted interest. At exit, the moment when the investment generates its largest cash flows, the sponsor receives the disposition fee and the promote simultaneously. This concentration of sponsor compensation at the moment of maximum liquidity is not inherently problematic, but it is a feature of the compensation structure that investors should understand. The PPM's fee disclosure section should address both the disposition fee and the promote, and the operating agreement should clearly specify the sequence: fees are paid before the waterfall calculation is applied to the remaining proceeds.

## The Critical Sequencing Point

The sequencing of the disposition fee relative to the waterfall calculation is a point of precision that matters economically and that automated distribution systems sometimes implement incorrectly. The disposition fee, along with any final period asset management fees, expense reimbursements, and other closing costs, must be deducted from gross disposition proceeds before the distribution waterfall is applied. The waterfall distributes what remains after those deductions, not the gross proceeds.

### **⚠ Disposition Fees Must Be Paid Before the Waterfall Calculation Applies**

*The disposition fee, final period asset management fees, and any other fees payable at closing are deducted from gross disposition proceeds before the distribution waterfall is applied. If the fund administrator or any automated distribution system applies the waterfall to gross proceeds before deducting fees, investors receive distributions calculated on an overstated base. That overpays investors at the sponsor's expense, which then requires a clawback.*

*The operating agreement must specify the order of operations explicitly. Gross proceeds, minus closing costs, minus fees, equals distributable proceeds. Then the waterfall applies to distributable proceeds. Any distribution implementation, automated or manual, must follow this sequence correctly.*

*This error is more common than it should be, particularly in first time offerings. Securities counsel reviewing the distribution mechanics against the operating agreement before any distribution is processed provides the verification that prevents it.*

## Carried Interest and the Promote

The promote, called carried interest in the fund context, is where the sponsor participates in the investment's long term success. After investors have received their capital back and their

preferred return, the sponsor receives a disproportionate share of remaining profits. This structure is designed to align the sponsor's financial incentive with the investment's performance. The promote has no value if the investment does not perform above the hurdle.

From a documentation standpoint, the promote is the most important and most complex element of the sponsor's compensation structure. Its calculation depends on the entire history of cash flows into and out of the investment: the timing and amount of capital contributions, the timing and amount of all distributions, and the applicable preferred return threshold. A promote calculated incorrectly at disposition may result in the sponsor taking too much (creating investor claims) or too little (which the sponsor will notice and contest). Precision in the operating agreement's waterfall provisions is not optional. It is the foundation of every distribution calculation the fund administrator will ever make.

### **Promote as a Distribution Right and as a Co-investment Interest**

The promote is typically structured as a distribution right of the manager entity. It is a contractual entitlement defined in the operating agreement, separate from any capital investment the sponsor makes alongside investors. The manager entity's promote is not a return on capital invested. It is a negotiated share of profits above a threshold, earned through the management work the sponsor performs over the investment's life.

That structure, the promote as a distribution right and investor capital as the equity interest, is the clean architecture. The sponsor's economic interest in the investment is entirely defined in the operating agreement. The investor's economic interest is represented by their membership interest. The two are separate and clearly distinguishable. The operating agreement governs both, and the fund administrator calculates both at each distribution event.

Some sponsors choose to participate in the investment as a co investor, contributing capital alongside investors and holding a membership interest in the same class, in addition to holding the promote right as manager. When the sponsor has both a capital interest and a promote interest, the operating agreement must clearly define what portion of each distribution belongs to the sponsor's capital position and what portion belongs to the manager's promote position. Mixing the two without clear documentation creates accounting complexity and investor relations problems when the distribution waterfall is applied.

### **Catch Up Distributions**

Catch up provisions, as discussed in Chapter 9, allow the sponsor to receive a concentrated allocation of profits for a defined period after the preferred return is satisfied, until the sponsor has reached a specified share of all distributions other than return of capital. The catch up is then complete, and the standard promote split governs ongoing distributions.

The catch up calculation is performed by the fund administrator using the same accounting logic applied throughout the investment's life. What the operating agreement must ensure is that the order of operations in the distribution calculation is clear. Preferred return is satisfied first. The catch up tier begins only after the preferred return is fully satisfied. The catch up ends when the specified cumulative ratio is reached. The residual split begins at that point. Each of these transitions requires precision in both the operating agreement's definition and the fund administrator's implementation.

## The Sponsor's Co-investment

The sponsor's co-investment, meaning the amount of capital the sponsor contributes to the investment alongside investors, is the most direct form of alignment available in the syndication structure. A sponsor who has meaningful personal capital at risk in the same investment, on the same terms, as the investors they are managing has a financial incentive that parallels investor incentives in a way that fee compensation alone does not create.

### Why Co-investment Matters to Investors

The promote aligns the sponsor's upside participation with investor performance. The sponsor makes more when investors make more above the hurdle. But the promote does not expose the sponsor to downside risk. If the investment loses value, investors lose capital. The sponsor loses the economic value of the promote, but not personal capital (unless they have co invested).

Co-investment changes that calculus. A sponsor who has contributed 3% to 5% of the equity alongside investors experiences a real dollar loss if the investment underperforms, a loss proportionate to their co-investment, on the same terms as investor losses. That personal financial exposure is a credibility signal that fee structures and promote percentages cannot replicate. The sponsor has backed their judgment with their own money.

Institutional investors understand this distinction clearly and expect meaningful co-investment from sponsors whose funds they commit to. The institutional market standard for fund co-investment is typically 1% to 5% of total commitments, which is enough to be economically meaningful but not so large as to create liquidity constraints on the management team. Individual high net worth investors in single asset syndications similarly expect to see co-investment, even if they are less likely to require it contractually.

### How Co-investment Is Structured

Co-investment is typically structured as a capital contribution by the sponsor's management entity or by individual principals of the sponsor to the same SPV or fund entity in which investors participate, on the same economic terms as investor contributions. The sponsor contributes

capital, receives membership interests at the investor price, and participates in distributions through the same waterfall as investors.

Several variations exist.

- Direct capital contribution at closing. The sponsor funds its co-investment alongside investor capital at the time of the initial closing. This is the cleanest structure and the most clearly verifiable.
- Proportional contribution with capital calls. In fund structures, the sponsor's co-investment commitment is funded in the same proportion as LP capital calls. As acquisitions are made and capital is drawn, the sponsor funds its pro rata share. This subjects the sponsor's capital to the same deployment risk as investor capital.
- Individual principal co-investment. Rather than the management entity contributing as the co investor, individual principals of the sponsor team contribute personally. This approach is sometimes used when the management entity does not have sufficient capital to make a meaningful contribution, and it achieves the same alignment signal through different mechanics. Individual contributions should be specifically disclosed. The PPM should identify who is contributing, in what amount, and on what terms.
- Deferred fee conversion. In some structures, the sponsor converts a portion of earned fees into an equity interest in the investment rather than receiving cash. This approach produces co-investment but does not require the sponsor to commit liquid capital. It is a legitimate structure, but it should be disclosed as fee conversion rather than as new capital contribution. The two are economically different.

Whatever form the co-investment takes, it must be disclosed specifically in the PPM: the amount, the contributor (management entity or principals), the terms, and how the contribution compares to total equity raised. A PPM that describes a 3% co-investment without specifying that it consists of fee conversions rather than new capital has not provided complete disclosure.

## Co-investment and the Alignment Signal

The co-investment is not just a financial arrangement. It is a communication about the sponsor's conviction in the investment. A sponsor who contributes 5% of the equity from personal capital has made a statement about their confidence in the underwriting that words in a pitch deck cannot replicate. A sponsor who contributes a nominal amount, or who structures the co-investment through accounting entries rather than through actual capital, has communicated something different.

Sophisticated investors notice this distinction. They ask not just whether a co-investment exists, but whether it is meaningful in relation to the sponsor's net worth and whether it is structured so that the sponsor actually feels the same economic pain as investors if the deal goes poorly. The

answers inform their assessment of the sponsor's confidence in their own work, an assessment that matters at least as much as any metric in the offering documents.

## Expense Reimbursements

Sponsors regularly incur out of pocket expenses in connection with sourcing, evaluating, and managing investments. These include travel costs, third party reports, legal fees for deal specific work, accounting fees, and the administrative costs of managing investor relationships. In most syndications, the SPV reimburses the sponsor for reasonable out of pocket expenses incurred on behalf of the investment, subject to the limitations and approval requirements specified in the operating agreement.

Expense reimbursements are not compensation in the same sense as fees. They are intended to return to the sponsor money actually spent on the investment's behalf, at cost and without markup. The operating agreement should be clear about this characterization. Expenses are reimbursed at cost, not marked up for profit. A sponsor who reimburses expenses above cost has effectively created a fee that was not disclosed as such.

The operating agreement should specify which expense categories are reimbursable (travel, third party reports, legal fees, accounting fees, and similar investment related costs); the approval process for large expenses (expenses above a specified threshold requiring prior approval from a specified party or committee); and any caps on reimbursable expenses in any given period. Without caps and approval processes, the expense reimbursement mechanism can become a vehicle for transferring costs from the sponsor's management business to the investment, which is precisely the kind of undisclosed cost transfer that the antifraud provisions prohibit.

## Fee Disclosure Obligations

Every fee the sponsor earns, and every expense the SPV reimburses, must be disclosed in the private placement memorandum. This is not an area where minimalism is a virtue. The antifraud provisions of federal securities law require that investors receive full and fair disclosure of all material information, and the fee structure is by definition material. Investors can and do make investment decisions based on how they evaluate sponsor compensation relative to projected returns.

### What Full Disclosure Requires

A PPM's fee disclosure section for a real estate offering should specifically address the items below.

- Each fee category, including its name, its calculation basis, the party to whom it is payable, and the timing of payment. Generic descriptions such as “sponsor fees” without specification of which entity receives the fee, on what basis, and when it is paid do not satisfy the disclosure standard.
- The dollar amount of each fee where calculable at the time of the offering, not just the percentage. A 1.5% acquisition fee on a \$22 million purchase is \$330,000, and investors benefit from seeing the dollar amount alongside the percentage. The combination of percentage rate and dollar amount provides the complete picture without requiring investors to do arithmetic.
- The total projected fee load, meaning the sum of all fees payable over the projected hold period, expressed both as a dollar amount and as a percentage of total equity raised. This composite view allows investors to evaluate the overall fee burden rather than evaluating each fee in isolation, which can obscure a total fee structure that is individually reasonable but collectively excessive.
- All affiliated transactions, meaning fees paid to sponsor related parties, including property management fees to an affiliated property manager, construction management fees to an affiliated construction entity, and any other service fees flowing from the SPV to entities controlled by or related to the sponsor. Affiliated transactions must be disclosed in the PPM’s conflicts of interest section in addition to the fee disclosure section, and the arm’s length character of each arrangement must be specifically addressed.
- Fee modifications and waivers, including any circumstance in which a disclosed fee may be reduced, deferred, or waived, and the conditions that would trigger such a modification. A sponsor who waives fees during a period of property distress should ensure that the waiver is documented and disclosed as it occurs, not treated as an informal accommodation.

The fee disclosure should appear prominently in the PPM, not buried in the operating agreement summary or distributed across multiple sections without cross references. Investors who cannot find and understand the full fee picture from the PPM alone have not received adequate disclosure.

## Conflicts of Interest Disclosure

Every arrangement in which the sponsor earns fees from the investment for services that are also in the sponsor’s own interest to provide creates a conflict of interest that must be disclosed specifically. The conflict arises because the sponsor, as manager of the SPV, is both the party who decides whether to hire a service provider and a beneficiary of the arrangement when the service provider is itself affiliated with the sponsor.

The principal conflicts requiring disclosure in most real estate syndications are described below.

**Affiliated property management.** The sponsor decides how much to pay for property management services while also receiving those payments through an affiliated manager. The conflict is that the sponsor could prefer higher property management fees, which increase the sponsor's income, over the investors' interest in competitive management costs.

**Affiliated construction management.** The sponsor oversees a renovation program while also receiving a construction management fee through an affiliated entity. The conflict is that the sponsor has an interest in maximizing the scope and cost of the renovation, which increases the construction management fee, rather than optimizing the renovation for investment returns.

**Affiliated financing.** Where the sponsor or its affiliates receive compensation in connection with arranging debt financing, the conflict is that the sponsor may prefer the lender who provides the most favorable economics to the sponsor rather than the lender offering the best overall terms for the investment.

**Cross deal conflicts.** Sponsors who manage multiple simultaneous investments face conflicts in allocating their time, deal flow, and resources across their portfolio. Fund documents should address the allocation policy that governs how the sponsor handles these cross deal conflicts.

Conflict disclosures should be specific and honest. They should not be a generic statement that conflicts may exist, but a specific description of each identified conflict, the nature of the competing interest, and the governance mechanism (if any) that the sponsor has established to manage the conflict. Generic conflict disclosures that do not describe the specific arrangements at issue provide legal cover rather than genuine disclosure.

### **⚠ Fee Disclosure Failures Are Antifraud Violations**

*A sponsor who fails to disclose a fee, who understates a fee in the PPM, or who takes fees at rates or in circumstances not described in the offering documents has not merely violated a disclosure requirement. Under Rule 10b-5, any material misstatement or omission in connection with the purchase or sale of a security is fraudulent.*

*Fee omissions and misstatements are among the most common bases for SEC enforcement actions in the private real estate space. The Commission has brought enforcement actions against sponsors who charged undisclosed fees, who took fees at rates exceeding what the PPM described, and who failed to disclose that fee receiving entities were affiliated with the sponsor.*

*The defense against these claims is not sophistication of the fee structure or reasonableness of the fee amounts. The defense is complete and accurate disclosure, documented before investors commit capital.*



## Alignment: Balancing Sponsor Compensation with Investor Returns

Every investor evaluating a private real estate offering is asking the same question. Is this sponsor's financial outcome tied to mine? Do they make money when I make money? Or do they earn enough in fees that they can come out ahead even on a deal that underperforms?

The conventional alignment tools (preferred returns that the sponsor cannot participate in until investors receive their pref, promotes that have value only above performance thresholds, and sponsor co-investment alongside investors) are the structural answers to that question. They work when they are properly designed, properly documented, and honestly implemented. They do not work when the promote is structured to pay the sponsor before investors have recovered their capital, when the co-investment is a nominal amount that does not represent genuine commitment, or when the fee structure is so heavy that the sponsor earns meaningful compensation regardless of performance.

### The Fee to Promote Balance

The ratio of fee income to promote income in a sponsor's overall economics is one of the clearest indicators of alignment. A sponsor whose primary income from a deal comes from fees (acquisition fees, construction management fees, disposition fees, asset management fees) has a compensation structure that is largely independent of investment performance. A sponsor whose primary income from a deal comes from the promote has an economic outcome that depends almost entirely on delivering returns to investors above the preferred return threshold.

Neither structure is inherently wrong. Sponsors who bear significant upfront costs in sourcing and executing deals need some current compensation that does not depend entirely on a disposition three to seven years away. Asset management fees that cover the cost of genuine ongoing management are a legitimate component of the sponsor's economics. The question is whether the fee structure is reasonable in relation to the services provided, or whether fees have grown to a level where the sponsor is essentially guaranteed meaningful compensation regardless of investment performance.

The practical test is straightforward. If the investment generates exactly the preferred return and not a dollar more (no promote, no catch up, no additional profit), what does the sponsor earn? If the answer is substantial fees that represent meaningful income, the alignment question is whether those fees are appropriate given the deal's structure and the investor relationship the sponsor is building. If the answer is modest fees that represent reasonable compensation for genuine services, the promote is doing its intended work.

### When Fee Structures Create Perverse Incentives



Certain fee structures create economic incentives that run counter to investor interests. Identifying these structures before they are embedded in the offering documents is one of the most practical services that experienced securities counsel provides.

**Front loaded fees that reduce invested capital.** Large acquisition fees and organization fees paid at closing reduce the equity actually deployed into the investment. A \$9 million equity raise with \$700,000 in upfront fees has \$8.3 million actually working in the deal. The preferred return, projected on \$9 million, must be generated from \$8.3 million of deployed capital. That dynamic affects the investment's economics and must be reflected accurately in the financial projections.

**Construction management fees that incentivize scope creep.** A construction management fee calculated as a percentage of total construction costs creates a financial incentive for the sponsor to expand the scope of the renovation rather than to minimize costs. This incentive is not inherently dishonest, but it runs counter to the investor's interest in an efficient, cost effective renovation. The operating agreement's construction budget approval provisions and change order controls are the mechanism for managing this conflict.

**Disposition fees that discourage early exit.** A large disposition fee, combined with a promote, can create a financial incentive for the sponsor to hold the investment longer than is optimal for investors, particularly when early exit proceeds would be insufficient to generate a meaningful promote but the asset management fee and disposition fee together provide adequate sponsor compensation from a longer hold. Investors who want the sponsor to optimize exit timing should ensure the promote structure is sufficiently weighted that the sponsor shares in the upside of a timely and well executed exit.

## Demonstrating Alignment Through Documentation

The strongest demonstration of sponsor alignment is not a declaration in the PPM that the sponsor is committed to investors' interests. It is a fee structure and co-investment arrangement that creates genuine financial consequences for underperformance. Investors who review the offering documents with that lens, asking what the sponsor earns if the investment barely meets the preferred return, what the sponsor earns if it significantly outperforms, and what capital the sponsor has at risk, will reach their own conclusions about alignment. The sponsor's job is to make sure the documents accurately reflect an arrangement that would withstand that scrutiny.

### A Note on Counsel's Role in Fee and Disclosure Review

*Experienced securities counsel reviewing an offering before it launches will identify the fee structure provisions most likely to create investor relations problems and the disclosure gaps most likely to create legal exposure. That review is most valuable before the offering*

*documents are circulated to investors, not after an investor has raised questions, and not after an enforcement inquiry has begun.*

*Sponsors who want to discuss whether a specific fee structure is appropriately disclosed, whether the operating agreement correctly sequences fees relative to the waterfall, or whether affiliated arrangements are documented in a way that will withstand investor and regulator scrutiny are welcome to reach out at [crowdfundlawyer.com](http://crowdfundlawyer.com).*

## Sponsor Compensation Summary

The following table summarizes the major sponsor compensation categories discussed in this chapter, along with typical structures, key disclosure points, and alignment notes.

| Fee or Compensation     | Typical Structure                                                             | Key Disclosure Points                                                                                     | Alignment Notes                                                                                          |
|-------------------------|-------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------|
| Organization Fee        | \$50K to \$150K flat, or 0.5% to 1.5% of equity. Paid at launch.              | PPM use of proceeds. Must itemize material components separately. Dollar amount alongside percentage.     | Front loaded. Earned regardless of performance. Should be modest relative to total equity raised.        |
| Acquisition Fee         | 0.5% to 2.0% of purchase price. Paid at closing.                              | PPM fee section. Dollar amount required. Specify party receiving payment and any offset provisions.       | Front loaded. Misaligned if large relative to promote. Should reflect genuine transaction work.          |
| Due Diligence Fee       | Often included in the acquisition fee. Charged separately on complex deals.   | PPM fee section. Describe services compensated.                                                           | Front loaded. May overlap with acquisition fee. Combined disclosure if combined fee.                     |
| Asset Management Fee    | 1% to 2% of equity, or 0.5% to 1% of gross asset value. Quarterly or monthly. | PPM fee section. Specify calculation basis (equity or GAV) and subordination to distributions.            | Ongoing. Tied to hold period, not performance. Should represent genuine management work.                 |
| Property Management Fee | 4% to 8% of gross revenue if sponsor affiliated.                              | PPM conflicts section. Affiliated arrangement must be on arm's length terms. Termination rights required. | Creates a conflict if affiliated. Competitive market rate required. Compare to third party alternatives. |

| Fee or Compensation             | Typical Structure                                                 | Key Disclosure Points                                                                              | Alignment Notes                                                                                              |
|---------------------------------|-------------------------------------------------------------------|----------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------|
| Construction or Development Fee | 3% to 5% of construction costs. Paid in installments.             | PPM fee section. Milestone payment schedule. Dollar amount alongside percentage.                   | Can create scope creep incentive. Milestone conditions align sponsor with efficient execution.               |
| Loan Origination Fee            | 0.25% to 1.0% of loan amount. Paid at financing close.            | PPM fee section. Disclose any lender paid components. Conflict disclosure required.                | Conflict of interest. Sponsor may prefer lender paying origination rather than best investor terms.          |
| Refinance Fee                   | 0.5% to 1.0% of new loan amount. Paid at refinancing close.       | PPM fee section. Describe services compensated and specify triggering conditions.                  | Legitimate if genuine refinancing work is performed. Requires disclosure of what work the fee compensates.   |
| Disposition Fee                 | 0.5% to 2.0% of gross sale price. Paid at closing.                | PPM fee section. Paid before the waterfall. Dollar amount at projected sale price.                 | Paid simultaneously with the promote. Sequencing is critical: fees deducted before the waterfall applies.    |
| Expense Reimbursements          | Reasonable out of pocket costs per the operating agreement.       | PPM. Operating agreement caps and approval requirements. No markup on cost.                        | Reimbursement at cost, not profit. Approval process prevents misuse. Caps prevent excessive transfer.        |
| Promoted Interest (Carry)       | 20% to 30% of profits above the pref. Paid through the waterfall. | PPM economics section. Operating agreement waterfall. Catch up mechanics specified.                | Primary alignment mechanism. Valueless if the investment does not clear the hurdle. Quantify in projections. |
| Catch Up Distribution           | Accelerated sponsor allocation after the pref is satisfied.       | PPM waterfall description. Operating agreement tier definition. Dollar impact in a worked example. | Legally legitimate. Economically significant. Investors should understand the effective promote percentage.  |

## Practical Takeaways

- Every fee a sponsor earns, from organization fees through the disposition fee and the promote, must be fully and specifically disclosed in the PPM. The disclosure obligation is not satisfied by broad category descriptions. It requires dollar amounts where calculable, calculation bases, payment timing, and identification of the party receiving payment.
- Organization fees must itemize material cost components. Investors are entitled to understand what formation work the fee compensates and approximately what each

component costs. Aggregating all costs into an undifferentiated number without itemization is a disclosure shortcut that creates investor relations problems and legal exposure.

- Asset management fees require disclosure of the calculation basis (equity or gross asset value) and the payment terms, including whether the fee is subordinated to investor distributions. The choice of calculation basis has meaningful economic implications that affect the financial projections and the investor's return analysis.
- Affiliated service arrangements, including affiliated property management, affiliated construction management, and affiliated financing services, are conflicts of interest that must be disclosed in the PPM's conflicts section in addition to the fee disclosure section. Each arrangement must be on arm's length terms, and the operating agreement should include termination rights that protect investors if the arrangement is not performed adequately.
- The disposition fee must be paid before the waterfall calculation is applied to gross disposition proceeds. The operating agreement must specify this sequencing explicitly, and any distribution system must implement it correctly. This error is common and consequential. Applying the waterfall to gross proceeds before deducting fees overpays investors at the sponsor's expense.
- The sponsor's co-investment is the most direct alignment mechanism available. A sponsor who contributes meaningful personal capital to the investment on the same terms as investors has financial consequences tied to investment performance that fee structures alone do not create. Investors should evaluate the co-investment's source (new capital or fee conversion), its amount relative to total equity, and whether it is structured to produce genuine downside exposure.
- Fee disclosure failures are antifraud violations under Rule 10b-5, not merely technical omissions. The SEC has brought enforcement actions against sponsors for undisclosed fees, fees taken at rates exceeding disclosed amounts, and failure to disclose that fee receiving entities were affiliated with the sponsor. Complete and accurate disclosure, documented before investors commit capital, is the only reliable defense.
- The fee to promote balance communicates something about the sponsor's orientation toward investors. Fee heavy structures reduce the sponsor's performance dependency. Promote heavy structures tie the sponsor's economics to investor outcomes. Neither is inherently wrong, but the balance is something sophisticated investors evaluate carefully and that sponsors should be prepared to discuss honestly.
- Experienced securities counsel reviewing the offering documents before launch, specifically evaluating whether the fee disclosure is complete, whether affiliated arrangements are adequately disclosed, and whether the distribution mechanics

correctly sequence fee payments before the waterfall, provides value that is disproportionate to its cost relative to the exposure it prevents.

## CHAPTER ELEVEN

# Tax Considerations for Real Estate Syndications and Funds

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Tax considerations are not a peripheral footnote to a real estate syndication. For many investors, the tax treatment of a real estate investment is as consequential as the projected cash on cash return, sometimes more so. Depreciation deductions that shelter operating income, capital gains rates that apply at exit, and 1031 exchange mechanics that defer recognition of gain entirely are not abstract concepts. They are the features that often determine whether an investor participates in a syndication and at what minimum return threshold.

For sponsors, understanding the tax framework serves two distinct purposes. First, it enables better deal structuring. Knowing how different entity types, acquisition structures, and exit strategies interact with federal tax law allows the sponsor to build offerings that deliver the after tax returns investors actually care about. Second, it creates a disclosure obligation. The PPM must describe the material tax consequences of the investment accurately enough that investors can make informed decisions, which requires that the sponsor and their counsel understand those consequences in enough depth to explain them.

This chapter covers the principal tax topics that arise in real estate syndications and funds. The topics include pass through taxation, depreciation, the passive activity loss rules, capital gains and recapture, 1031 exchanges, FIRPTA for foreign investors, carried interest taxation under Section 1061, and state and local tax considerations. It concludes with the coordination question that experienced practitioners consistently flag as underappreciated: how securities counsel and tax counsel need to work together, not sequentially, to produce an offering structure that works as both a legal and a tax matter.

### **⚠ This Chapter Addresses General Tax Concepts, Not Tax Advice**

*The tax rules discussed in this chapter are general principles applicable to most real estate syndications as of the time of this writing. Tax law changes frequently. The One Big Beautiful Bill Act (Public Law 119-21), signed July 4, 2025, made significant changes to bonus depreciation, the Section 199A qualified business income deduction, and several other real estate relevant provisions, and the specific tax consequences of any particular investment depend on facts and circumstances that vary by investor, by entity, and by deal.*

*Nothing in this chapter constitutes tax advice. Sponsors should retain qualified tax counsel, a CPA or tax attorney with specific real estate fund experience, before finalizing any*

*offering structure that relies on specific tax consequences. Investors should consult their own tax advisors regarding the consequences of a particular investment before committing capital.*

## Pass Through Taxation: The Core Tax Advantage

The most fundamental tax feature of a real estate syndication is also the one that is most often taken for granted. The entity that holds the investment does not itself pay federal income tax. A properly structured LLC or limited partnership is a pass through entity for federal tax purposes. Its income, deductions, credits, and losses flow directly to the members or partners and are reported on their individual tax returns. The investment's tax attributes are available to investors directly, without an intermediate layer of corporate level tax.

This pass through structure is what makes the depreciation deductions, cost segregation benefits, and other tax advantages of real estate ownership available to syndication investors. If the SPV were taxed as a corporation, which is the default for entities that elect or are required to be treated as C corporations, the depreciation deductions would reduce the corporation's taxable income but would not flow to investors. Investors would instead receive dividends (taxable at the investor level) from after tax corporate earnings, losing the benefit of real estate's most powerful tax tools at the investor level.

The preference for pass through entities is so strong in real estate syndication that it effectively dictates the entity form: LLCs and LPs, not corporations. Most real estate syndications are structured as manager managed LLCs, which are treated as partnerships for federal tax purposes when they have more than one member. The LLC form achieves the same tax treatment as a limited partnership while avoiding the LP's requirement for a general partner with unlimited liability.

### How LLC and LP Income Flows to Investors

A partnership, including a multi member LLC treated as a partnership, does not pay federal income tax at the entity level. Instead, the partnership files an informational return (Form 1065) that reports total income, deductions, and credits for the entity and each partner's allocable share. Each partner then includes their allocable share of the partnership's items on their own tax return, whether or not any cash was actually distributed.

This last point deserves emphasis because it creates a disconnect between cash distributions and taxable income that surprises some investors. If the SPV generates \$500,000 in rental income but distributes only \$200,000 to investors during the year, each investor reports their

allocable share of the full \$500,000 in income on their tax return, not just the \$200,000 they received. Conversely, if the SPV generates large depreciation deductions that produce a tax loss even while generating positive cash flow, investors may report a tax loss on their return even in a year when they received a cash distribution. The tax reality and the cash reality can diverge substantially, and investors need to understand this before committing capital.

The allocation of income, loss, and deductions among partners is governed by the operating agreement's allocation provisions, which must satisfy either the substantial economic effect rules or the partners' interests in the partnership standard under the Treasury regulations. Getting the allocation provisions right is a technical tax matter that requires specific attention from qualified tax counsel during the operating agreement drafting process. Allocation provisions that do not satisfy these standards can cause the IRS to reallocate items away from the intended recipients.

## K-1 Reporting Obligations

Each partner's allocable share of partnership items is reported on Schedule K-1, which the partnership issues to each partner annually. The K-1 reports the partner's share of ordinary income or loss, rental income or loss, capital gains and losses, interest income, qualified business income, depletion, and each of the separately stated items that flow to individual returns. The partnership is required to issue K-1s no later than the due date of the partnership return, which is March 15 for calendar year partnerships (or the next business day if that date falls on a weekend or legal holiday), and September 15 if the partnership has filed for an extension.

K-1 preparation for a real estate syndication requires specific expertise. The K-1 must correctly track each partner's adjusted basis in their partnership interest, which starts at their capital contribution and is adjusted over time by income allocations, loss allocations, and distributions, because basis determines how much loss a partner can deduct and the tax consequences at exit. K-1s that are incorrect, late, or inconsistent with the partnership's books create investor relations problems and can trigger IRS scrutiny.

Real estate funds that hold multiple properties and have investors who entered at different closings face particularly complex K-1 preparation challenges. Each investor's share of income and loss depends on when they joined and their specific capital account position. Fund administrators with specific real estate fund accounting experience are essential for producing accurate, timely K-1s in a multi asset, multi closing fund structure.

## Depreciation: Real Estate's Most Powerful Tax Tool



Depreciation is the mechanism through which tax law allows the owner of a depreciable asset to recover the asset's cost over time through annual deductions. For real estate, depreciation produces one of the most powerful tax benefits available to individual investors: the ability to generate a tax deduction, sometimes a very large one, without a corresponding cash expenditure. The property generates rental income and cash flow. Depreciation generates deductions that reduce or eliminate the taxable portion of that income, sometimes producing a tax loss on paper even in a cash flow positive year.

Understanding depreciation in the real estate context requires understanding three distinct concepts: the straight line depreciation of the building itself, the accelerated depreciation available through cost segregation studies, and the bonus depreciation rules that have been significantly expanded under the One Big Beautiful Bill Act of 2025.

### **Straight Line Depreciation of Real Property**

Under the general depreciation rules of Section 168, residential rental property is depreciated over 27.5 years using the straight line method. Commercial real property is depreciated over 39 years. Straight line depreciation divides the depreciable basis of the property (generally the acquisition cost plus improvements, less the value allocated to land, which is not depreciable) by the recovery period to produce an annual depreciation deduction.

On a \$10 million multifamily acquisition where \$8.5 million is allocated to the building and \$1.5 million to non-depreciable land, the annual straight line depreciation deduction is approximately \$309,000 (\$8.5 million divided by 27.5 years). For investors in a 37% federal bracket, that deduction, assuming they can use it, is worth approximately \$114,000 in annual tax savings. Across a five year hold, the cumulative deduction of approximately \$1.5 million can represent roughly \$560,000 in tax value, a benefit that materially enhances after tax returns relative to a non-depreciable investment generating the same Pre-tax cash flow.

The depreciable basis of the property is determined at acquisition and adjusted for improvements made during the hold period. Improvements add to depreciable basis. Certain events reduce it. The allocation between land and building value is typically supported by an independent cost segregation or appraisal study. An allocation that assigns too much value to the building (and thereby inflates depreciation) is a potential audit risk that tax counsel should assess.

### **Cost Segregation Studies: Accelerating Depreciation**

A cost segregation study is an engineering based analysis that reclassifies portions of a real property's depreciable basis from the 27.5 year or 39 year life of the building into shorter lived personal property and land improvement categories. Personal property (fixtures, specialized equipment, certain interior finishes) may qualify for 5 year or 7 year depreciation. Land

improvements (parking lots, landscaping, outdoor lighting) typically qualify for 15 year depreciation. Reclassifying even a modest portion of a building's cost into these shorter lived categories can dramatically accelerate the timing of depreciation deductions.

A cost segregation study on a \$10 million multifamily acquisition might identify \$1.5 million to \$2.5 million of the building's cost as qualifying for 5 year or 15 year recovery periods rather than 27.5 year. That reclassification front loads a significant portion of the total depreciation into the early years of the investment, the years when the investor most benefits from the deduction to shelter operating income. Because the total amount of depreciation over the property's useful life is the same regardless of whether it is taken straight line or accelerated, the cost segregation study does not create additional deductions. It moves existing deductions earlier in time, increasing their present value.

Cost segregation studies are prepared by engineering firms with specific expertise in the field. The study must be conducted by a qualified person and must be adequately substantiated to withstand IRS scrutiny. The cost of the study, typically \$5,000 to \$25,000 depending on property size and complexity, is almost always recovered many times over in present value tax benefit, making it a standard practice for any significant real estate acquisition. The PPM should disclose whether a cost segregation study is planned and should note that the actual tax benefits will depend on the study results and each investor's specific tax circumstances.

### **Bonus Depreciation: Permanent 100% Expensing Under OBBBA**

Bonus depreciation, meaning the ability to immediately deduct the cost of qualifying property in the year it is placed in service rather than depreciating it over the asset's recovery period, was the most significant tax planning tool for real estate investors following the Tax Cuts and Jobs Act of 2017. The TCJA expanded bonus depreciation to 100% for qualifying property placed in service after September 27, 2017, and extended the provision to used (acquired) property, not just newly manufactured property. The provision was scheduled to phase down under the TCJA: 80% in 2023, 60% in 2024, 40% in 2025, 20% in 2026, and 0% thereafter.

The One Big Beautiful Bill Act (Public Law 119-21), signed by President Trump on July 4, 2025, fundamentally changed that trajectory. Under Section 168(k) as amended by the OBBBA, 100% bonus depreciation is now permanently reinstated for qualifying property acquired and placed in service after January 19, 2025. The qualifying property categories are unchanged: most tangible MACRS property with a recovery period of 20 years or less, computer software, qualified improvement property, and other items listed in Section 168(k). For real estate investors, the practical effect is that personal property and land improvements identified in a cost segregation study can again be fully expensed in the year placed in service, with no scheduled phase down.

Property acquired on or before January 19, 2025 (including property acquired under a written binding contract entered into before January 20, 2025) remains subject to the pre OBBBA phase down: 40% for property placed in service in 2025 and 20% for property placed in service in 2026. Determining the acquisition date can require detailed analysis of contract execution dates, contingencies, and construction commencement dates. Sponsors with assets acquired late in 2024 or early in 2025 should work with tax counsel to determine which rate applies to their specific facts.

The OBBBA also raised the Section 179 expense limit to \$2.5 million (from approximately \$1.25 million under prior law) with a phase out beginning at \$4 million of qualifying purchases (up from \$2.5 million). Section 179 is generally less useful than bonus depreciation for real estate syndication purposes because most states conform to Section 179 but do not conform to federal bonus depreciation, so coordination with state tax counsel is appropriate when both tools are available.

The OBBBA also introduced a new and limited 100% depreciation regime under Section 168(n) for “qualified production property,” which is nonresidential real property used as an integral part of certain manufacturing, agricultural production, or chemical refining activities, where construction begins between January 20, 2025 and December 31, 2028 and the property is placed in service before January 1, 2031. The Section 168(n) regime has limited application to typical multifamily and commercial real estate syndications and is most relevant for sponsors developing or acquiring industrial production facilities.

The interaction between bonus depreciation and the passive activity loss rules (discussed in the next section) remains a critical planning consideration. Investors who cannot use large passive losses in the year they are generated may find that the accelerated depreciation creates suspended losses rather than immediate tax savings. The timing benefit that makes cost segregation and bonus depreciation powerful is reduced (though not eliminated) if the investor cannot use the deductions when they arise.

One adjacent OBBBA change worth noting: the Section 199A qualified business income deduction, which permits eligible individuals to deduct up to 20% of qualified business income (including qualified REIT dividends and certain pass through rental income that rises to the level of a trade or business), was scheduled to expire at the end of 2025 under the TCJA and is now permanent under the OBBBA. Whether a particular real estate rental activity rises to the level of a trade or business for Section 199A purposes is a fact specific determination governed by Revenue Procedure 2019-38 and related guidance.

## Passive Activity Loss Rules

Section 469 of the Internal Revenue Code contains the passive activity loss rules, which are arguably the most consequential limitation on the tax benefits of real estate investment for individual investors. These rules restrict the ability of most investors to use losses from passive activities to offset income from active sources (wages, business income, portfolio income). Understanding which investors can use real estate losses, and which cannot, is essential for sponsors who are marketing the tax benefits of their offerings.

## **The Passive and Non Passive Distinction**

Under Section 469, income and losses are classified as either passive or non-passive based on the taxpayer's material participation in the activity. A passive activity is one in which the taxpayer does not materially participate, meaning one in which they are essentially a passive investor rather than an active operator. Real estate rental activities are generally classified as passive activities per se, regardless of the level of the investor's participation, with one major exception discussed below.

The passive activity loss rules work as follows. Losses from passive activities can be used only to offset income from other passive activities. They cannot be used to offset active income (W-2 wages, Schedule C self-employment income) or portfolio income (dividends, interest, capital gains from securities). Passive losses that cannot be used in the year they are generated are suspended. They carry forward indefinitely until the investor has passive income to absorb them or until they dispose of the passive activity in a fully taxable transaction, at which point all suspended losses are released.

For the typical syndication investor, who is a high income professional or business owner not materially participating in real estate as their primary business, this means that the depreciation deductions generated by the investment do not produce immediate tax savings against their W-2 income or other non-passive income. The deductions create suspended passive losses that are tracked and carried forward until there is passive income to use them against or until the investment is sold. The tax benefit is real, but it is deferred.

## **Real Estate Professional Status**

The major exception to the per se passive classification of rental activities is the real estate professional exception. Under Section 469(c)(7), a taxpayer who qualifies as a real estate professional is not subject to the automatic passive classification of rental activities. Instead, each rental activity is treated the same as any other trade or business activity, and the taxpayer's losses from those activities are non-passive to the extent the taxpayer materially participates.

Qualifying as a real estate professional requires meeting two tests in a given tax year. First, more than half of the taxpayer's personal services for the year must be performed in real

property trades or businesses in which the taxpayer materially participates. Second, the taxpayer must perform more than 750 hours of services in those real property trades or businesses. Both tests must be met in each year the taxpayer wants to claim real estate professional status.

The real estate professional exception is genuinely valuable but genuinely demanding. A W-2 employee who works 2,000 hours per year in their primary job faces a threshold problem. Satisfying the first test (more than half of personal services in real property trades) while also working a full time job is mathematically impossible without extraordinary real estate activity, and the IRS scrutinizes returns where a taxpayer claims both substantial W-2 income and real estate professional status. The election is most appropriate for investors who are full time real estate operators whose primary occupation is in real estate.

The PPM should never represent that investors will qualify as real estate professionals or that they will be able to use the investment's losses as non-passive. That determination is individual to each investor based on their specific facts and circumstances. The appropriate disclosure is that some investors may qualify for real estate professional status and that those investors should consult their tax advisors about whether they do qualify.

## **Suspended Losses and Exit Timing**

Passive losses that cannot be used in the year they are generated are suspended and carried forward. For investors who accumulate large suspended passive losses during the hold period, because they had no passive income to absorb the depreciation deductions year by year, those suspended losses are released when the investment is sold in a fully taxable transaction. This creates a powerful exit dynamic. The suspended losses offset the gain recognized at exit, reducing or eliminating the taxable gain that would otherwise be recognized.

This interaction between suspended losses and exit gain is one of the most important tax planning considerations for value add syndication investors. An investor who has accumulated \$200,000 in suspended passive losses from the investment's annual depreciation deductions can use those losses to offset \$200,000 of the gain recognized when the property is sold, effectively reducing their taxable gain at exit. This is not a tax loophole. It is the intended operation of the passive activity loss rules, which allow investors to benefit from the economic losses represented by depreciation even if they cannot use them in real time.

Exit timing matters for investors with suspended losses because the losses are released only in a fully taxable sale, not in a 1031 exchange (where gain is deferred) or a partial sale. Investors who plan to use a 1031 exchange to defer their gain should understand that a 1031 exchange also preserves rather than releases their suspended losses, which carry forward to the replacement property rather than being used at the time of exchange.

## Capital Gains and Depreciation Recapture

When a real estate investment is sold, the tax consequences consist of two distinct components that are frequently conflated: the capital gain or loss on the disposition, and the depreciation recapture that applies to a portion of that gain. Understanding both, and the different tax rates that apply to each, is essential for sponsors presenting projected after tax returns and for investors evaluating those projections.

### Section 1231 Gains

Real property used in a trade or business, which includes rental property, is Section 1231 property. The gain or loss from the sale of Section 1231 property is characterized under special rules that provide net gain treatment that is generally favorable to taxpayers. If the taxpayer's net Section 1231 gains for the year exceed net Section 1231 losses, the net gain is treated as long term capital gain, taxed at preferential capital gains rates (currently 0%, 15%, or 20% for most taxpayers depending on income). If net Section 1231 losses exceed gains, the net loss is treated as an ordinary loss, fully deductible against ordinary income.

This favorable asymmetric treatment is one of the reasons real estate is so tax favored among investment categories. The appreciation in a property's value is generally taxed as long term capital gain at preferential rates. The losses, if any, receive ordinary loss treatment. Investors who have held the investment for more than one year, which is essentially every syndication investment given typical hold periods, receive the long term capital gain rate treatment on the Section 1231 portion of their gain.

There is one important limitation: the Section 1231 lookback rule. If a taxpayer has taken Section 1231 ordinary losses in any of the five preceding tax years, net Section 1231 gains in the current year are recharacterized as ordinary income to the extent of those prior year ordinary losses. This prevents taxpayers from taking ordinary loss treatment in bad years and capital gain treatment in good years without accounting for the asymmetry. Investors with significant real estate losses in prior years should be aware of this limitation.

### Section 1250 Depreciation Recapture

When depreciable real property is sold, Section 1250 requires that a portion of the gain be characterized as ordinary income rather than capital gain, specifically the gain attributable to accelerated depreciation taken in excess of straight line depreciation. For property depreciated under the straight line method (which is required for real property under current law), the Section 1250 recapture rules produce what is sometimes called unrecaptured Section 1250 gain rather than true ordinary income recapture.

Unrecaptured Section 1250 gain is a specific category of long term capital gain that is taxed at a maximum rate of 25% rather than the 0%, 15%, or 20% rates applicable to other long term capital gain. The amount subject to this 25% rate is the lesser of (1) the total depreciation deductions taken on the property, or (2) the total gain recognized on the sale. In plain terms: to the extent the property sells for more than its adjusted (depreciated) basis, the gain up to the amount of all depreciation previously taken is taxed at a maximum rate of 25%. Any remaining gain above the original cost basis is taxed at the standard long term capital gain rates.

### **Worked Example: Depreciation Recapture on a \$12.5 Million Sale**

#### **Assumptions**

Acquisition price: \$10,000,000

Depreciation taken over a 5 year hold: \$1,450,000 (straight line)

Adjusted basis at sale: \$10,000,000 minus \$1,450,000 = \$8,550,000

Sale price: \$12,500,000

Total gain recognized: \$12,500,000 minus \$8,550,000 = \$3,950,000

#### **Tax Treatment of the \$3,950,000 Gain**

Unrecaptured Section 1250 gain: \$1,450,000, taxed at a maximum of 25%.

(equal to total depreciation taken, which is less than total gain)

Remaining Section 1231 gain: \$2,500,000, taxed at the long term capital gain rate (0%, 15%, or 20%).

(the portion of the gain above the original cost basis)

#### **The Tax Benefit**

The \$1.45 million in depreciation deductions sheltered ordinary income during the hold at the investor's marginal rate (up to 37%), but is recaptured at no more than 25% on sale.

The net rate arbitrage on that portion of the investment's return is up to 12 percentage points, in addition to the time value of taking the deductions early.

## **1031 Like Kind Exchanges**

Section 1031 of the Internal Revenue Code allows a taxpayer to defer the recognition of gain from the sale of real property held for investment or productive use in a trade or business by reinvesting the proceeds in qualifying like kind replacement property. The gain is not forgiven. It is deferred until the replacement property is eventually sold in a taxable transaction. But for investors who intend to continue investing in real estate, the ability to roll proceeds from one investment into the next without paying current tax is one of the most powerful wealth building tools available.



1031 exchanges are relevant to real estate syndication in two distinct ways. First, the sponsor may plan to use a 1031 exchange to roll the fund's proceeds from one property into a replacement property during the fund's life, deferring gain at the entity level. Second, and more commonly relevant in syndication practice, individual investors who receive sale proceeds from a syndication and want to roll those proceeds into replacement real estate face specific structural challenges because the form of their investment (a fractional membership interest) limits their 1031 options.

## Requirements and Timeline

A valid 1031 exchange requires that the property sold (the relinquished property) and the replacement property both be of like kind, which means real property for real property, broadly defined to include all forms of investment real estate. Both properties must be held for investment or productive use in a trade or business. The taxpayer must follow strict identification and exchange timelines, and a qualified intermediary must hold the proceeds between the sale and the reinvestment.

The exchange is not a simultaneous transaction. The taxpayer sells the relinquished property, the proceeds go directly to a qualified intermediary (not to the taxpayer), the taxpayer identifies replacement property within 45 days of the sale, and the replacement property must be acquired within 180 days of the sale (or the due date of the taxpayer's tax return for the year of sale, if earlier). These are strict statutory deadlines. Missing either the 45 day identification deadline or the 180 day closing deadline disqualifies the exchange.

Boot, meaning the receipt of cash or non like kind property in connection with an exchange, is taxable to the extent received. If the taxpayer receives \$200,000 in boot from the exchange, that \$200,000 is taxable in the year of the exchange. Minimizing or eliminating boot requires reinvesting all the proceeds (including repaying any exchange related debt) in the replacement property.

## Identification and Closing Rules

The 45 day identification rule requires the taxpayer to designate in writing, before the deadline, which property or properties they intend to acquire as replacement property. Three identification rules govern how many properties can be identified.

- Three property rule. The taxpayer may identify up to three replacement properties without regard to their fair market value. This is the most commonly used rule.
- 200% rule. The taxpayer may identify any number of replacement properties so long as their aggregate fair market value does not exceed 200% of the fair market value of the relinquished property.



- 95% rule. The taxpayer may identify any number of properties of any aggregate value so long as the taxpayer actually acquires at least 95% of the aggregate value of all identified properties. This rule is rarely used because its practical requirements are so demanding.

The closing rule requires that replacement property be received by the taxpayer within 180 days of the date the relinquished property is sold. This deadline is absolute and cannot be extended by IRS agreement except in very limited circumstances (federally declared disasters and similar events). A taxpayer who has not found acceptable replacement property within 180 days must complete the exchange with whatever is available or recognize the gain.

### **DST and TIC Structures for Fractional 1031 Replacement Interests**

The most significant challenge individual syndication investors face when pursuing a 1031 exchange is the form of their investment interest. An investor who holds a fractional membership interest in an LLC that sold its property cannot simply roll their share of the sale proceeds into a new LLC syndication as a 1031 exchange. The IRS has consistently ruled that fractional interests in LLCs that own real estate are not themselves real property for purposes of Section 1031. The investor owns an equity interest in an entity, not a direct real property interest.

Delaware Statutory Trusts, discussed in Chapter 7, were specifically developed to address this problem. A DST interest qualifies as a direct real property interest for 1031 purposes under Revenue Ruling 2004-86, which means investors who receive cash from a syndication can use that cash as 1031 exchange proceeds to acquire a DST interest in a professionally managed real estate portfolio. The DST provides a replacement property solution for 1031 investors who need to close quickly, who want to deploy into institutional quality real estate they could not acquire directly, and who want to remain invested in real estate without the operational demands of direct ownership.

Tenant in common structures (also discussed in Chapter 7) offer a similar 1031 solution under Revenue Procedure 2002-22's safe harbor conditions. TICs were the dominant institutional 1031 vehicle before DSTs emerged, and both remain in use. The choice between DST and TIC for a specific investor's 1031 needs depends on deal size, investor preference for governance rights, and the availability of suitable properties in each structure.

Sponsors who raise capital from investors planning to complete 1031 exchanges into the offering face their own timing problem. The investor's 45 day and 180 day deadlines create closing pressure that the fund's normal subscription and closing process may not accommodate. If the offering is structured as a TIC or DST specifically to attract 1031 exchange investors, the PPM must specifically address the exchange structure and the procedures for accommodating exchange investors' timing requirements.

## **FIRPTA and Foreign Investors**

The Foreign Investment in Real Property Tax Act of 1980, known as FIRPTA, imposes U.S. tax on the gain recognized by foreign persons (non U.S. individuals, foreign corporations, and certain other foreign entities) from the disposition of U.S. real property interests. FIRPTA is the federal mechanism that ensures the U.S. captures tax on real property gains earned by foreign investors, who might otherwise be beyond the reach of U.S. tax enforcement at the time of a property sale.

For real estate syndications, FIRPTA matters in three contexts. First, when a transferee purchases a U.S. real property interest directly from a foreign person. Second, when a partnership with foreign partners sells real property and must address withholding on the foreign partners' share of the gain. Third, when a foreign partner transfers a partnership interest in a partnership that holds U.S. real property. Three different statutory regimes govern these three contexts, and the rates and mechanics differ.

### **Section 1445: Direct Transfers of U.S. Real Property Interests**

Under Section 1445, a transferee of a U.S. real property interest acquired from a foreign person must generally withhold 15% of the amount realized on the disposition (10% for certain residential property purchases at or below \$1,000,000 where the buyer intends to use the property as a residence). The 15% rate is applied to the gross amount realized, not to the gain. The withheld amount is a deposit against the foreign seller's eventual U.S. tax liability and is reconciled when the foreign person files a U.S. tax return reporting the sale.

The Section 1445 withholding regime applies primarily to direct transfers of real property where the transferor is a foreign person. For a domestic partnership's sale of property the partnership owns, the partnership is generally not subject to Section 1445 withholding on its own sale. Instead, the partnership becomes subject to the partnership level withholding regime under Section 1446 with respect to the foreign partners' share of the gain.

### **Section 1446: Partnership Withholding on Foreign Partners' ECI**

When a domestic partnership that is not publicly traded disposes of a U.S. real property interest at a gain, the gain is treated as effectively connected income (ECI) and is governed by Section 1446 rather than Section 1445. The partnership is required to withhold and remit tax on the foreign partners' allocable share of the ECI, with the withholding calculated at the highest applicable U.S. tax rate for the partner type. For foreign individual partners, the applicable rate is currently 37% (the highest individual rate). For foreign corporate partners, the applicable rate is 21% (the corporate rate). The withholding is reported on Forms 8804, 8805, and 8813.

The Section 1446 rate is materially higher than the Section 1445 rate, and the difference matters when projecting after tax distributions to foreign partners at exit. A foreign individual investor whose allocable share of a partnership gain is \$1,000,000 will face approximately \$370,000 in partnership level withholding under Section 1446, which the partnership must remit to the IRS before distributing the remainder to the partner. The foreign partner can file a U.S. tax return to claim a refund if the withheld amount exceeds their actual U.S. tax liability after taking into account deductions, losses, and applicable treaty benefits.

Sponsors who accept foreign investor capital should address Section 1446 withholding mechanics specifically in the operating agreement, including the manager's authority to withhold from foreign partner distributions and the obligation to file the required IRS forms on the required schedule. Sponsors who present projected after tax returns to foreign investors based on the 15% Section 1445 rate are understating the actual partnership level withholding that will apply on exit.

### **Section 1446(f): Transfers of Partnership Interests by Foreign Persons**

Section 1446(f), enacted as part of the Tax Cuts and Jobs Act and effective for transfers occurring after 2017, requires the transferee of a partnership interest from a foreign person to withhold 10% of the amount realized on the transfer, unless an exception applies. The 10% rate is applied to the gross sales price of the partnership interest, not to the gain. This regime applies when a foreign partner sells their partnership interest to a third party, regardless of whether the partnership itself sells the underlying real property.

Common exceptions include certifications by the transferor that they are not a foreign person, certifications by the partnership regarding the percentage of ECI in the partnership, and certifications regarding the absence of gain on the transfer. These certifications are subject to specific form and substantiation requirements that must be followed for the exception to apply.

For sponsors who permit secondary transfers of partnership interests, Section 1446(f) creates a compliance obligation on the transferee that the operating agreement's transfer mechanics should address. A buyer of a foreign partner's interest who fails to withhold under Section 1446(f) can be held personally liable for the unwithheld tax.

### **FIRPTA Exemptions and Planning**

Several exemptions reduce or eliminate FIRPTA related withholding in specific circumstances.

- Domestically controlled REIT. If a REIT is domestically controlled, meaning less than 50% of the REIT's fair market value is held by foreign persons during the relevant testing period, distributions from the REIT's sale of U.S. real property interests are not subject to FIRPTA on dispositions of stock in the REIT. Real estate sponsors who structure their

offering as a REIT (discussed in Chapter 7) and can maintain domestically controlled status have a mechanism to limit FIRPTA exposure for foreign investors. Proposed regulations from 2024 and 2025 have addressed look through rules for testing this status, and the regulatory landscape continues to evolve.

- **Qualified foreign pension funds.** Certain foreign pension funds and their wholly owned subsidiaries that meet specific requirements are exempt from FIRPTA. This exemption was significantly expanded by the PATH Act and refined in subsequent legislation, and it is relevant for sponsors raising capital from foreign institutional investors.
- **Withholding certificates.** A foreign transferor may apply to the IRS for a withholding certificate (Form 8288-B) to reduce or eliminate withholding based on the actual expected tax liability. The IRS typically has at least 90 days to act on such applications, so sellers relying on withholding certificates must plan well in advance of the transaction.

For most private real estate syndications that accept foreign investor capital, partnership level Section 1446 withholding is a compliance reality that must be planned for specifically. The operating agreement should address the mechanism for calculating and remitting withholding at the time of a property sale, including the authority for the manager to withhold from foreign partner distributions and the obligation to file the required IRS forms on the required schedule.

Sponsors who are uncertain whether any of their investors may be foreign persons (which can occur when investors hold their interests through U.S. based entities that are actually owned by foreign persons) face additional complexity. The look through rules that determine whether a domestic entity is itself a U.S. real property interest because of its foreign ownership require analysis that goes beyond the investor level documentation typically collected at subscription.

## **Carried Interest Taxation: Section 1061**

The taxation of carried interest, meaning the promoted interest the sponsor earns as a share of the investment's profits, has been an area of political and legislative debate for years. The current rules, codified in Section 1061 of the Internal Revenue Code as enacted by the Tax Cuts and Jobs Act of 2017, impose specific requirements on the holding period necessary for carried interest income to qualify as long term capital gain rather than short term capital gain or ordinary income.

Under pre TCJA law, carried interest income that reflected a share of long term capital gains was itself taxed as long term capital gain in the hands of the sponsor, even though the sponsor had not contributed capital to generate that gain and was effectively being paid for services. Section 1061 partially limited this treatment by imposing a three year holding period requirement (rather than the standard one year long term capital gain holding period) for carried interest

holders to receive long term capital gain rates on their share of partnership gains. The OBBBA did not change the three year holding period under Section 1061.

## How Section 1061 Works

Under Section 1061, a taxpayer who holds an applicable partnership interest (API), defined generally as a partnership interest held in connection with the performance of substantial services in a trade or business involving the raising or returning of capital and investing in or developing specified assets, must hold the interest for more than three years to treat their share of partnership gains as long term capital gain. Gains allocated to API holders from the sale of assets held by the partnership for three years or less are treated as short term capital gain, taxed at ordinary income rates, even if the partnership interest itself was held for more than one year.

For a real estate fund sponsor whose promoted interest is an applicable partnership interest, the three year holding period requirement means that gain allocated to the sponsor from properties sold within the fund's first three years will be taxed as short term capital gain rather than long term capital gain. For a fund with a three to five year investment period and a typical five to seven year hold on individual assets, many of the properties sold toward the end of the fund's life will have been held for more than three years, qualifying the related carry income for long term capital gain rates. Properties sold in the early years may not satisfy the three year threshold.

## Planning Considerations for Sponsors

Section 1061 creates planning considerations that affect both deal structure and fund timing. The Treasury regulations under Section 1061 generally track the holding period of the underlying asset, not the API itself, in determining whether gain allocated to the API holder is long term or short term. A sponsor who receives a promoted interest at fund formation will have its character determined on a deal by deal basis based on how long the partnership held each property that generated the relevant gain.

Treasury regulations under Section 1061 include several exceptions and limitations that affect how the rule applies in specific circumstances, including provisions addressing capital interest gains (which are not subject to the three year holding period) and look through rules for tiered partnership structures. Sponsors should work with tax counsel who has specific experience with Section 1061 to analyze how the rule applies to their specific promoted interest structure and fund timeline.

State tax treatment of carried interest varies. Most states follow the federal characterization of income, so carried interest income recharacterized as short term capital gain or ordinary income under Section 1061 will also be taxed at ordinary income rates at the state level in most

jurisdictions. A few states have enacted their own carried interest provisions that may differ from the federal rule. The state analysis is always required alongside the federal analysis.

## State and Local Tax Considerations

Federal tax is only part of the tax picture for real estate investors and sponsors. State and local tax considerations, which vary dramatically across jurisdictions, can significantly affect the after tax return of a real estate investment and the administrative burden of operating a fund with investors in multiple states.

### State Income Tax on Partnership Income

Most states with income taxes tax partnership income at the partner level, similar to the federal approach. A partner who is a resident of California, for example, is taxed by California on their entire distributive share of partnership income, regardless of where the partnership operates. A partner who is a non-resident of the state where the property is located may be taxed by that state on the income attributable to the property located there, requiring the filing of a non-resident state return.

In funds with investors across many states and properties in multiple states, the state tax compliance picture is genuinely complex. Investors may need to file non-resident returns in every state where the fund owns property, an obligation that surprises many individual investors who are not accustomed to multi-state filing. The PPM should disclose the potential for multi-state filing obligations and should recommend that investors consult their own tax advisors about state filing requirements.

Some states impose composite returns or withholding mechanisms that allow the partnership to file a combined return on behalf of non-resident partners, reducing the individual filing burden. Whether these mechanisms are available and advantageous depends on the specific states involved and the investor's overall tax situation. The fund's tax counsel should evaluate these options for each state where the fund has significant operations.

### Transfer Taxes and Deed Recording Taxes

Several states and many municipalities impose transfer taxes on the sale of real property, typically calculated as a percentage of the sale price. Transfer taxes are generally borne by the seller (the SPV) as a closing cost. In states with high transfer taxes, including New York and some other high cost markets, transfer taxes can be a significant closing cost that must be factored into the exit economics.

Some jurisdictions also impose transfer taxes on the transfer of controlling interests in entities that own real property, sometimes called controlling interest transfer taxes or indirect transfer

taxes. These provisions are designed to prevent avoidance of direct property transfer taxes by selling the entity rather than the property. In jurisdictions with such taxes, transfers of significant percentages of the LLC's membership interests, including secondary transfers of investor interests that aggregate to a controlling interest, may trigger transfer tax. Sponsors who plan offerings with secondary market access in high transfer tax jurisdictions need to specifically analyze these rules.

## Property Taxes and Assessment Appeals

Property taxes are assessed and administered at the local government level, typically the county or municipality where the property is located. Property taxes are an operating expense of the SPV and directly reduce the property's net operating income. Sponsors who acquire properties at prices significantly above the previously assessed value should anticipate a property tax reassessment that increases the annual property tax burden, a cost that must be reflected in the underwriting and financial projections.

Many jurisdictions allow property owners to appeal their assessed value if they believe it is excessive relative to the property's fair market value. Assessment appeals can produce meaningful property tax savings over the hold period, and sponsors who are knowledgeable about the assessment appeal process in their primary markets can generate investment level savings that less sophisticated operators miss. The cost of an assessment appeal, typically modest relative to the potential savings, is a legitimate operating expense of the SPV.

## Texas and Other No Income Tax States

Texas, Florida, and several other states impose no individual income tax, which creates a meaningful after tax advantage for investors who are residents of those states relative to residents of high income tax states like California (13.3% top rate) and New York. Sponsors raising capital from a geographically diverse investor base should be aware that the state income tax impact of a given investment is materially different for a Texas based investor compared to a California based investor, and that the PPM's tax disclosure should acknowledge this variability rather than implying that the tax consequences are uniform across investors.

## Coordination Between Securities Counsel and Tax Counsel

One of the most consistent patterns in deals that go wrong from a tax and securities law standpoint is that securities counsel and tax counsel worked independently rather than together. Securities counsel drafted the offering documents based on how they understood the deal to be structured. Tax counsel structured the entity for tax efficiency based on their own analysis. When the two workstreams collide at closing, or worse, after the offering has launched, the



conflicts are expensive to resolve and sometimes cannot be fully resolved without material cost to investors.

The coordination problem is not that securities lawyers do not understand tax or that tax lawyers do not understand securities law. It is that each discipline has legitimate independent concerns that can produce structuring requirements that are in tension with each other, and those tensions must be identified and resolved during the design phase rather than after the documents are drafted.

## Where Securities and Tax Considerations Intersect

Several specific areas require coordinated analysis between securities counsel and tax counsel in every real estate syndication.

**Entity structure.** The entity type (LLC taxed as partnership, LP with LLC as GP, S corporation, C corporation, or REIT) has both securities law and tax consequences. The securities lawyer cares about the governance implications of the entity form, the governing document framework, and the regulatory requirements that apply to each entity type. The tax lawyer cares about the pass through tax treatment, the qualification requirements, the allocation rules, and the exit tax consequences. Both must approve the entity structure before formation.

**Allocation provisions.** The operating agreement's allocation of income, loss, and deductions among investors must satisfy the substantial economic effect rules or the partners' interests in the partnership standard. Allocations that are designed for tax efficiency, such as special allocations of depreciation to investors with high ordinary income, must also comply with the economic arrangement described in the PPM. If the PPM describes a pro rata allocation and the operating agreement implements a special allocation, the documents are inconsistent, which is both a disclosure problem and a potential securities violation.

**Depreciation projections in the PPM.** If the PPM includes tax benefit projections (projected K-1 losses, projected depreciation deductions, projected after tax returns), those projections must be based on accurate assumptions about the applicable tax law and reviewed by tax counsel before they are shown to investors. The OBBBA changes to bonus depreciation and Section 199A are particularly relevant. Pre 2025 model disclosures may now be materially inaccurate.

**Investor qualification for specific tax benefits.** Some tax benefits (real estate professional status, qualified opportunity zone benefits, 1031 exchange eligibility) require investor specific analysis. The offering documents should not represent that all investors will qualify for or receive specific tax benefits that are actually dependent on individual investor circumstances. The right language is drafted by securities counsel who understands the disclosure standard, in consultation with tax counsel who understands the tax requirements.



**Exit structure.** Whether the fund's exit from an investment is structured as an asset sale, an entity sale, or a 1031 exchange has both securities law and tax consequences. The operating agreement's major decision provisions should give the manager authority to pursue tax efficient exit structures while ensuring that material decisions affecting investor tax consequences require appropriate investor consent.

## The Practical Framework for Effective Coordination

The most effective coordination between securities counsel and tax counsel starts at the deal structuring phase, before the entity is formed, before the PPM is drafted, and before any investor conversations have occurred. At that initial stage, both counsel should be present in the same conversation (or at minimum, in active coordination on the same day) to address the entity structure, the allocation framework, the anticipated depreciation strategy, and the planned exit mechanics.

Coordination should continue at the PPM drafting stage, when tax counsel should review the tax disclosure sections for accuracy and completeness and securities counsel should ensure that the tax disclosure language satisfies the material information disclosure standard. The goal is not for each lawyer to do the other's job. It is for each to flag the issues in their domain that the other's document or structure creates.

For first time sponsors who are assembling their professional team for the first time, the question of whether securities counsel and tax counsel know each other and have worked together matters. Attorneys who have collaborated on real estate fund transactions understand each other's concerns and can resolve structural conflicts efficiently. Attorneys who are meeting each other for the first time through a client's deal spend more time educating each other and more time reconciling independently developed positions.

### A Note on Assembling the Right Team

*The tax considerations discussed in this chapter (pass through allocations, depreciation planning, passive activity loss analysis, 1031 exchange mechanics, FIRPTA, carried interest taxation, and state tax) span a specialized body of knowledge that most generalist CPAs and accountants are not equipped to address comprehensively in the private real estate fund context. The OBBBA changes alone are significant enough that pre 2025 templates and assumptions require fresh review.*

*Sponsors should retain a CPA or tax attorney who has specific experience preparing partnership tax returns, cost segregation analysis, and K-1s for real estate funds with multiple investors, not a generalist who handles personal returns and occasional commercial transactions. The quality of the tax work product directly affects investors' tax*

*outcomes and, through the accuracy of the K-1s, directly affects the operating agreement's economic terms as actually applied.*

*Securities counsel who has structured real estate syndications and is familiar with the tax framework of these deals is better positioned to produce offering documents that accurately describe and complement the tax structure the sponsor's tax counsel is implementing. Sponsors who are building their professional team for a first or second offering are welcome to reach out at [crowdfundlawyer.com](https://crowdfundlawyer.com) to discuss what that team should include and how to identify qualified members.*

## Tax Concepts Quick Reference

The following table summarizes the key tax concepts covered in this chapter and their principal implications for real estate syndication investors and sponsors.

| Tax Concept                     | How It Works                                                                                                       | Primary Benefit                                                                                       | Key Limitation or Risk                                                                                                                                |
|---------------------------------|--------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------|
| Pass Through Taxation           | Partnership and LLC income, deductions, and losses flow directly to investors. No entity level federal income tax. | Depreciation deductions, losses, and credits flow to investors without corporate level tax reduction. | Taxable income allocates to investors whether or not cash is distributed. Complex K-1 preparation required.                                           |
| Straight Line Depreciation      | Building cost (excluding land) deducted over 27.5 years (residential) or 39 years (commercial).                    | Annual non-cash deductions shelter rental income from federal tax each year of the hold.              | Recaptured at maximum 25% on sale. Does not reflect economic reality of appreciating property.                                                        |
| Cost Segregation                | Engineering study reclassifies portions of building cost into 5, 7, or 15 year property categories.                | Front loads depreciation into early years, maximizing present value of deductions.                    | Suspended passive losses if investor cannot use deductions against passive income. Recapture on sale.                                                 |
| Bonus Depreciation (Post OBBBA) | Immediate expensing of qualifying personal property and land improvements identified in cost segregation.          | 100% permanent for property acquired and placed in service after January 19, 2025 (under OBBBA).      | Phase down rates (40% in 2025, 20% in 2026) apply to property acquired on or before January 19, 2025. Passive activity limitations may defer benefit. |
| Section 179 Expensing           | Immediate expensing of qualifying property up to \$2.5 million (post OBBBA).                                       | Available where state does not conform to federal bonus                                               | Subject to taxable income limitation. Generally less useful than bonus                                                                                |

| Tax Concept                          | How It Works                                                                                                | Primary Benefit                                                                                             | Key Limitation or Risk                                                                                           |
|--------------------------------------|-------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------|
|                                      |                                                                                                             | depreciation. Phaseout begins at \$4 million.                                                               | depreciation for federal purposes.                                                                               |
| Section 199A QBI Deduction           | Up to 20% deduction of qualified business income, including qualified REIT dividends.                       | Now permanent under OBBBA. Available for pass through rental activities meeting trade or business standard. | Phase ins, thresholds, and limitations apply. Rental qualification as trade or business is fact specific.        |
| Passive Activity Rules               | Losses from rental activities generally usable only against other passive income.                           | Losses carry forward indefinitely. Released in full in taxable sale year.                                   | Cannot offset W-2 income for most investors. Real estate professional exception is demanding.                    |
| Section 1231 Gains                   | Net gain from investment real estate taxed at long term capital gain rates.                                 | Preferential capital gain rates (0%, 15%, or 20%) on property appreciation rather than ordinary income.     | Lookback rule recharacterizes gain as ordinary to extent of prior year 1231 losses.                              |
| Unrecaptured Section 1250            | Depreciation taken on real property recaptured at maximum 25% rate on sale.                                 | Recapture rate (25%) is below ordinary income rates (up to 37%) for most investors.                         | All depreciation taken is subject to recapture. Reduces effective return relative to no depreciation investment. |
| 1031 Exchange                        | Gain deferred by reinvesting sale proceeds in like kind replacement property.                               | Defers recognition of all realized gain. Allows continued compounding without tax drag.                     | Strict 45 day and 180 day deadlines. Boot is taxable. LLC interests are not eligible relinquished property.      |
| DST and TIC for 1031                 | Direct real property interests qualifying as 1031 replacement property for individual investors.            | Provides 1031 eligible replacement property for investors exiting a syndication.                            | Rev. Proc. 2002-22 and Rev. Ruling 2004-86 constraints. DST management inflexibility.                            |
| FIRPTA Section 1445                  | 15% withholding by transferee on amount realized in direct purchase of USRPI from foreign person.           | Reconcilable on foreign seller's U.S. tax return. Withholding certificate may reduce rate.                  | Applied to gross amount realized, not gain. Withholding may exceed actual tax liability.                         |
| Partnership Withholding Section 1446 | Partnership withholds on foreign partner's share of ECI from real property sale at highest applicable rate. | Coordinates with FIRPTA to capture U.S. tax on foreign investors' partnership gains.                        | Withholding at 37% for individuals or 21% for corporations is substantially higher than Section 1445 rate.       |
| Section 1446(f) Transfers            | 10% withholding by transferee on amount realized in transfer of                                             | Complements Section 1445 and 1446 to address                                                                | Compliance obligation on transferee. Personal liability for failure to                                           |

| Tax Concept  | How It Works                                                                           | Primary Benefit                                                     | Key Limitation or Risk                                                                     |
|--------------|----------------------------------------------------------------------------------------|---------------------------------------------------------------------|--------------------------------------------------------------------------------------------|
|              | partnership interest by foreign person.                                                | foreign sales of partnership interests.                             | withhold. Certifications can reduce rate.                                                  |
| Section 1061 | Carried interest gains are long term only if underlying assets held more than 3 years. | Long term capital gain rates on promote when 3 year hold satisfied. | Short term ordinary income rates on promote for early exit gains. State conformity varies. |

## Practical Takeaways

- Pass through taxation is the foundation of the real estate syndication tax advantage. The SPV, whether an LLC or LP, pays no federal income tax itself. All income, deductions, credits, and losses flow through to investors and are reported on their individual returns. This structure is what makes depreciation deductions and other real estate tax benefits available at the investor level.
- The K-1 is not a formality. It is the legal document that tells each investor what to report on their tax return. K-1s that are late, inaccurate, or inconsistent with the partnership's books create investor relations problems and potential IRS scrutiny. Fund administrators with specific real estate fund experience produce better K-1s. Sponsors who attempt to produce K-1s without qualified assistance produce problems.
- Cost segregation is standard practice for significant acquisitions. The cost of the study is typically recovered many times over in present value tax benefit. The PPM should disclose whether a cost segregation study is planned and should note that actual tax benefits depend on study results and each investor's specific circumstances.
- Bonus depreciation has been restored to 100% permanently under the OBBBA for property acquired and placed in service after January 19, 2025. Property acquired on or before January 19, 2025 remains subject to the pre OBBBA phase down (40% for 2025, 20% for 2026, 0% thereafter). Sponsors with assets acquired around the transition date should work with tax counsel to determine which rate applies, and projections in offering materials should reflect the actual applicable rate rather than assumptions from earlier templates.
- Most syndication investors cannot use real estate losses against their W-2 income. The passive activity loss rules limit rental losses to offset against passive income only. Suspended losses carry forward and are released in the year of a taxable sale. Sponsors should not represent to investors that they will receive immediate tax savings from depreciation deductions without specifically addressing whether the investor's tax situation allows use of passive losses.

- Depreciation recapture is taxed at a maximum of 25%, not at ordinary income rates, for most real estate investments. This rate arbitrage, deducting at up to 37% during the hold and recapturing at no more than 25% at exit, is a genuine after tax benefit that is often underappreciated in investor presentations. Projections that show the same rate for both depreciation benefit and recapture cost are understating the net benefit.
- 1031 exchanges require a qualified intermediary, strict 45 day and 180 day deadlines, and complete reinvestment of proceeds to avoid boot. Individual investors who hold LLC membership interests cannot directly 1031 exchange those interests. Only direct real property interests qualify. DSTs and TICs provide the primary institutional solution for investors seeking 1031 eligible replacement interests.
- FIRPTA related withholding for partnerships with foreign partners is governed by Section 1446, not Section 1445, and the withholding rate is the highest applicable U.S. tax rate (37% for individuals, 21% for corporations), substantially higher than the 15% direct sale rate. Sponsors who accept foreign investor capital must plan for partnership level withholding at exit and should not project after tax returns to foreign investors based on the lower Section 1445 rate. Section 1446(f) imposes a separate 10% withholding obligation on transferees in partnership interest transfers by foreign persons.
- Section 1061's three year holding period requirement for carried interest long term gain treatment is directly relevant to fund sponsors' after tax economics on deals exited within the first three years. The rule was not changed by the OBBBA. Sponsors should model the Section 1061 impact on their carry before finalizing the fund's distribution waterfall projections.
- State tax consequences vary significantly by investor residence and property location. Investors may be required to file non-resident returns in every state where the fund holds property. This obligation should be disclosed in the PPM, not discovered by investors when they receive their K-1s.
- Securities counsel and tax counsel must work together, not sequentially. The entity structure, allocation provisions, tax projections in the PPM, investor qualification language, and exit structure all require coordinated analysis by both disciplines. The OBBBA changes to bonus depreciation and Section 199A make this coordination especially important during the current transition period. Sponsors who bring both counsel to the table at the deal structuring stage, not after the documents are drafted, build offerings that work as both legal and tax matters.

## CHAPTER TWELVE

# Selecting Your Securities Exemption

Choosing the right securities exemption is not a compliance checkbox. It is the structural decision that determines the investor universe available to the offering, the marketing strategy the sponsor can lawfully pursue, the ongoing reporting obligations the sponsor accepts, and the documentation requirements that govern investor onboarding. Everything downstream of the exemption choice flows from it. Select the wrong exemption, or begin the offering without having made a deliberate choice, and the consequences range from expensive to irreversible.

The framework for exemption selection is the same across all private real estate syndications. The Securities Act of 1933 requires registration or an exemption from registration for every offer and sale of a security in the United States. The available exemptions, including Regulation D's Rule 506(b) and Rule 506(c), Regulation A+, Regulation CF, Regulation S, and a few others, each have defined requirements, defined investor pools, defined disclosure obligations, and defined marketing constraints. None of that changes based on the type of real estate being acquired or the specific structure of the offering.

What does change is how the exemption's requirements interact with the sponsor's investor relationships, marketing strategy, offering size, timing constraints, and capital raising objectives. A sponsor raising capital from established high net worth relationships without any public marketing faces a different analysis than a sponsor building a digital investment platform designed to reach retail investors. Getting this decision right, and making it first before any marketing materials are prepared or investor conversations occur, is the foundation on which every subsequent compliance decision rests.

This chapter works through each major exemption, explains what it requires and what it prohibits, describes when it is the right tool, and identifies the most common mistakes sponsors make in the selection and execution process. It concludes with a decision framework and comparison table for sponsors evaluating which exemption fits a specific offering.

## Registration and Exemption: The Default Rule and Its Exceptions

The Securities Act of 1933 establishes a baseline rule that applies without exception: every offer and sale of a security must either be registered with the SEC or qualify for a statutory or regulatory exemption from registration. There is no general waiver, no threshold below which the registration requirement disappears, and no grace period for sponsors who have not yet determined which exemption applies to their offering. The registration requirement attaches

from the first offer, not the first sale, and the obligation to comply with the applicable exemption is continuous from that moment.

Registering a public offering involves preparing a detailed registration statement containing extensive disclosure about the issuer, its management, its financial condition, and the terms of the offering; filing that statement with the SEC; submitting to SEC review and comment; and then complying with ongoing reporting obligations once the offering is effective. For a real estate syndication, this process is almost never the right choice. It is expensive, commonly \$500,000 to \$1 million or more in legal and accounting fees for a typical offering, time consuming, typically requiring six months to a year from commencement to effectiveness, and designed for companies raising capital from the general public, not for sponsors raising equity for a specific real estate acquisition from a defined pool of investors.

Private placement exemptions allow sponsors to raise capital without going through the full registration process, provided they satisfy the specific conditions of the chosen exemption. These conditions are not negotiable and are not aspirational. Sponsors who satisfy them can raise capital from qualified investors through private channels. Sponsors who fail to satisfy them, even inadvertently, lose the exemption and are left with an unregistered public offering, with all the rescission liability, regulatory enforcement exposure, and investor litigation that entails.

The consequences of an unregistered offering extend beyond administrative exposure. Section 12(a)(1) of the Securities Act gives purchasers in an unregistered offering the right to rescind their purchase, meaning the right to demand their money back regardless of how the investment has performed. A real estate syndication that loses the benefit of its chosen exemption may face rescission demands from every investor who participated, at a moment when the underlying real estate investment may not be liquid enough to fund those demands. The stakes make getting the exemption right from the beginning a legal and financial necessity.

## **Regulation D: The Workhorse of Real Estate Capital Raising**

Regulation D, promulgated under the Securities Act by the SEC, provides the primary exemption framework for private real estate capital raising in the United States. It has been the dominant exemption for private real estate syndications for decades, and it remains the appropriate tool for the vast majority of private real estate offerings. Understanding Regulation D, specifically the differences between its two primary rules, 506(b) and 506(c), is foundational to any serious discussion of securities law compliance for real estate sponsors.

### **Rule 506(b): Private Capital from Known Investors**

Rule 506(b) is the workhorse of American private capital formation. Under this rule, a sponsor may raise an unlimited amount of capital from investors, with no cap on offering size. The eligible investor universe is broad: all accredited investors plus up to 35 non-accredited but sophisticated investors. The sophisticated investor category covers people who, even without meeting the financial thresholds for accredited status, have enough investment knowledge and experience to evaluate the opportunity on its merits without the protections that registration would provide.

Accredited investor status under 506(b) is self-certified. The sponsor does not have to independently verify accreditation beyond collecting representations in the subscription agreement. This reduced verification burden is one of 506(b)'s most operationally attractive features. No third party document review, no income verification, no net worth documentation beyond what the investor represents.

The critical limitation, and the condition that most commonly catches sponsors off guard, is the prohibition on general solicitation. The offering must be genuinely private. Communications about the specific investment opportunity must be directed only to investors with whom the sponsor has a pre-existing substantive relationship. The sponsor must have known the investor before presenting the deal, must understand the investor's financial circumstances well enough to assess suitability, and must have a basis for believing the opportunity is appropriate for them.

### What “Pre-existing Substantive Relationship” Actually Means

Pre-existing substantive relationship sounds more precise than it is. The SEC has never defined it with sharp edges, but enforcement history and staff guidance paint a consistent picture. The relationship must predate the offering. A sponsor cannot meet someone at a conference and call them a pre-existing relationship when they pitch the deal the following week. The relationship must also be substantive. The sponsor must have enough information about the investor's financial situation to make an informed judgment about suitability, not just know their name and contact information.

The relationship must also have been established without general solicitation. A sponsor who builds an investor list by posting on social media, running online advertisements, or presenting at public events has engaged in general solicitation in the course of creating those relationships, even if the actual deal pitch comes later in a one on one conversation. The earlier activity taints the relationship for 506(b) purposes. This is a source of genuine problems for sponsors who move between marketing activities and capital raising activities without maintaining clear conceptual separation between the two.

For sponsors who operate websites, publish educational content, appear on podcasts, or maintain any public facing marketing presence, which describes most professionally managed



real estate platforms, the line between permissible educational content and prohibited deal promotion requires attention. Publishing educational content about real estate investing is not general solicitation. The line is crossed when the content promotes a specific investment opportunity, describes a particular property, discusses projected returns for a current offering, or invites people to contact the sponsor about participating. A sponsor who writes about real estate syndication generally can maintain a 506(b) posture. A sponsor who describes their current deal in public channels has crossed into general solicitation territory, foreclosing 506(b) for that offering.

### **⚠ Digital Presence and 506(b) Discipline Require Deliberate Line Drawing**

*The practical challenge for sponsors with active digital presences is that the marketing infrastructure most associated with professional real estate platforms (investor portals, deal specific websites, email campaigns describing current opportunities) is inherently public facing. A publicly accessible page describing a specific offering is general solicitation. Full stop.*

*Sponsors who want to rely on 506(b) while using digital channels must ensure that deal specific information is accessible only to investors with confirmed pre-existing relationships, not to the general internet. That is an access control decision that must be made before the marketing infrastructure is built, not after investors have already seen content that constituted solicitation.*

## **Rule 506(c): General Solicitation with Verified Accreditation**

Rule 506(c) emerged from the JOBS Act of 2012 as a direct response to the tension between private offering requirements and the realities of digital marketing. It allows sponsors to engage in general solicitation (advertising, social media marketing, online platforms, public presentations, podcasts, email campaigns to strangers) while still relying on a private placement exemption, provided they satisfy a stricter investor eligibility standard on the back end.

For sponsors who use digital marketing, operate public facing investment platforms, or build their investor base through any form of public outreach, 506(c) is frequently the more appropriate choice. It removes the awkward discipline of maintaining 506(b) boundaries while simultaneously trying to build a visible public presence, by permitting the public marketing and concentrating the compliance energy instead in the verification process.

## **What 506(c) Requires**

The tradeoff for general solicitation permission is a stricter accreditation standard. Under 506(c), all investors must be accredited. The non-accredited sophisticated investor allowance of 506(b)

is not available. The issuer must also take reasonable steps to actually verify that accredited status, rather than simply accepting investor self-certification.

Reasonable steps to verify accreditation under 506(c) means reviewing third party documentation that independently establishes the investor's financial qualifications. For income based accreditation, that means two years of tax returns or W-2s showing income above the applicable threshold, plus a representation that the investor reasonably expects to continue meeting the income standard. For net worth based accreditation, that means account statements, appraisals, and credit reports sufficient to verify that assets minus liabilities exceed \$1 million excluding the primary residence, or a written confirmation letter from a licensed attorney, CPA, registered investment advisor, or registered broker dealer who has reviewed the investor's financial information and confirmed accredited status.

Self-certification through a checkbox in the subscription agreement does not satisfy the 506(c) verification requirement. This distinction is one of the most common compliance errors in the private real estate market. Sponsors who believe they are conducting 506(c) offerings because they are marketing publicly, but who are accepting investor self-certification rather than obtaining third party verification documentation, have a problem. A 506(c) offering with self-certified accreditation is not a 506(c) offering. It is an unregistered public offering.

### **⚠ 506(c) Verification Must Use Third Party Documentation, Not Self-certification**

*Many investment platforms include investor questionnaires that ask investors to self-certify their accredited status by checking a box. That satisfies 506(b). It does not satisfy 506(c).*

*A sponsor who uses general solicitation (any public marketing, any publicly accessible offering description, any advertising) and who relies on investor self-certification of accreditation has not complied with 506(c). They have sold securities without a valid exemption. The verification requirement is not a formality. It is the condition that makes general solicitation permissible.*

*Accreditation verification services that review documentation and issue verification letters have become the standard mechanism for satisfying this requirement. Many of these services integrate directly with investment platforms, allowing verification to be completed as part of the digital investor onboarding process.*

## **Marketing Considerations Under 506(c)**

The general solicitation permission of 506(c) does not mean anything goes. Every marketing statement (website content, social media posts, investor presentations, pitch decks, podcasts, email campaigns) is a statement to potential investors subject to the antifraud provisions of the

securities laws. Material misstatements or misleading omissions in any marketing communication create liability regardless of the exemption used.

Particular care is required with return projections, which must be clearly labeled as projections with meaningful risk disclosures and must not be structured in ways that could be read as guarantees; liquidity representations, which create investor expectations about secondary market access that must be accurate and achievable; and social media, where informal posts about the offering create the same antifraud exposure as formal marketing materials. A social media post describing projected returns is a securities communication. It should be reviewed by securities counsel before publication, not treated as casual commentary.

The rule of thumb for 506(c) marketing is that everything a potential investor might see and rely upon in deciding whether to invest must be accurate, balanced, and consistent with the offering documents. The permission to market publicly comes with the responsibility to market carefully.

### **Which Regulation D Rule Is Right for Your Offering?**

The decision between 506(b) and 506(c) is driven primarily by two factors: the sponsor's marketing strategy and the composition of the investor base.

If the sponsor is raising capital exclusively from investors they know personally, including existing relationships with high net worth individuals, family offices, or institutional investors who have invested with the sponsor before, and if the sponsor is not using any form of public marketing to promote the specific offering, 506(b) is the right choice. Its reduced verification burden, broader investor universe (including sophisticated non-accredited investors), and lower administrative overhead are genuine advantages when the sponsor already has the investor relationships they need.

If the sponsor is using any form of public marketing (digital platforms, social media, email campaigns to non-established relationships, public events, advertising of any kind), 506(c) is not optional. The moment general solicitation occurs, the exemption must be 506(c) or the offering is unregistered. The additional verification burden of 506(c) is the price of the marketing flexibility it permits, and for sponsors who rely on digital channels to build their investor base, that price is worth paying.

The single most important rule: the exemption is selected first. Marketing activities are designed around it. No general solicitation should occur before the sponsor has affirmatively decided that the offering will be conducted under 506(c). Once general solicitation has occurred in connection with a specific offering, 506(b) is unavailable for that offering regardless of what the sponsor might prefer.

## Regulation A+: Public Offerings for Growth Stage Sponsors

Regulation A+, sometimes called a mini public offering or a mini IPO, occupies a middle ground between a fully registered public offering and a private placement. It allows issuers to raise capital from both accredited and non-accredited investors using an offering circular reviewed and qualified by the SEC, without going through the full registration process that a traditional public offering requires. For real estate sponsors seeking to build a genuinely broad investor base that includes retail investors, Regulation A+ is the most important exemption to understand.

### Tier 1 and Tier 2

Regulation A+ has two tiers with meaningfully different characteristics and cost profiles.

**Tier 1** allows issuers to raise up to \$20 million in any 12 month period from both accredited and non-accredited investors. It does not preempt state securities law, meaning the offering must qualify under each state's blue sky laws in every state where it is offered. For a national real estate offering, this state by state qualification process can be expensive and time consuming, making Tier 1 poorly suited for most real estate sponsors with national capital raising ambitions.

**Tier 2** allows issuers to raise up to \$75 million in any 12 month period from both accredited and non-accredited investors. It preempts state blue sky registration requirements (though notice filings are still required in some states). Non-accredited investors in a Tier 2 offering can invest up to the greater of 10% of their annual income or 10% of their net worth. The offering circular must be reviewed and qualified by the SEC, and the issuer has ongoing reporting obligations, including annual reports (Form 1-K), semiannual reports (Form 1-SA), and current reports for material events (Form 1-U).

For most sponsors considering Regulation A+ for a real estate offering, Tier 2 is the relevant option. The \$75 million annual cap is sufficient for many real estate deals and fund raises. The preemption of state blue sky registration simplifies multi-state offerings. And the ability to reach non-accredited retail investors, potentially at investment minimums of \$1,000 to \$5,000 per investor, is the primary reason to use Regulation A+ at all. If the offering is limited to accredited investors, Rule 506(c) is simpler, faster, and dramatically cheaper.

### The SEC Review and Qualification Process

Before any securities can be sold under Regulation A+, the issuer must file an offering circular (on Form 1-A) with the SEC and obtain SEC qualification. This is not a registration requirement in the traditional sense. The SEC does not register or approve the offering. But the qualification process involves substantive SEC review, staff comments, and multiple rounds of response before the offering circular is declared qualified and sales may commence.

The qualification timeline is real and must be built into the project schedule. The SEC's initial review of a Form 1-A typically takes 30 to 45 days. If the SEC issues comments, which is nearly universal, the issuer must respond, the SEC reviews the response, and additional rounds may follow. The total process from initial filing to qualification commonly takes three to six months. Sponsors who underestimate this timeline, including those who plan to open sales before qualification is complete, face a securities violation, not a scheduling inconvenience.

The offering circular required for a Regulation A+ offering resembles a registration statement in scope and detail. It must include audited financial statements (two years for Tier 2 offerings), a detailed description of the business and the offering, a management discussion and analysis, executive compensation disclosure, and extensive risk factors. Preparing an offering circular for a real estate Regulation A+ offering is a substantial legal and accounting undertaking that requires specific experience with the form and the SEC review process.

## Ongoing Reporting Obligations

Tier 2 issuers face ongoing annual and semiannual reporting obligations that persist throughout the life of the offering and beyond. Annual reports on Form 1-K, which must be filed within 120 days of the fiscal year end, include audited financial statements and a management discussion of performance. Semiannual reports on Form 1-SA, which must be filed within 90 days of the end of the first six months of the fiscal year, include unaudited financial statements. Material events (property acquisitions, significant financial developments, changes in management) must be reported on Form 1-U within four business days.

These are real ongoing obligations with real costs. The accounting fees associated with annual audits and regular financial reporting, combined with the legal fees for preparing and filing the forms, represent a meaningful ongoing expense that the offering must be large enough to justify. For a \$75 million Regulation A+ offering, these costs are a reasonable cost of access to the retail investor market. For a \$10 million offering, the cost benefit analysis is less compelling.

## When Regulation A+ Makes Sense for Real Estate

Regulation A+ is appropriate when the sponsor's primary objective is access to the retail investor market, meaning investors who do not meet the accredited investor thresholds and who cannot participate in Regulation D offerings. Real estate sponsors who have exhausted or are not targeting the traditional high net worth accredited investor base, who want to build a large investor community with lower minimum investments, and who have the operational infrastructure to handle a large number of small investors are the natural fit for Regulation A+.

It is also appropriate when the sponsor intends to build a platform rather than raise capital for a single deal. A real estate investment company that plans to make multiple offerings over time to

a growing retail investor base, using the SEC qualified offering circular as the foundation for a publicly marketed investment program, is a natural Regulation A+ candidate.

It is not appropriate as a substitute for Regulation D for sponsors who are raising capital from accredited investors and who simply prefer to avoid verification requirements. The cost differential between a Regulation D offering (\$15,000 to \$50,000 in legal fees for a straightforward PPM and Form D filing) and a Regulation A+ offering (\$300,000 to \$600,000 in upfront legal and accounting fees, plus ongoing reporting) makes Regulation A+ the wrong tool for a sponsor who could accomplish their capital raising objectives under Regulation D.

### **⚠ Regulation A+ Requires SEC Qualification Before Any Securities Are Sold**

*The offering circular must be filed with and qualified by the SEC before any securities can be sold and before any investor commitments can be accepted with the intent to issue securities. Selling interests, or even collecting investor commitments, before SEC qualification is a securities violation regardless of how far along the qualification process has progressed.*

*The qualification timeline must be built into the offering schedule from the beginning, not treated as a parallel process while sales are beginning. Sponsors who start marketing before qualification is complete, or who accept investor funds in anticipation of qualification, create legal exposure that is difficult and expensive to remediate.*

## **Regulation CF: The Crowdfunding Option**

Regulation Crowdfunding, commonly called Regulation CF, allows issuers to raise capital from the general public through SEC registered online crowdfunding platforms, subject to relatively low offering size limits. The current annual offering cap under Regulation CF is approximately \$5 million, adjusted periodically by the SEC. Non-accredited investors may participate, with investment limits tied to their income and net worth.

### **Investment Limits and Aggregate Offering Caps**

Regulation CF imposes investment limits on non-accredited investors that depend on income and net worth. If either the investor's annual income or net worth is less than \$124,000, the investor's limit in any 12 month period across all Regulation CF offerings is the greater of \$2,500 or 5% of the greater of annual income or net worth. If both annual income and net worth are equal to or more than \$124,000, the limit is 10% of the greater of annual income or net worth, with an aggregate cap of \$124,000 in any 12 month period across all Regulation CF offerings. The aggregate limits apply across all Regulation CF offerings in a 12 month period,

not per offering. An investor who has already invested up to the cap in other Regulation CF offerings cannot invest additional amounts in a new one. The threshold figures are adjusted by the SEC periodically for inflation.

The \$5 million annual aggregate offering cap constrains the offering size to a fraction of what most meaningful commercial real estate deals require. A \$15 million multifamily acquisition with \$5 million in equity cannot be fully funded through Regulation CF regardless of how many investors participate. For real estate deals of any significant size, Regulation CF is structurally insufficient.

### **Platform Requirements and Registered Intermediaries**

Every Regulation CF offering must be conducted through a registered crowdfunding intermediary, either a registered broker dealer or a registered funding portal (a category created specifically for Regulation CF). The issuer cannot conduct a Regulation CF offering directly without an intermediary. The intermediary is responsible for investor education, investor suitability screening, escrow of investor funds, and EDGAR filing compliance.

The intermediary requirement creates a structural dependency that affects the sponsor's control over the investor experience. The crowdfunding platform determines the investor onboarding process, the presentation of the offering, and the mechanics of investor communication. Sponsors who want to control their own investor experience, including their own branding, their own communication, and their own data, find the platform intermediary requirement limiting. The platform is not merely a service provider. It is a required participant whose compliance obligations shape the entire offering process.

### **Limitations for Real Estate Transactions**

For most professional real estate sponsors, Regulation CF is not the right tool. Its limitations are structurally incompatible with most commercial real estate transactions. The \$5 million offering cap is too small for most meaningful deals. The intermediary requirement limits sponsor control. The per investor investment limits mean that large checks from individual investors are not available. The \$5 million must come from many small investors, which creates significant investor relations overhead.

Regulation CF has genuine appeal for very small deals, such as a local retail property or a small multifamily acquisition, where community investor participation is itself a marketing objective and where the sponsor is comfortable with the platform intermediary structure. For sponsors building institutional quality real estate platforms, Regulation D or Regulation A+ will almost always be the better tool.



## Regulation S: Offerings to Non U.S. Persons

Regulation S provides an exemption from the Securities Act's registration requirements for offers and sales of securities that occur outside the United States, to non U.S. persons. It is not a standalone offering structure for most real estate sponsors. It is typically used in combination with a domestic offering under Regulation D or Regulation A+, allowing sponsors to reach international investors simultaneously with a domestic capital raise. As real estate syndication has become increasingly global, understanding Regulation S has become a practical necessity for sponsors with any meaningful international investor base.

### The Core Requirements

Regulation S has two foundational requirements that must both be satisfied. First, the offer and sale must be made in an offshore transaction, meaning the buyer must be outside the United States at the time of the offer and sale, and no directed selling efforts toward U.S. persons may occur in connection with the offering. Second, the issuer must implement reasonable safeguards against resale of the securities to U.S. persons during the applicable restricted period.

The definition of a U.S. person under Regulation S is more nuanced than it might appear. It includes U.S. citizens and residents regardless of where they are physically located. A U.S. citizen living in London is a U.S. person for Regulation S purposes and cannot participate in a Regulation S offering. The definition also encompasses certain entities: partnerships and corporations organized under U.S. law, estates of U.S. persons, and trusts administered by U.S. persons. Confirming non U.S. person status requires substantive due diligence, including review of passport and residency documentation, not just a checkbox on a subscription form.

### The Three Safe Harbors: Categories 1, 2, and 3

Regulation S provides three safe harbor categories that define the conditions for compliance. The applicable category depends on the nature of the issuer and the securities being offered.

**Category 1** is available for securities of foreign issuers where there is no substantial U.S. market interest in the class of securities being offered. It provides the broadest protection and the most flexibility, but it is generally not available for U.S. real estate sponsors offering equity securities in U.S. real estate assets. The SEC will typically view such offerings as having substantial U.S. market interest.

**Category 2** is available for equity securities of reporting issuers (companies required to file with the SEC under the Exchange Act) and debt securities of non-reporting issuers. The restricted period is 40 days. For private real estate sponsors who are not Exchange Act reporting



companies and who are offering equity interests in real estate entities, Category 2 is also generally not available.

**Category 3** applies to equity securities of non-reporting issuers, which is the category most relevant for private real estate syndications. Under Category 3, the restricted period for equity securities is one year from the later of the completion of the offering or the date the investor's securities were acquired. During this restricted period, the securities cannot be transferred to U.S. persons without an independent registration exemption.

For a U.S. real estate sponsor offering equity interests in a U.S. LLC or LP to non U.S. investors under Regulation S, Category 3 is the applicable framework. The one year restricted period must be enforced through offering document restrictions, certification requirements, and ongoing monitoring of transfers during the restricted period.

### Flowback Restrictions and the Restricted Period

The flowback restrictions are the mechanism through which Regulation S prevents offshore securities from reentering the U.S. market during the restricted period through secondary transfers. During the one year Category 3 restricted period, the issuer and any distributor must not make directed selling efforts to U.S. persons in connection with the offering, and the offering documents must include restrictive legends, certification requirements for transfers, and structural safeguards that prevent resale to U.S. persons.

After the restricted period expires, the securities held by non U.S. persons may be resold to U.S. persons only if an independent registration exemption is available, typically Rule 144, if the applicable holding period has been satisfied. Transfers within the restricted period between non U.S. persons outside the United States generally do not require an independent exemption, provided they are not made to U.S. persons and are not directed selling efforts.

Monitoring compliance with the restricted period in a conventional paper based offering requires ongoing attention. Transfer restriction legends on certificates or equivalent documentation, certification requirements imposed on any transferee, and tracking of the one year restricted period for each investor's position are all part of the compliance picture. These monitoring obligations are real and must be specifically addressed in the offering documents and the sponsor's compliance procedures.

### Practical Use for Real Estate Sponsors with International Investor Bases

For real estate sponsors who have established relationships with non U.S. family offices, international high net worth investors, or foreign institutional investors, Regulation S provides the legal framework for including those investors in a domestic real estate offering. The mechanics are straightforward. U.S. investors participate under Rule 506(b) or 506(c). Non U.S.

investors participate under Regulation S. A single SPV or fund entity issues interests to both groups under a unified set of offering documents that address both regimes.

The PPM must address both the domestic and offshore-exemptions. The subscription agreement must include appropriate representations from non U.S. investors regarding their status, their location at the time of purchase, and their agreement to the transfer restrictions applicable during the restricted period. The operating agreement must address the transfer restriction provisions that apply to Regulation S interests and the enforcement mechanism for those restrictions.

## Combining Exemptions: Simultaneous Domestic and International Offerings

Many sophisticated real estate sponsors combine a domestic Regulation D offering with a concurrent Regulation S offering, reaching U.S. accredited investors through the domestic exemption while simultaneously reaching international investors through the offshore-exemption. Under this structure, U.S. investors and non U.S. investors receive interests in the same SPV or fund entity, but their eligibility is governed by different legal frameworks that must both be satisfied.

### How the Combined Structure Works

#### Combined Reg D 506(c) and Regulation S Structure

*Domestic component under Rule 506(c): all U.S. investors must be accredited investors; accreditation must be verified through third party documentation; general solicitation is permitted for the domestic component; Form D must be filed within 15 days of the first sale; Rule 144 lockup of 12 months applies before secondary transfers.*

*Offshore component under Regulation S, Category 3: all investors must be non U.S. persons confirmed through documentation review; no directed selling efforts to U.S. persons in connection with the offering; restricted period of one year from the later of offering completion or the investor's acquisition; transfer restrictions must prevent resale to U.S. persons during the restricted period; the subscription agreement must include non U.S. person representations and transfer covenants.*

*Both investor populations hold interests in the same entity. The offering documents must address both exemptions. Transfer restrictions must distinguish between U.S. and non U.S. holders and apply the appropriate regime to each.*

Secondary transfers within a combined Reg D and Reg S offering require specific analysis. A non U.S. investor who wants to sell their interest during the Regulation S restricted period must

find either another eligible non U.S. person as buyer (permitted under the offshore transfer provisions) or a U.S. accredited investor who can satisfy an independent transfer exemption. A U.S. investor who wants to sell their interest must find either another accredited investor (after the Rule 144 lockup period) or a qualifying non U.S. buyer who can take the interest under Regulation S. These cross category transfers require legal analysis that must be built into the transfer review process.

### **⚠ Multi Exemption Structures Require Multi Exemption Legal Analysis**

*The legal analysis for a combined Reg D and Reg S offering is not simply the sum of two standalone analyses. Each exemption has its own investor eligibility requirements, its own marketing restrictions, its own disclosure obligations, and its own transfer restriction framework. Coordinating those requirements for a single offering serving two investor populations requires securities counsel who understands both regimes.*

*Sponsors who build multi exemption offering structures without qualified securities counsel, or who rely on platform level documentation that was not specifically reviewed for their offering's facts, are accepting legal risk that the offering documents may not support the exemptions they are relying upon.*

## **Rule 144 and the Holding Period Requirement**

Rule 144 governs when holders of restricted securities, including securities acquired in private placements and other unregistered transactions, may resell those securities without registration. The most important Rule 144 requirement for real estate syndication purposes is the holding period. Restricted securities may generally not be resold for 12 months from the date they were acquired from the issuer.

This 12 month holding period is one of the most consistently mishandled compliance requirements in private real estate offerings, not because sponsors are unaware of it, but because enforcing transfer restrictions manually is operationally difficult across a large investor base. The sponsor or transfer agent must track the acquisition date for each investor's position and confirm that the holding period has elapsed before approving any proposed transfer. This process is prone to error, delay, and inconsistency in paper based systems.

In a conventional syndication, the operating agreement's transfer restriction provisions should implement the Rule 144 holding period by prohibiting any transfer of membership interests for 12 months from the date of original acquisition. Investors must agree to these restrictions in the subscription agreement, and any proposed secondary transfer must be reviewed for compliance

before it is permitted. This review should include confirmation of the acquisition date, the identity of the proposed transferee, the transferee's accredited investor status, and any additional transfer conditions in the operating agreement.

### When the 12 Month Clock Starts

A common timing error is treating the subscription date as the start of the Rule 144 holding period. The holding period runs from the date the investor actually acquires the restricted securities, which is the date of closing and issuance, not the date they signed the subscription agreement or committed capital. In real estate syndications where capital calls occur months after subscription, or where the closing occurs weeks after the subscription is received, this distinction matters. An investor who subscribed in January but did not close until April has a holding period that begins in April.

In fund structures where interests are issued in tranches as capital calls are funded, the holding period starts separately for each tranche. An investor who funds three capital calls over 18 months has three separate holding periods running concurrently. The interests issued at the first capital call become transferable 12 months from their issuance; the second call interests 12 months from their issuance; and so on. Tracking these tranche specific holding periods requires specific record keeping that the fund administrator must maintain.

## Intrastate Offering Exemptions

The Securities Act's Section 3(a)(11) provides a statutory exemption for offerings that are part of an issue offered and sold only to persons resident within a single state or territory, where the issuer is also a resident of and doing business within that state. Rule 147 and Rule 147A provide regulatory safe harbors for relying on the intrastate exemption.

Rule 147 (the traditional intrastate exemption) requires the issuer to be incorporated or organized in the state, to have its principal place of business there, to conduct 80% of its business operations there, to use at least 80% of the offering proceeds for business within the state, and to offer and sell only to in state residents. The offering is subject to state blue sky law in the offering state, and the securities have transfer restrictions preventing resale to out of state residents for 6 months after the offering.

Rule 147A is a modernized version that allows the issuer to be incorporated out of state while maintaining its principal place of business in the offering state, and that allows general solicitation directed only to in state residents. Otherwise, the substantive requirements are similar to Rule 147.

For most real estate syndications, the intrastate exemptions are of limited practical value. Real estate sponsors who raise capital from investors in multiple states cannot rely on the intrastate

exemption for those multi-state raises. The exemption is most useful for sponsors who are raising capital exclusively from investors in a single state, who have no investors (current or anticipated) in other states, and whose investor pool is small enough to make multi-state compliance unnecessary. For sponsors who are building a scalable capital raising program, starting under a state limited exemption and then needing to migrate to Regulation D is operationally awkward. Starting with Regulation D, even for an initially single state offering, preserves flexibility as the investor base grows.

## Factors Sponsors Should Consider When Selecting an Exemption

No exemption is universally right for every sponsor in every situation. The correct choice depends on the intersection of several factors that are specific to the sponsor, the offering, and the investors they are trying to reach.

### Investor Base and Accreditation Profile

The single most important factor is who the sponsor wants to reach. If the offering is directed exclusively at accredited investors with established relationships, Rule 506(b) may be the right tool if no public marketing is involved. If the sponsor wants to use digital marketing and a public facing platform while limiting the offering to accredited investors, 506(c) is the appropriate choice. If the investor base includes non-accredited retail investors at all, Regulation A+ is the only viable private placement path. If capital is coming from non U.S. sources, Regulation S must be part of the structure.

One common mistake is selecting an exemption based on what the sponsor has used before, rather than what the investor base of the specific offering requires. A sponsor who raises every deal under 506(b) from a network of established high net worth relationships may not be the right fit for a digital offering targeting retail investors at \$5,000 minimums, and the reverse is true as well. Each offering should be evaluated on its own facts, and the exemption should follow from those facts rather than from prior habits.

### Marketing Strategy and Platform Architecture

The marketing strategy and the exemption must match from the beginning. A sponsor who builds a publicly accessible online platform describing a specific offering, before selecting an exemption, may have inadvertently engaged in general solicitation that locks them into 506(c) regardless of their original intent. Exemption selection should be the first decision, made before any marketing infrastructure is designed, before any offering specific content is published, and before any investor conversations about the specific deal occur.

The platform architecture must reflect the exemption's requirements, not the other way around. A sponsor who decides after building the platform that they want to use 506(b) has likely already engaged in general solicitation through the platform that forecloses that option. The sequence is exemption selection first, platform design second.

## Offering Size and Timeline

Regulation A+ imposes a \$75 million annual cap that limits larger offerings. Regulation D has no offering size limit, making it the appropriate path for any offering where the capital requirement could potentially exceed \$75 million. Regulation CF's \$5 million cap makes it structurally irrelevant for most commercial real estate transactions.

Timeline constraints are equally determinative. A Regulation A+ offering requires SEC qualification, commonly three to six months, before any securities can be sold. A Regulation D offering can proceed as soon as the offering documents are complete and Form D is filed, effectively immediately. Sponsors who have a property under contract with a fixed closing deadline cannot afford a six month SEC review process. Timing constraints frequently point toward Regulation D by default, even for sponsors who would otherwise consider Regulation A+.

## Ongoing Reporting Obligations

Regulation D imposes minimal ongoing SEC reporting. A Form D notice filing, followed by annual amendment filings for ongoing offerings, is the principal federal filing requirement. The investor information rights that flow from the operating agreement are the primary ongoing disclosure mechanism. Regulation A+ Tier 2 imposes annual reports, semiannual reports, and current event reports that represent a genuine administrative burden. For sponsors who are not prepared for ongoing SEC reporting obligations, Regulation D is the appropriate tool. For sponsors who are building a publicly marketed real estate investment platform with retail investor participation, Regulation A+'s reporting requirements are the price of admission to that investor base.

## Exemption Comparison Table

The following table summarizes the key characteristics of each exemption as they apply to a private real estate offering. The table is a reference tool. The specific analysis for any given offering requires legal review of the offering's specific characteristics.

| Exemption     | Offering Cap                       | Investor Pool                                                                    | General Solicitation                                         | SEC Review                                                                         | Key Limitations                                                                                      |
|---------------|------------------------------------|----------------------------------------------------------------------------------|--------------------------------------------------------------|------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------|
| Rule 506(b)   | Unlimited                          | Accredited investors plus up to 35 sophisticated non-accredited                  | Prohibited. Pre-existing substantive relationships required. | Form D notice filing only (no SEC review)                                          | No public marketing. Pre-existing relationships must be documented. Accreditation is self-certified. |
| Rule 506(c)   | Unlimited                          | Accredited investors only (no non-accredited exception)                          | Permitted. All forms of general solicitation allowed.        | Form D notice filing only (no SEC review)                                          | Third party verified accreditation required. Self-certification does not satisfy the standard.       |
| Reg A+ Tier 1 | \$20 million per year              | Accredited and non-accredited investors                                          | Permitted                                                    | SEC qualification required. State blue sky qualification also required.            | State by state qualification required. No preemption of state law. Limited to \$20 million.          |
| Reg A+ Tier 2 | \$75 million per year              | Accredited and non-accredited. 10% income or net worth limit for non-accredited. | Permitted                                                    | SEC qualification required (3 to 6 months). Ongoing annual and semiannual reports. | SEC review timeline. Ongoing reporting obligations. Audited financials required. \$75 million cap.   |
| Regulation CF | Approximately \$5 million per year | General public (accredited and non-accredited)                                   | Permitted through registered intermediary only               | Filed on Form C through EDGAR. Intermediary review.                                | Must use registered crowdfunding platform. \$5 million cap is too small for most commercial deals.   |
| Regulation S  | Unlimited (offshore only)          | Non U.S. persons only                                                            | Permitted offshore. No directed selling                      | No SEC registration required.                                                      | One year restricted period                                                                           |

| Exemption                    | Offering Cap                    | Investor Pool                                  | General Solicitation                                        | SEC Review                              | Key Limitations                                                                                                   |
|------------------------------|---------------------------------|------------------------------------------------|-------------------------------------------------------------|-----------------------------------------|-------------------------------------------------------------------------------------------------------------------|
|                              |                                 |                                                | efforts to U.S. persons.                                    | Compliance with Rules 903 and 904.      | (Category 3 equity). Flowback restrictions. Non U.S. person status must be verified.                              |
| Reg D plus Reg S Combined    | Unlimited                       | U.S. accredited investors and non U.S. persons | 506(c): permitted domestically. Reg S: permitted offshore.  | Form D only for domestic component.     | Dual exemption analysis required. Secondary transfers between investor classes require specific analysis.         |
| Intrastate (Rule 147 / 147A) | None (state law caps may apply) | In state residents only                        | Rule 147A: permitted if directed only to in state residents | No SEC review. State blue sky required. | Investors must be in state residents. Offering cannot include out of state investors. 6 month resale restriction. |

## The Decision Framework: Which Exemption Is Right for Your Offering?

The following framework distills the exemption selection analysis into a series of sequential questions. Each question narrows the field until the appropriate exemption is identified.

| Decision Factor                                     | Implication                                                                                                                  |
|-----------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------|
| Will the offering include any non U.S. investors?   | Yes: Regulation S must be part of the structure (combined with a domestic exemption). No: evaluate domestic exemptions only. |
| Will the offering include non-accredited investors? | Yes: Regulation A+ Tier 2 is the only domestic private placement path. No: evaluate Regulation D.                            |



| Decision Factor                                                                           | Implication                                                                                                                                           |
|-------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------|
| Will the sponsor use any form of public marketing?                                        | Yes: Rule 506(c) (accredited only, verified). No: Rule 506(b) (accredited plus sophisticated non-accredited, self-certified) is available.            |
| Does the sponsor have pre-existing substantive relationships with all intended investors? | Yes: Rule 506(b) viable if no general solicitation. No: Rule 506(c) required for any investor reached through public channels.                        |
| Does the offering need to close within 6 months?                                          | Yes: Regulation D (no SEC review). No: Regulation A+ is potentially feasible if retail access is a priority.                                          |
| Does the offering exceed \$75 million in equity?                                          | Yes: Regulation D required (no cap). Reg A+ not available above this threshold. No: evaluate all options.                                             |
| Is the offering limited to investors in a single state?                                   | Yes: Intrastate exemption (Rule 147 or 147A) may be available but consider scalability. No: federal exemption required.                               |
| Are secondary transfers anticipated?                                                      | Yes: Rule 144 holding period applies under Regulation D. Build the transfer restriction framework accordingly. Reg A+ has different resale mechanics. |

## Why Early Planning Is Not Optional

Securities exemptions are chosen at the beginning of the offering process, and many of the most important consequences of that choice cannot be reversed later. A sponsor who engages in general solicitation before selecting an exemption has potentially foreclosed the option of relying on 506(b) for that offering, even if they later determine that 506(b) would have been the better fit. A sponsor who begins marketing before a Regulation A+ offering circular is qualified by the SEC has offered and sold unregistered securities.

The timing problem extends to the offering documents. The PPM, operating agreement, subscription agreement, and investor qualification procedures all reflect the chosen exemption. If the exemption changes after the documents are drafted, because a marketing activity that occurred before the exemption was selected constituted general solicitation, the documents must be revised, investors who subscribed under the original exemption may need to be re solicited under the new one, and the legal analysis confirming that the offering is compliant must be redone. The remediation is expensive and often incomplete.

Early planning is the discipline that makes everything else possible. The exemption is selected first. The marketing strategy is designed around it. The offering documents are drafted consistent with it. The investor onboarding procedures implement its requirements. Everything

flows in that order, and reversing the flow later is always more-expensive than doing it right the first time.

Sponsors who want to build a scalable capital raising program, one that can grow from one deal to a portfolio, from a single state to national reach, from accredited investors to retail investors, need a securities compliance framework that is designed for that growth. The exemption decisions made on the first offering shape the infrastructure that the platform is built on. Treating those decisions as afterthoughts, and retrofitting compliance after the fact, is the approach that consistently produces the most expensive problems.

### **A Note on Exemption Selection and Legal Counsel**

*Exemption selection is a legal analysis, not a platform feature. The fact that an investment platform claims to support multiple exemptions does not mean that a specific offering is compliant with the exemption it purports to use. The legal requirements of each exemption must be specifically implemented in the offering documents, the investor qualification procedures, and the marketing conduct of the specific offering.*

*Securities counsel who has structured private real estate offerings knows where the common mistakes occur, and the mistake list is longer than most sponsors appreciate before they encounter it. Counsel who has experience with both 506(b) and 506(c) offerings, who understands the pre-existing relationship analysis for 506(b), who knows what third party verification actually requires under 506(c), and who can evaluate whether a specific marketing activity crossed the general solicitation line provides something that no platform documentation can replicate: a legal judgment about whether this specific offering, marketed in this specific way, to these specific investors, satisfies the chosen exemption.*

*Sponsors who are selecting an exemption for a new offering or evaluating whether prior marketing activities have affected their exemption options are welcome to reach out at [crowdfundlawyer.com](http://crowdfundlawyer.com).*

## **Practical Takeaways**

- Exemption selection is the most consequential structural decision in a private real estate offering. Everything downstream (marketing strategy, investor pool, offering documentation, transfer restriction framework, ongoing reporting obligations) flows from it. The decision must be made before the first investor is approached, the first marketing material is published, and the offering documents are drafted.

- Rule 506(b) is the right tool for sponsors raising capital from investors with established pre-existing relationships, without any public marketing. Building investor relationships without general solicitation requires discipline in how investors are identified and approached. Digital marketing that promotes specific offerings, public presentations about current deals, and online platforms describing live investment opportunities all constitute general solicitation that forecloses 506(b) for that offering.
- Rule 506(c) is the appropriate choice for sponsors who use digital marketing, maintain public facing investment platforms, or reach investors through any form of public outreach. The tradeoff is mandatory third party verification of accredited investor status. Self-certification through a subscription agreement checkbox does not satisfy the standard. Every investor in a 506(c) offering must have their accreditation verified through review of actual documentation.
- Regulation A+ Tier 2 is the only private placement path to non-accredited retail investors. Its \$75 million annual cap, three to six month SEC qualification process, and ongoing reporting obligations make it a significant commitment that must be justified by the retail investor access it provides. For sponsors whose investor base is limited to accredited investors, Regulation D is almost always the more efficient tool.
- Regulation CF's \$5 million annual cap makes it structurally inadequate for most commercial real estate transactions. It is appropriate for very small deals with genuine community investor appeal, not for sponsors building institutional quality real estate platforms.
- Regulation S is the framework for international capital. Non U.S. investors in a domestic real estate syndication participate under Regulation S, with a one year restricted period during which resale to U.S. persons is prohibited. Combined Reg D and Reg S structures are common for sponsors with mixed domestic and international investor bases and require specific legal analysis for both investor populations.
- Rule 144's 12 month holding period for Regulation D securities applies from the date of issuance, not from the date of subscription. In fund structures where interests are issued in tranches over multiple capital calls, each tranche has its own 12 month holding period that must be tracked separately. Transfer restrictions in the operating agreement must implement this requirement specifically.
- General solicitation that has already occurred cannot be undone. A sponsor who engaged in general solicitation before selecting an exemption may have foreclosed 506(b) as an option for that offering regardless of subsequent choices. The exemption selection must precede any public marketing activity.
- Changing exemptions after an offering has launched is expensive and often impossible to do cleanly. Investor accreditation that was self-certified cannot retroactively become third party verified. The investment in getting the exemption right at the outset is small

compared to the cost of cleaning up an exemption that was selected incorrectly or not selected at all.

## CHAPTER THIRTEEN

# What Is General Solicitation?

The general solicitation rules exist because of a straightforward regulatory concern: securities sold publicly to strangers require more investor protection than securities sold privately to people who know the sponsor, can ask questions, conduct their own diligence, and make informed decisions. The distinction between public marketing and private communication is the boundary securities law draws between offerings that require full registration and those that can proceed under a private placement exemption.

That boundary has never been harder to maintain than it is today. The channels through which sponsors communicate with potential investors (websites, social media, podcasts, email newsletters, online investment portals, and digital marketing campaigns) are inherently public. A post on LinkedIn reaches everyone who follows the sponsor, and everyone who follows the people who share it. An investment website is visible to anyone with an internet connection. A pitch deck sent by email can be forwarded anywhere.

Real estate syndication sponsors sit squarely in this tension. The same digital infrastructure that makes it possible to build a professional investment platform, cultivate a national investor base, and efficiently reach qualified capital sources is also the infrastructure most likely to constitute general solicitation under securities law. Understanding exactly where the line falls, what crosses it, and how to build a compliant marketing program on either side of it is essential for any sponsor who communicates publicly about their investment activities.

This chapter covers the traditional general solicitation framework and why it still matters in the digital age, how Rule 506(c) changes the landscape by permitting public marketing with a stricter back end standard, what discipline a 506(b) offering requires and the specific traps that catch sponsors who do not understand it, how social media and online content interact with the general solicitation analysis, and how to build a marketing and investor communications program that is designed for compliance from the ground up rather than retrofitted after the fact.

## The Rule: Why General Solicitation Matters

Private securities offerings have never been meant to be public. The principle underlying Section 4(a)(2) of the Securities Act, the statutory exemption on which Regulation D is based, is that offerings not involving a public offering are exempt from registration. The phrase “public offering” has been interpreted through decades of SEC guidance and court decisions to mean marketing directed at the general investing public rather than at a defined, qualified group of investors.

The practical implementation of this principle in Regulation D Rule 506(b) is the general solicitation prohibition. Sponsors relying on 506(b) cannot use any form of general solicitation or general advertising to offer or sell securities. The prohibition is absolute within the offering. There is no de minimis exception for a single public mention, no safe harbor for a single social media post, and no cure period that allows a sponsor to walk back a general solicitation after the fact.

Before the JOBS Act in 2012, this prohibition applied to every Regulation D offering. Every sponsor, regardless of investor network or marketing approach, had to keep their offering private. The JOBS Act created Rule 506(c) as the first lawful path to public marketing of an unregistered securities offering, but it did not eliminate 506(b) or change the no solicitation rule that governs it. Sponsors who choose 506(b) today operate under the same general solicitation prohibition that has always applied. What has changed is that digital technology has multiplied both the opportunities to inadvertently cross the line and the stakes when they do.

The stakes are real. A general solicitation in connection with a 506(b) offering does not merely create a technical deficiency. It eliminates the exemption entirely. An offering that loses its 506(b) exemption because of general solicitation is an unregistered public offering. Under Section 12(a)(1) of the Securities Act, every investor who purchased in that offering has a statutory right to demand rescission, meaning the right to get their money back, regardless of how the underlying real estate has performed. In a real estate syndication where investor capital has been deployed into an illiquid asset, a rescission demand from every investor in the offering is a genuinely catastrophic outcome.

## What Constitutes General Solicitation

General solicitation has never been defined by statute with surgical precision, which is part of what makes it difficult to apply in practice. The SEC has described it as any communication that conditions the public mind regarding a securities offering, a phrase that captures the concern about public awareness without drawing a bright line between permissible and impermissible communications.

What is clear is this: any communication directed to the general public that promotes a specific securities offering, including communications that identify the investment opportunity, discuss expected returns, describe the investment terms, or invite participation, is general solicitation. Equally clear is that routine business communications, educational content about investing generally, and discussions of investment philosophy and track record that do not promote a specific current offering are generally not. The hard cases are in the middle, and they require legal judgment rather than mechanical rule application.

## Advertising and Public Media

Any communication delivered through media that reaches the general public (print advertising, broadcast media, online advertising) is general solicitation if it promotes a specific securities offering. This includes paid placements in real estate investment publications, targeted digital advertising on any platform, display advertising on financial websites, and any other paid medium that reaches an audience of undefined composition.

The general nature of the audience is the critical factor. Advertising by definition reaches people the advertiser has not individually identified, evaluated, or determined to have a pre-existing relationship with the issuer. A paid advertisement describing a specific investment opportunity, regardless of how targeted its audience may be on the platform's end, reaches people with whom the sponsor has no relationship. That is the definition of the problem the general solicitation rules are designed to address.

## Websites, Social Media, and Online Platforms

A publicly accessible website describing a specific investment opportunity (property details, equity target, minimum investment, projected returns, or any other offering specific information) is general solicitation. The fact that a website is digital rather than print does not change the analysis. A website accessible to anyone who visits it, describing a current offering, is a public communication about a specific securities offering.

Social media posts on LinkedIn, X, Instagram, Facebook, YouTube, or any other platform that describe a specific current offering are general solicitation. This includes posts that identify the property, discuss projected returns, share a link to an investment portal, describe the deal terms, or invite followers to invest or express interest. The fact that the audience is the sponsor's followers rather than the general public does not eliminate the general solicitation analysis. The followers include strangers, and the posts can be shared beyond the original audience.

Online investment portals and deal specific landing pages that are accessible without meaningful access controls (meaning anyone can register, complete a questionnaire, and immediately view offering materials) are general solicitation. The public accessibility of the content is what matters, not the nominal presence of a registration gate.

## Seminars and Public Presentations

Presenting at a public conference, webinar, or event where the audience is open to the general public and describing the terms of a specific offering is general solicitation. This includes real estate investment conferences, online webinars promoted through public channels, investor

education events, and any other presentation setting where the audience is composed of people the sponsor has not previously vetted.

The public nature of the event is the determining factor, not the size of the audience. A webinar with twenty attendees who registered through a public link is a public event. A private dinner with twenty investors who were individually invited through pre-existing relationships is not. The number of people present does not change the general solicitation analysis. The nature of the channel through which they were assembled does.

## Email Campaigns to Non Established Relationships

Sending deal specific emails to lists that include people with whom the sponsor has no pre-existing substantive relationship is general solicitation. This applies regardless of how the list was compiled: a purchased contact list, a list of people who registered on the sponsor's website without being individually vetted, a list assembled from conference attendee rosters, or any other collection of contacts that has not been individually screened.

The category of recipient (real estate investor, high net worth individual, or any other demographic) does not change the analysis. The sponsor must have a genuine pre-existing substantive relationship with each individual recipient for a deal specific email not to constitute general solicitation. A mass email, however targeted its recipient list, is general solicitation if the list includes people without that relationship.

### **⚠ The Distinction Is Between the Offering and the Sponsor, Not Between Public and Private Channels**

*A common misconception is that any public communication about real estate investing constitutes general solicitation. It does not. Sponsors can maintain a robust public presence (website, social media, podcast appearances, conferences) as long as those public communications do not promote a specific current offering.*

*The prohibition is on publicly offering securities, not on public communications generally. A sponsor who writes extensively about multifamily investing on LinkedIn, never mentioning a current offering, is not engaged in general solicitation. The same sponsor who posts a description of their current deal with a link to the investment portal is.*

*The channel is not the issue. The content is.*

## What Generally Does Not Constitute General Solicitation



Understanding the line requires knowing both sides of it. The following categories of activity are generally permissible under any exemption because they do not promote a specific current offering.

- Publishing educational content about real estate investing, syndication mechanics, market analysis, or investment strategy that does not describe or promote any specific current offering.
- Maintaining a professional website that describes the sponsor's background, investment philosophy, historical track record, and general approach, without describing any specific current offering or inviting visitors to invest in a current deal.
- Speaking on podcasts or panels about real estate investing strategies, market conditions, or the business of real estate syndication, without identifying a specific current offering by name, terms, or return projections.
- Sharing blog posts, articles, or research about real estate markets, investment trends, or industry analysis, again without identifying a specific current offering.
- Discussing investment opportunities individually with people who have an existing substantive relationship with the sponsor and who were introduced through a trusted referral or who have previously invested with the sponsor.
- Issuing routine investor updates and communications to existing investors about the performance of existing investments. These are investor relations communications about completed or ongoing investments, not solicitations for new ones.
- Meeting with a prospective investor at a conference or industry event to discuss the sponsor's investment approach generally, without describing a specific current offering, provided the meeting arose from a professional context that does not itself constitute general solicitation.

The common thread through all of these permissible activities is that none of them promotes a specific current offering. They build the sponsor's brand, credibility, and investor relationships without crossing into offering specific solicitation. This brand building function is not only permissible. It is the foundation of a sustainable investor development program that can support compliant capital raising over time.

## **The Pre-existing Substantive Relationship Requirement Under 506(b)**

Under Rule 506(b), the safeguard against general solicitation is the pre-existing substantive relationship requirement. A communication that would otherwise constitute general solicitation (reaching out to invite someone to invest in a specific offering) is not treated as general solicitation if the sponsor has a pre-existing substantive relationship with the recipient. The

relationship is the legal foundation that transforms a communication about a specific offering from a prohibited public solicitation into a permitted private communication.

### **What Makes a Relationship Substantive and Pre-existing**

The SEC has explained that a substantive relationship requires the sponsor to have enough information about the investor's financial circumstances, investment experience, and sophistication to assess whether the specific investment opportunity is appropriate for that investor. This is not a ceremonial requirement. The relationship must be genuine, must predate the offering, and must provide the sponsor with real knowledge of the investor, not merely an acquaintance from a networking event.

A relationship is pre-existing if it was established before the specific offering commenced, before the sponsor began activities related to the particular deal that is being offered. The timing matters. A relationship formed in connection with the marketing of a specific offering, even if it involves collecting information about the investor, is not a pre-existing relationship for that offering. The relationship must have developed independently of and prior to the offering.

A relationship is substantive if it involves the sponsor having actual knowledge of the investor's financial situation. This typically means knowing approximately what the investor's net worth or annual income is, understanding their investment experience and risk tolerance, and having had sufficient interaction with the investor to form a genuine judgment about whether a private securities offering would be appropriate for them. An investor whose only connection to the sponsor is that they followed the sponsor on social media, downloaded a white paper from the sponsor's website, or attended a public event where the sponsor spoke does not have a substantive relationship.

### **How to Document and Establish Qualifying Relationships**

Building 506(b) compliant investor relationships requires developing investor contacts through channels that do not themselves constitute general solicitation, before any specific offering begins. The mechanism for establishing a pre-existing relationship without general solicitation is to get to know prospective investors through individual interactions: referrals from existing investors, personal introductions through professional networks, prior investment relationships, and professional contexts where the sponsor learns about the investor's financial situation through genuine dialogue.

Many sponsors use an investor registration or expression of interest process to formalize these relationships before a specific offering begins. A prospective investor who completes a questionnaire about their investment experience, financial circumstances, and investment objectives, and who is individually evaluated and admitted to the sponsor's investor network, can then receive information about a specific offering without the communication constituting

general solicitation. The process works only if the relationship is established through this process before any specific offering is presented. Timing is the critical variable.

Documentation of established relationships should include the date the relationship was established, the mechanism through which it was established (referral, introduction, prior investment, individual outreach), the information collected about the investor's financial circumstances, and the basis for the sponsor's determination that the investor is an appropriate recipient of private securities communications. This documentation should be maintained in the sponsor's investor relationship management system and should be reviewable as a contemporaneous record if the general solicitation analysis is ever questioned.

## Common Mistakes That Inadvertently Trigger General Solicitation

The four 506(b) traps that most frequently catch sponsors who do not understand the full scope of the prohibition are described below.

**Trap 1: The publicly accessible investment portal.** Building an online platform where anyone can register and access offering materials, even with a questionnaire gate, does not create the pre-existing relationship required by 506(b). A stranger who finds the platform through a Google search and completes an investor questionnaire is still a stranger. The portal must be genuinely access controlled, admitting only investors whose pre-existing relationships have been separately established through other channels. A registration wall without a pre-existing relationship is not a 506(b) compliance mechanism.

**Trap 2: Social media announcement of a current offering.** A sponsor who has been building a public social media presence with educational content, and who then mentions on LinkedIn or X that they are raising capital for a specific deal, has very likely engaged in general solicitation. The mention of a specific current offering, combined with the public reach of the social media platform, conditions the public mind with respect to the offering. This is true even if the post does not include offering terms, a link to an investment portal, or an explicit invitation to invest. Announcing that a current offering is underway publicly is the problem.

**Trap 3: Email to an unscreened list.** Sending a deal specific email to any list that includes people without a pre-existing substantive relationship is general solicitation regardless of how the list was compiled. A list of people who signed up on the sponsor's website, a list assembled from conference attendance records, a purchased investor list: none of these constitute a list of pre-existing relationships. The email must be limited to investors who have individually been screened and admitted to the sponsor's investor network through a separately established process.

**Trap 4: Podcast or conference appearances describing current offerings.** Public appearances are generally permissible under 506(b) as long as they focus on investment

strategy and market analysis generally. The line is crossed when the sponsor describes the terms, return projections, or investment mechanics of a specific current offering in a public forum. In a podcast or conference setting, a sponsor relying on 506(b) can say “we are active acquirers of multifamily properties in the Sunbelt” but cannot say “we are currently raising capital for a 150 unit acquisition in Austin at an 8% preferred return.” The first is brand positioning. The second is general solicitation.

### **⚠ A Registration Wall Does Not Create a Pre-existing Relationship**

*A common misconception among sponsors building online investment platforms for 506(b) offerings is that requiring users to create an account or complete a questionnaire before viewing offering materials satisfies the pre-existing relationship requirement. It does not.*

*The relationship must predate the offering in a meaningful, substantive way. A stranger who finds the platform through a search engine and completes an investor questionnaire has not established a pre-existing relationship with the sponsor, regardless of the questions answered or the information provided at sign up.*

*The correct structure for a 506(b) online platform is: (1) the sponsor develops relationships with investors through separately established channels (referrals, individual introductions, prior investment relationships); (2) those investors are admitted to the platform based on the pre-existing relationship; and (3) they then view offering information through the platform. The platform is the delivery tool. It does not create the qualifying relationship.*

## **Rule 506(c): Embracing General Solicitation Compliantly**

The Jumpstart Our Business Startups Act of 2012 fundamentally changed the private capital formation landscape by creating Rule 506(c), the first lawful path to public marketing of an unregistered securities offering in the eighty year history of the Securities Act. The premise of 506(c) is a direct exchange. Sponsors who want to market publicly accept stricter investor eligibility standards on the back end. Public marketing is permitted, but every investor must be accredited and accreditation must be verified through actual documentation, not accepted on the investor’s word.

For real estate sponsors who use digital channels to reach investors (websites describing their investment approach, social media content, podcast appearances, email marketing), 506(c) is often the more operationally appropriate choice. It removes the operational burden of maintaining 506(b) discipline in a digital environment where the line is difficult to hold consistently, by permitting the public marketing and concentrating compliance energy instead in the verification process.

## The Verification Requirement: What “Taking Reasonable Steps” Means

The core obligation of 506(c) is that the issuer must take reasonable steps to verify that each investor is accredited. The SEC’s rules and interpretive guidance make clear that reasonable steps means actual documentation review, not investor self-certification, not a questionnaire with checkboxes, and not a statement from the investor that they meet the applicable thresholds.

What reasonable steps requires in practice: the sponsor must review third party documentation that independently establishes the investor’s financial qualifications. This is not the investor telling the sponsor they are accredited. It is the sponsor independently confirming that the investor qualifies through review of documents the investor did not create themselves. The documentation reviewed, the date of review, and the determination made must be documented in the sponsor’s records for every 506(c) investor.

The legal standard is objective. Did the sponsor take steps that a reasonable person would take in the circumstances to verify accreditation? The answer depends on what the sponsor knew about the investor, what documentation was available, and whether any red flags existed that would have required additional investigation. A sponsor who relies on a single piece of documentation that does not adequately establish accreditation has not taken reasonable steps, even if the investor actually was accredited.

## Permitted Verification Methods

The SEC’s Rule 506(c) adopts a principles based standard rather than prescribing specific documents for all situations, but it provides several non-exclusive safe harbor methods that constitute reasonable steps for specific categories of accreditation.

**Income based accreditation.** Review copies of any IRS form that reports income (W-2s, 1099s, K-1s, Schedule C) for the two most recent fiscal years showing income above the applicable threshold (\$200,000 individual or \$300,000 joint), plus a written representation from the investor that they have a reasonable expectation of reaching the same income level in the current year. Two years of IRS forms plus the investor’s forward looking representation together constitute reasonable steps for income based accreditation.

**Net worth based accreditation.** Review bank statements, brokerage account statements, tax assessments for real property, and a credit report, documents that together establish assets and liabilities, sufficient to confirm that the investor’s net worth (excluding the value of their primary residence) exceeds \$1 million. The sponsor must collect documentation on both assets and liabilities. An asset statement without a liability check does not permit the net worth calculation.

**Third party professional confirmation.** Obtain written confirmation from a licensed attorney, a CPA, a registered investment advisor, or a registered broker dealer that they have reviewed the

investor's financial situation and concluded that the investor qualifies as accredited. The confirming professional must have actually reviewed the investor's financial information. A pro forma letter is not adequate. This method transfers the document review obligation to the qualified professional and is increasingly used through third party accreditation verification services that integrate with investment platforms.

**Existing investor status.** For investors who have previously invested in an issuer's 506(b) offering and are investing in a subsequent 506(c) offering from the same issuer, the issuer can rely on a written certification from the investor confirming continued accredited status. This method is available only for existing investor relationships where prior verification was completed, not for new investors.

Third party accreditation verification services (companies that review documentation and issue verification letters on behalf of investors) have become the practical standard for satisfying the 506(c) verification requirement in most digital investment platforms. These services typically review the documentation directly, make the accreditation determination, and issue a verification letter or confirmation to the sponsor. Many integrate directly with investment portals, allowing the verification step to be completed as part of the digital investor onboarding process before the investor can access offering materials or subscribe.

## Practical 506(c) Marketing Programs

The general solicitation permission of 506(c) enables sponsors to build a real marketing program, not just a private deal room, but a public facing investment platform that attracts, educates, and converts investors across digital channels. The components of such a program in practice are described below.

- A public facing website that describes the sponsor's investment approach, team background, historical track record, and investment thesis. The website is accessible to anyone, updated regularly, and designed to build credibility with the investing public. The website can describe specific current offerings and include investor registration flows because the offering is being conducted under 506(c).
- Social media presence across platforms relevant to the target investor audience (LinkedIn for accredited investor and institutional relationships, Instagram and YouTube for broader wealth management audiences) that creates consistent educational content and periodic deal specific marketing posts describing current offerings.
- Email marketing to broad lists of prospective investors who have expressed interest in real estate investment opportunities (lists built through website registrations, content downloads, event attendance, and other digital lead generation), with deal specific campaigns that describe current offerings and invite subscribers to begin the investment process.

- Content marketing through blogs, newsletters, podcasts, and video that builds the sponsor's brand as an authority in their asset class and market, driving qualified investor traffic to the investment platform.
- Paid digital advertising on platforms where accredited investors are reachable (LinkedIn is the most commonly used for accredited investor targeting), with ad creative that describes the investment opportunity and directs prospective investors to the offering page.

Each of these channels is fully permissible under 506(c) for deal specific marketing, provided the underlying offering is being conducted under 506(c) and every subscribing investor goes through the required accreditation verification process before committing capital. The marketing draws investors in. The verification process confirms their eligibility before any investment is accepted.

## Social Media, Podcasts, and Online Content: Where the Line Sits

Social media, podcasting, and content marketing have become central to how real estate sponsors build their brands and their investor bases. These channels create genuine marketing value and genuine securities compliance risk that every sponsor who uses them needs to understand.

### Social Media Marketing Under 506(c)

Rule 506(c) permits sponsors to market their offerings on social media platforms, including LinkedIn, X, Instagram, YouTube, and others. A real estate offering can describe the property, the investment terms, the expected return profile, and the subscription process in a publicly accessible post without violating securities law, as long as the offering is conducted under 506(c) and all investors go through verified accreditation.

That permission does not mean the content is unregulated. Every marketing statement (social media posts, website content, email campaigns) is a communication to potential investors, subject to the antifraud provisions of the securities laws. Material misstatements and misleading omissions in social media marketing are as much a securities fraud concern as misstatements in a formal PPM. The medium does not change the legal character of the communication.

Specific antifraud risks in social media marketing for real estate offerings include the items described below.

- Return projections presented as likely outcomes rather than estimates. A post stating that investors can expect a 15% annual return is materially different from one that



describes a 15% projected return on specified assumptions with accompanying risk disclosure.

- Liquidity representations that are not currently supportable. Describing secondary market access or exit flexibility as a feature of the investment when those features are contingent on future events that have not yet occurred is a category of representation that requires careful qualification.
- Track record presentations that cherry pick favorable outcomes or misrepresent historical performance. This is particularly dangerous in social media formats where context and footnotes are limited and audiences may draw conclusions the sponsor did not intend.
- Fee structure simplification that inadvertently omits material fees. Social media posts that describe projected net returns without disclosing the full fee load may be materially misleading even if each stated fact is technically accurate.

## Offering Websites and Investment Portals Under 506(c)

An investment website or deal specific landing page describing a specific offering is general solicitation, and under 506(c), that is entirely permissible. The website can describe the property, the investment terms, the minimum investment, the sponsor's track record, and the subscription process, all visible to the public.

The disclosure standard for an investment website is higher than sponsors sometimes appreciate. The website is a marketing communication directed at potential investors, and its content must be consistent with the offering documents, including the PPM, the subscription agreement, and the operating agreement. Any discrepancy between what the website says and what the offering documents say creates antifraud exposure. Investors who subscribed based on website representations have a claim if those representations were materially different from the formal disclosures.

The most common website disclosure failures in real estate offerings are return projections without risk disclosure; projected exit timelines presented as commitments rather than estimates; fee structures that differ from or are inconsistent with the operating agreement's disclosures; and descriptions of management team experience that overstate the team's actual track record with the specific asset class or strategy being offered.

### **⚠ The Investment Website Is Part of the Offering. It Must Be Reviewed by Counsel.**

*The content of a website describing a specific offering is a statement to potential investors subject to the antifraud provisions of the securities laws. Before any publicly accessible*



*offering page goes live, securities counsel should review it for consistency with the PPM and subscription agreement, accuracy of all factual representations, appropriate qualification of return projections, and completeness of risk disclosure.*

*A website that goes live without counsel review is an unreviewed offering communication that creates antifraud exposure from the moment of publication. The PPM and the website either say the same thing or they create a conflict that investors can use to support a misrepresentation claim. Those are the only two options.*

## Podcasts and Content Marketing

Podcast appearances and content marketing can be an effective component of a sponsor's investor development program, and their securities compliance implications depend entirely on whether specific current offerings are described.

A podcast appearance in which the sponsor discusses real estate investing strategy, market conditions, multifamily fundamentals, or the mechanics of real estate syndication, without identifying a specific current offering by name, terms, or return projections, is generally permissible under any exemption. The content builds credibility and investor interest generally, without constituting a solicitation for a specific offering.

The same appearance becomes general solicitation when the sponsor describes the terms of a current offering: the specific property, the equity target, the preferred return rate, the hold period, the projected returns, or anything else that identifies the specific investment opportunity being marketed. That transition, from general discussion of the investment business to specific description of a current offering, is the line that determines whether the podcast appearance is brand building or general solicitation.

For sponsors conducting 506(c) offerings, describing current offerings on podcasts is permissible provided the offering is being conducted under 506(c) and the statements made are accurate, balanced, and consistent with the offering documents. For sponsors conducting 506(b) offerings, any podcast description of a specific current offering is general solicitation that compromises the exemption.

## Influencer Marketing and Paid Promoters

The proliferation of content creators and social media influencers in the real estate investment space has created a category of marketing activity that deserves specific attention.

Arrangements where third parties are compensated to promote specific real estate investment offerings to their audiences carry two distinct legal risks that sponsors frequently underestimate.

**Unregistered broker dealer risk.** A paid promoter who recommends a specific securities offering to potential investors may be engaged in the business of soliciting investors for compensation, which is the definition of broker dealer activity under the Securities Exchange Act. A social media influencer who receives a fee for driving subscribers to an offering page, an affiliate marketer who receives a referral fee for each investor who subscribes, or a podcast host who is paid to promote a specific offering is potentially acting as an unregistered broker dealer. The analysis turns on the nature of the activity, not on the label. The promoter does not need to be understood by investors as a securities professional for the broker dealer analysis to apply.

**Mandatory compensation disclosure under Section 17(b).** Section 17(b) of the Securities Act of 1933, often called the anti-touting provision, makes it unlawful for any person to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication that describes a security for consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt (past or prospective) of that consideration and the amount of it. A sponsored social media post about a real estate offering that does not disclose the compensation arrangement violates Section 17(b) regardless of whether the post complies with FTC disclosure requirements for consumer advertising. The securities law disclosure obligation is independent of, and in addition to, any FTC requirements.

### **⚠ Paid Promoters and Influencers for Real Estate Offerings Are High Risk Arrangements**

*The combination of broker dealer registration risk and mandatory compensation disclosure obligations under Section 17(b) makes paid promotion arrangements for real estate securities offerings genuinely dangerous territory. Sponsors who engage influencers, affiliate marketers, or paid referral networks to drive investor traffic to a specific offering should have those arrangements reviewed by securities counsel before they launch.*

*The analysis turns on several factors: how the promoter is compensated (flat fee, per lead, per investor, or percentage of capital raised), what representations the promoter makes about the offering, whether the promoter is communicating with investors only once or maintaining an ongoing advisory relationship, and whether the promoter exercises any judgment about which investors to direct to the offering.*

*Arrangements where compensation is transaction based, meaning the promoter is paid when an investor subscribes, are the highest risk and the most likely to constitute unregistered broker dealer activity. These arrangements must be reviewed by securities counsel before launch, not after a regulatory inquiry arrives.*

## Real Estate Crowdfunding Platforms and General Solicitation

Real estate crowdfunding platforms (online marketplaces that connect real estate sponsors with investors) occupy a specific position in the general solicitation landscape that deserves its own treatment. These platforms function as both marketing channels and compliance infrastructure, and the legal consequences of using them depend heavily on how the platform is structured and which exemption the sponsor is relying upon.

### How Crowdfunding Platforms Interact with General Solicitation

A real estate crowdfunding platform that publicly lists investment opportunities, meaning any visitor to the website can see current offerings, read their descriptions, and begin the investment process, is a general solicitation channel. The platform's public facing listings are accessible to the general public and describe specific securities offerings. Any sponsor who lists on such a platform is engaging in general solicitation from the moment the listing goes live.

For sponsors listing on a public real estate crowdfunding platform, this means 506(c) is the required exemption, not 506(b). A sponsor who lists on a public platform and then purports to rely on 506(b) has an exemption problem from day one. The platform's public accessibility, combined with the offering description visible to anyone who visits the site, constitutes exactly the kind of general solicitation that 506(b) prohibits.

### Platform Managed Investor Qualification

Most established real estate crowdfunding platforms that operate under 506(c), and most reputable platforms today have made the transition, have built investor qualification processes into their onboarding flows. These processes typically collect the documentation required for third party accreditation verification, either reviewing it directly or connecting investors with third party verification services. The platform's compliance infrastructure effectively handles the 506(c) verification requirement on the sponsor's behalf.

Sponsors using platform managed investor qualification need to understand the legal consequences of that delegation. The obligation to verify investor accreditation under 506(c) rests with the issuer, namely the sponsor, not with the platform. If the platform's verification process is inadequate and an investor who is not accredited subscribes through the platform, the liability for the exemption failure falls on the sponsor. A platform's representations about its compliance program are not a substitute for the sponsor's own understanding of whether that program is adequate.

Before listing on any crowdfunding platform and relying on its investor qualification process, sponsors should understand exactly what documentation the platform reviews, how it makes

accreditation determinations, and whether the process it employs constitutes reasonable steps for 506(c) purposes. This is a legal analysis that should involve securities counsel familiar with the platform's specific procedures, not a business decision based on the platform's marketing materials.

## The Registered Broker Dealer Requirement for Platforms

Regulation CF crowdfunding platforms must be registered as broker dealers or registered funding portals. Real estate investment platforms operating under Regulation D do not face the same mandatory registration requirement, but they face a different question: does the platform's activity (soliciting investors, reviewing suitability, accepting subscriptions, and receiving compensation for those activities) constitute broker dealer activity that requires FINRA registration?

The SEC and FINRA have consistently maintained that platforms that receive compensation for facilitating securities transactions, including success fees, listing fees tied to successful raises, or any other transaction based compensation, may be engaged in unregistered broker dealer activity. This analysis applies to crowdfunding platform operators and to sponsors who pay platforms based on the amount of capital raised.

The registered broker dealer question for platforms is a legal analysis that the platform's own counsel should have completed before the platform launched. Sponsors who are using a platform should ask whether the platform has that analysis and is satisfied with its conclusions, because the sponsor's use of an unregistered broker dealer is itself a compliance problem under Regulation D.

## Building a Compliant Investor Relations and Marketing Program

For sponsors building a recurring real estate investment program, meaning one that will be used across multiple offerings over time, the marketing and investor communication infrastructure needs to be designed with the general solicitation framework in mind from the beginning. Not deal by deal, but as a platform level architecture that consistently reflects the chosen exemption's requirements.

## The Platform Level Decision

The foundational question for any sponsor building a recurring offering program is whether the platform will operate under 506(b) or 506(c). This is not a deal by deal decision. It is a platform level decision that shapes the entire investor outreach infrastructure.

A 506(c) platform is built for public marketing: a public facing website that can describe specific offerings, social media presence that can promote current deals, email campaigns to broad lists, and paid advertising. The investor portal is publicly accessible, though it requires verified accreditation before any investment can be accepted. This model allows the broadest possible investor reach and is compatible with how most professional real estate investment platforms actually operate.

A 506(b) platform is built for private relationships: no public facing offering pages, email campaigns limited to prescreened investors, no social media promotion of specific offerings, and an investor portal that is strictly access controlled to investors with confirmed pre-existing relationships. This model can work but requires operational discipline that is genuinely more demanding in the digital age than most sponsors appreciate when they first encounter it.

Most real estate investment platforms that are designed for growth and that use any form of digital marketing choose 506(c). The public marketing permission is too valuable, and the 506(b) discipline too difficult to maintain consistently at scale, for a platform that intends to grow beyond a small, defined investor circle. The better question is not whether to use 506(c), but how to build the 506(c) verification process correctly.

## Separating Brand Building from Deal Marketing

Regardless of which exemption a platform uses, there is universal value in separating brand building communications from deal specific marketing. This separation serves both a compliance function and a strategic one.

Brand building communications (educational content about real estate investing, market analysis, investment philosophy, sponsor background and track record, thought leadership on topics relevant to the target investor audience) can be distributed broadly and publicly under any exemption. They build the sponsor's credibility and investor relationships over time without creating exemption specific compliance concerns. They are the foundation of a sustainable investor development program.

Deal specific marketing (descriptions of a specific property, offering terms, return projections, subscription mechanics) must be calibrated to the exemption used for that specific offering. Under 506(c), it can be public. Under 506(b), it must be private. The most effective platforms maintain a consistent brand building presence that is always public and always exemption agnostic, and then activate deal specific marketing through channels that match the specific offering's exemption.

## Documentation of the General Solicitation Analysis

Sponsors relying on 506(b) should document their general solicitation analysis for each offering, specifically which communications were made in connection with the offering, to whom, and why each communication is believed to fall within the 506(b) framework. This documentation is not required by the SEC, but it is the evidence a sponsor needs if a later review raises questions about whether general solicitation occurred.

The documentation should capture a list of all communications made to potential investors about the specific offering, a description of the pre-existing relationship basis for each communication, and an explanation of why the communication does not constitute general solicitation. This is the kind of contemporaneous compliance record that demonstrates the sponsor took the 506(b) requirements seriously from the beginning.

For 506(c) offerings, documentation of the general solicitation analysis is less critical, because general solicitation is permitted, but documentation of the accreditation verification process for every investor is essential. The sponsor must be able to demonstrate, for every investor who subscribed, that the required documentation was reviewed, the accreditation determination was made, and the determination was recorded before the investment was accepted.

### **⚠ The General Solicitation Analysis Must Be Done Before Marketing Begins, Not Afterward**

*Sponsors who begin marketing a specific offering and then ask their attorney whether they have engaged in general solicitation are asking the wrong question at the wrong time. By then, the marketing has already occurred, and if it constituted general solicitation, the 506(b) exemption may already be compromised.*

*The analysis (which exemption applies to this offering, what marketing is permissible under that exemption, what documentation is required, what safeguards are needed) must be completed before any offering specific communication goes out. There is no retroactive cure for general solicitation that has already occurred.*

*The conversation with securities counsel happens before the first investor email, before the offering page goes live, and before the social media post is drafted. Not after.*

## **General Solicitation Quick Reference: Common Activities and Their Analysis**

The following table summarizes common sponsor marketing activities and their general solicitation status under 506(b) and 506(c). This table is illustrative, not exhaustive. The analysis of any specific communication requires evaluation of its specific content and context.

| Activity                                                                           | 506(b) Analysis                                                                           | 506(c) Analysis                                                                                                  |
|------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------|
| Educational blog post about real estate syndication mechanics                      | Permitted. No specific offering promoted.                                                 | Permitted. No specific offering promoted.                                                                        |
| Professional website describing sponsor background and historical track record     | Permitted. No specific offering promoted.                                                 | Permitted. No specific offering promoted.                                                                        |
| LinkedIn post announcing a new acquisition and describing deal terms               | General solicitation. Publicly promotes a specific current offering.                      | Permitted. Describes a specific offering under a public exemption.                                               |
| Publicly accessible investment portal with offering terms visible to all visitors  | General solicitation. Accessible to the general public without pre-existing relationship. | Permitted. Public access allowed under 506(c). Verified accreditation required to invest.                        |
| Password protected investor portal accessible only to pre-approved investors       | Permitted if access genuinely restricted to investors with pre-existing relationships.    | Permitted. Access controls can be more restrictive than the exemption requires.                                  |
| Email to all newsletter subscribers describing a specific current offering         | General solicitation if the list includes persons without pre-existing relationships.     | Permitted under 506(c). Verified accreditation required before accepting investment.                             |
| Email to individually prescreened investors in the sponsor's vetted network        | Permitted. Pre-existing relationship established separately.                              | Permitted.                                                                                                       |
| Paid digital advertising (LinkedIn, Google) promoting a specific current offering  | General solicitation. Paid advertising to an undefined audience.                          | Permitted under 506(c). Verified accreditation required to invest.                                               |
| Podcast appearance discussing real estate market and investment strategy generally | Permitted. No specific offering promoted.                                                 | Permitted. No specific offering promoted.                                                                        |
| Podcast appearance describing terms and returns of a specific current offering     | General solicitation. Publicly promotes a specific offering.                              | Permitted under 506(c). Statements must be accurate and consistent with the PPM.                                 |
| Influencer paid to drive traffic to a specific offering page                       | General solicitation, plus potential unregistered broker dealer activity.                 | Permitted if properly disclosed under Section 17(b). Broker dealer analysis required for compensation structure. |
| Conference presentation on investment strategy and market thesis                   | Permitted. No specific offering promoted.                                                 | Permitted.                                                                                                       |



| Activity                                                                       | 506(b) Analysis                                                             | 506(c) Analysis                                                                  |
|--------------------------------------------------------------------------------|-----------------------------------------------------------------------------|----------------------------------------------------------------------------------|
| Conference presentation describing a specific current capital raise with terms | General solicitation. Publicly promotes a specific offering.                | Permitted under 506(c). Content must comply with antifraud requirements.         |
| Investor referral from an existing investor to a specific named prospect       | Permitted. Individual referral through an established relationship channel. | Permitted.                                                                       |
| Social media post mentioning a current capital raise without offering terms    | Likely general solicitation. Announces a specific offering to the public.   | Permitted under 506(c). Ensure consistency with formal offering documents.       |
| Public listing on a real estate crowdfunding platform                          | General solicitation. The platform is publicly accessible.                  | Permitted. Verify the platform's accreditation verification process is adequate. |

## Practical Takeaways

- General solicitation is any communication directed at the general public that promotes a specific securities offering. The line between general solicitation and permissible brand building is not the channel used. It is whether a specific current offering is being promoted. Educational content about real estate investing generally is not general solicitation. Describing the terms of a specific current offering in a public forum is.
- Rule 506(b) absolutely prohibits general solicitation. Maintaining 506(b) discipline in the digital age requires operational intentionality that most sponsors underestimate: access controlled investor portals that admit only investors with separately established pre-existing relationships, email communications limited to that prescreened group, social media content that does not describe specific current offerings, and public appearances that discuss investment strategy generally rather than specific current deals.
- The pre-existing substantive relationship requirement of 506(b) is not satisfied by a registration wall, an investor questionnaire at sign up, or a login gate. The relationship must genuinely predate the offering, must be substantive enough to enable a suitability assessment, and must have been established through channels that themselves do not constitute general solicitation.
- General solicitation that has already occurred cannot be undone. If general solicitation has been made in connection with a 506(b) offering, the exemption may already be compromised regardless of what the sponsor does afterward. The analysis must be completed before any offering specific communication is made, not after.
- Rule 506(c) permits general solicitation, including websites, social media, advertising, public presentations, and email campaigns, but requires verified accreditation of every



investor through actual third party documentation review. Self-certification by the investor does not satisfy the 506(c) verification standard. This requirement applies to every subscribing investor without exception.

- Every marketing statement in a 506(c) offering, including social media posts, website content, and email campaigns, is subject to the antifraud provisions of the securities laws. Return projections must be qualified, liquidity representations must be accurate and achievable, and all marketing content must be consistent with the formal offering documents. The medium does not lower the legal standard.
- Paid promoters and influencers who receive compensation for driving investor traffic to a specific offering may be acting as unregistered broker dealers, and their compensation must be disclosed to investors under Section 17(b) of the Securities Act. These arrangements must be reviewed by securities counsel before launch. Transaction based compensation structures, where the promoter is paid per investor or per dollar raised, are the highest risk category.
- Real estate crowdfunding platforms that publicly list investment opportunities are general solicitation channels. Sponsors who list on public platforms must use 506(c), not 506(b). Sponsors relying on platform managed investor qualification should understand exactly what documentation the platform reviews and whether that process constitutes reasonable steps under 506(c), because the legal obligation rests with the issuer, not the platform.
- The platform level decision between 506(b) and 506(c) shapes the entire investor outreach infrastructure. Most real estate investment platforms designed for growth choose 506(c) because the public marketing permission is too valuable and the 506(b) discipline too demanding to maintain consistently at scale. The better question is not whether to use 506(c) but how to build the verification process correctly.
- The general solicitation analysis is not something a sponsor does once and moves on from. Every new offering, every new marketing campaign, and every significant change in marketing channels or audience reach should prompt a fresh analysis of whether the current activities are consistent with the exemption being relied upon for that specific offering.

**CHAPTER FOURTEEN**

# Accredited Investors and Investor Qualification

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Investor eligibility is where the securities laws' promise of investor protection becomes concrete. Every exemption from registration draws a line around who can invest, and those lines exist for a specific reason. The investor on the other side of them is presumed to have the financial sophistication, the advisory access, or the risk tolerance to evaluate and absorb the investment without the full disclosure protections that a registered public offering provides. Cross that line, by admitting an investor who does not qualify, and the exemption is in jeopardy. The consequences run from rescission liability to regulatory enforcement, and they materialize at the worst possible moment: when the investment is already deployed in an illiquid real estate asset.

The accredited investor standard is one of the most precisely defined concepts in securities law, and one of the most frequently misapplied. The income thresholds, the net worth calculation, the primary residence exclusion, the professional certification categories, and the entity qualification tests each have specific legal meaning that diverges from common sense interpretation in ways that create real compliance exposure. A sponsor who relies on what accreditation seems to mean, rather than what it legally requires, is building on a foundation that a closer look will undermine.

This chapter covers the full accredited investor framework as it applies to private real estate syndications: who qualifies and on what basis, what verification looks like under each exemption, the non-accredited investor pathways that exist and what using them requires, what sophisticated investor status means and when it matters, how investor questionnaires should be designed, and what ongoing investor qualification requires when an investor's status changes after the investment closes. Throughout, the chapter identifies the most common mistakes sponsors make in each area, because the pattern of error is consistent enough to be instructive for sponsors who want to avoid it.

## The Accredited Investor Standard: Why It Exists

The accredited investor concept rests on a regulatory judgment about investor protection: investors who meet certain financial thresholds are presumed to have either the financial ability to sustain losses from a failed investment or the advisory access (accountants, attorneys, financial advisors) to evaluate investment opportunities that less wealthy investors cannot access. The SEC's implicit theory is that investors with \$1 million in net worth or \$200,000 in

annual income can take care of themselves in private markets without the mandatory disclosure regime that public offerings provide.

That theory has been debated academically for decades, and its critics have a point. Wealth is an imperfect proxy for investment sophistication, and many accredited investors have very little experience evaluating private securities offerings. The SEC acknowledged this tension in 2020 when it expanded the accredited investor definition to include professional certification holders, a recognition that expertise, not just wealth, can justify access to private offerings. But for the working sponsor, the definitional framework is fixed regardless of its theoretical underpinnings. The rules are the rules, and the obligation is to apply them correctly.

The practical significance of accredited investor status in a Regulation D offering is this: sponsors who admit investors who do not qualify lose the exemption. Rule 506(b) allows up to 35 non-accredited but sophisticated investors, with additional disclosure obligations. Rule 506(c) allows only accredited investors, verified through documentation. Admitting an investor who is neither accredited nor sophisticated, or an accredited investor who was not verified when 506(c) requires verification, is a compliance failure that exposes the entire offering to Section 12(a)(1) rescission claims. Every investor who participated, not just the one who should not have, has a right to demand their money back.

## Individual Accredited Investor Tests

Individual investors qualify as accredited investors under Rule 501(a) through one of several independent tests. Meeting any single one is sufficient. An investor does not need to satisfy multiple criteria simultaneously. The tests are structured as alternatives: income, net worth, professional certification, or spousal joint income. Each is analyzed independently, and qualifying under any one of them establishes accredited status.

### The Income Test

An individual qualifies as an accredited investor based on income if they have earned income exceeding \$200,000 in each of the two most recent calendar years, or exceeding \$300,000 in combined income with a spouse or spousal equivalent in each of those years. The investor must also have a reasonable expectation of reaching the same income level in the current year.

Several nuances matter in practice. The income threshold applies to earned income (wages, salaries, self-employment income, bonus compensation, and similar active sources), not to capital gains, investment income, or other passive sources that appear on a tax return. A real estate investor who earned \$180,000 in salary and \$50,000 in rental income has \$180,000 in earned income for the test, not \$230,000.

The two year look back uses calendar years, not rolling 12 month periods or the investor's fiscal year. An investor who earned \$180,000 in 2024 and \$225,000 in 2025 does not satisfy the income test for a 2026 offering. The threshold must be met in each of the two most recent years, and the 2024 figure falls short.

The spousal equivalent provision was added in 2020 to recognize unmarried partners and same sex couples in states that do not recognize their relationships for income tax purposes. A spousal equivalent is a cohabitant occupying a relationship generally equivalent to a spouse, and joint income with a spousal equivalent counts toward the \$300,000 threshold on the same basis as income with a legal spouse.

The current year expectation requirement is forward looking but does not require a guarantee. A physician who earned \$280,000 in each of the prior two years and has the same medical practice in the current year has a reasonable expectation of meeting the threshold for the current year even before the year is complete. A real estate developer whose prior year income was unusually elevated by a single large transaction may have a less defensible claim to current year expectation if the transaction that produced the income was non-recurring.

### **The Net Worth Test: \$1 Million Excluding Primary Residence**

An individual qualifies as an accredited investor based on net worth if they have individual or joint net worth exceeding \$1,000,000, excluding the value of their primary residence. This exclusion is one of the most important and most frequently misapplied aspects of the entire accredited investor definition.

The exclusion works as follows. The fair market value of the investor's primary residence is not included as an asset in the net worth calculation. Additionally, any mortgage or other debt secured by the primary residence, up to the fair market value of the home, is also excluded from liabilities for purposes of the net worth calculation. The home drops out of both sides of the balance sheet up to the amount of its value.

There is an important wrinkle that sponsors and investors most often get wrong. If the total debt secured by the primary residence exceeds its fair market value, the excess is counted as a liability that reduces the investor's net worth. An investor with a home worth \$600,000 and a mortgage of \$700,000 has \$100,000 in excess debt that must be counted as a liability in the net worth calculation, even though the home itself is excluded from assets.

#### **Primary Residence Net Worth Calculation: Three Common Mistakes**

##### **Mistake 1: Counting the home's value as an asset**

A home worth \$800,000 is excluded from both assets and the first \$800,000 of the mortgage. Do not include it on either side of the ledger.

**Mistake 2: Forgetting to count excess mortgage as a liability**

If a home is worth \$600,000 but carries a \$700,000 mortgage, the \$100,000 excess counts as a liability that reduces the net worth figure.

**Mistake 3: Using assessed value rather than fair market value**

The exclusion applies to the fair market value of the primary residence, not the tax assessed value. These can differ significantly. Using assessed value may produce an inaccurate calculation.

**Practical Note**

In cases where the primary residence calculation is close to the \$1,000,000 threshold, have the investor work with a licensed professional to prepare the net worth calculation before verification is submitted. Borderline cases require documentation, not approximation.

The joint net worth provision allows a married couple or spousal equivalent pair to count their combined net worth, including assets held jointly, assets held individually, and liabilities held in either name, for purposes of the \$1,000,000 threshold. An investor whose individual net worth falls short but whose combined net worth with their spouse exceeds the threshold qualifies on a joint basis.

Net worth is a snapshot calculation taken at the time of the investment. It is not an average, not a projection, and not a calculation that the investor can retroactively reconstruct. An investor whose net worth crossed the \$1,000,000 threshold six months ago but has since declined below it does not currently qualify on the net worth basis. The obligation is to confirm current qualification, not historical qualification.

## Professional Certification and Knowledgeable Employee Standards

In 2020, the SEC expanded the accredited investor definition to include individuals who hold certain professional financial certifications or designations as evidence of financial sophistication. This expansion reflects a recognition that expertise, not just financial wealth, can justify access to private securities offerings.

The SEC designated holders of three FINRA licenses as automatically qualifying as accredited investors: the Series 7 (general securities representative license), the Series 65 (investment adviser representative license), and the Series 82 (private securities offerings representative license). Holding any of these licenses in active good standing with FINRA establishes accredited investor status regardless of the holder's income or net worth.

This expansion is significant for real estate sponsors because it expands the eligible investor pool to include investment professionals who may not meet the income or net worth thresholds. Younger financial advisors, securities registered representatives, and others with genuine investment expertise but earlier career wealth levels are now eligible. The license must be active and in good standing. A lapsed or revoked license does not qualify. Verification is straightforward: active FINRA registration is publicly accessible through BrokerCheck, FINRA's public database.

The SEC retained authority to designate additional certifications, designations, and credentials as qualifying for accredited investor status, and has indicated it may expand the list. Sponsors who encounter investors who hold professional designations not currently on the list (Chartered Financial Analysts, Certified Financial Planners, and similar credentials) should confirm with securities counsel whether those designations currently confer accredited investor status before accepting such an investor into a 506(c) offering.

Separately, the Investment Company Act provides a category for "knowledgeable employees" of private funds, specifically employees involved in the fund's investment activities who may invest in the fund regardless of whether they meet the financial thresholds for accredited investor status. For most real estate syndication sponsors, this category applies primarily to the employees and principals of the sponsor's management company who want to invest in deals they manage. It does not expand the eligible investor pool for external investors.

## Entity Accredited Investors

Many investors in real estate syndications are not individuals but entities: LLCs, trusts, corporations, partnerships, family offices, and institutional investors. The accredited investor definition accommodates all of these, but each entity type has its own qualifying criteria that must be satisfied independently. An entity that qualifies does not also require the individual investors behind it to be accredited. An entity that does not qualify cannot be made to qualify by the accredited status of its beneficial owners, unless they fall into the all accredited equity owners category described below.

## Financial Institutions and Regulated Entities

Banks, savings institutions, broker dealers, insurance companies, registered investment companies, and business development companies automatically qualify as accredited investors. The rationale is that these entities are subject to comprehensive regulatory oversight that provides investor protection independent of the accredited investor framework. Verifying accredited status for a regulated entity means confirming its regulatory registration (through SEC EDGAR for registered investment companies, through FINRA BrokerCheck for broker dealers, or through banking regulator records for banks), not reviewing financial statements.

## Investment Funds and Registered Advisers

Investment advisers registered with the SEC or a state securities regulator qualify as accredited investors. Private business development companies and certain other investment funds also qualify. For these entities, regulatory registration status is the relevant verification inquiry, not asset size or financial position.

## Corporations, LLCs, and Partnerships: The \$5 Million Asset Test

A corporation, limited liability company, or partnership qualifies as an accredited investor if it has total assets in excess of \$5,000,000, provided it was not formed for the specific purpose of acquiring the securities being offered. The \$5,000,000 threshold refers to total assets, not net assets, not invested capital, not revenue, measured at the time of investment.

The not formed for the specific purpose requirement is the one that most frequently catches sponsors. When an investor forms a new LLC specifically to participate in a particular offering, a common practice among investors who prefer to hold real estate investments through separate entities for liability protection or estate planning purposes, that entity may not qualify as an accredited investor on the basis of total assets alone, because it was formed for the specific purpose of making this investment. A three week old LLC formed to invest in the sponsor's current offering is not a \$5,000,000 asset entity for accredited investor purposes, even if it holds \$5,000,000 in assets contributed by its founding members.

In that case, the analysis must shift. Is the entity eligible as an all accredited equity owners entity? Can the individual members qualify on their own? These are the questions that must be answered when an entity formed specifically to participate in the offering presents for subscription.

## Entities Where All Equity Owners Are Accredited

Any entity in which all of the equity owners are individually accredited investors qualifies as an accredited investor itself, regardless of the entity's asset size, age, or regulatory status. This is the most commonly applicable category for the investment entities that real estate syndication investors frequently use: family LLCs, investment clubs, holding companies formed for estate planning purposes, and similar vehicles.

The critical word is "all." Every equity owner must independently qualify as accredited. If a family LLC has five members and one of them does not meet any accredited investor test, the entire entity fails this qualification. It cannot participate as an accredited entity investor. The analysis cannot be cured by having the non-accredited member assign their interest to someone else for purposes of the subscription. The composition of the entity at the time of investment is what controls.

For verification, the sponsor must collect accreditation documentation from each individual equity owner of the entity. Verifying the entity requires verifying each of its owners, which is more documentation intensive than verifying a single individual but straightforwardly achievable when the equity owner group is small.

## **Qualified Institutional Buyers**

Qualified institutional buyers (QIBs) are a category defined separately under Rule 144A that overlaps with but is distinct from the accredited investor definition. A QIB is generally an institution that owns and invests on a discretionary basis at least \$100 million in securities. This threshold is substantially higher than the \$5 million asset test for entity accreditation under Regulation D, and it covers a specific class of institutional investor (registered investment companies, insurance companies, banks, pension plans, and similar) that operates at institutional scale.

For most private real estate syndications, QIB status is relevant primarily as context when institutional investors ask about the exemption framework. A pension fund or endowment investing in a Regulation D offering qualifies as an accredited investor through its regulatory status and asset base. It does not need to establish QIB status for Regulation D purposes. QIB status becomes relevant when securities are being offered under Rule 144A, a separate institutional resale exemption that has limited application in the private real estate syndication context.

## **Family Offices and Family Clients**

Family offices, meaning entities established by ultra-high net worth families to manage their investments and financial affairs, qualify as accredited investors if they have at least \$5,000,000 in assets under management, are not formed for the specific purpose of acquiring the securities being offered, and their prospective investments are directed by a person who has such knowledge and experience in financial and business matters that they are capable of evaluating the investment. Family clients of a qualifying family office also qualify on the basis of the family office's qualification, provided they invest through the family office rather than directly.

Family office qualification requires confirming assets under management through financial statements or custodian documentation, along with confirmation that the investment decision maker has the requisite expertise. The \$5 million AUM threshold is measured against the family office's total investable assets, not the specific amount being invested in this offering.



| Entity Type                                                         | Accredited Investor Qualification Basis                   | Key Verification                                                     |
|---------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------------------------|
| Banks, savings institutions, broker dealers                         | Automatically qualify. Federally or state regulated.      | Confirm regulatory registration (FDIC, FINRA, state).                |
| Insurance companies                                                 | Automatically qualify. Regulated entities.                | Confirm state insurance regulatory status.                           |
| Registered investment advisers                                      | Automatically qualify. SEC or state registered.           | Confirm SEC or state registration through IAPD or state records.     |
| Registered investment companies                                     | Automatically qualify. SEC registered.                    | Confirm SEC registration through EDGAR.                              |
| Employee benefit plans with more than \$5M assets                   | Qualify based on plan assets. Plan fiduciary must decide. | Plan financial statements confirming asset level.                    |
| Corporation, LLC, or partnership not formed for specific purpose    | Qualify if total assets exceed \$5,000,000.               | Financial statements confirming total assets.                        |
| Entity formed for the specific purpose of this investment           | Must qualify under the all equity owners accredited test. | Accreditation verification from each equity owner.                   |
| Any entity where all equity owners are individually accredited      | Qualifies regardless of entity size or type.              | Accreditation documentation from every equity owner.                 |
| Family offices with \$5M or more AUM                                | Qualify with investment decision maker expertise.         | AUM documentation. Investment director qualifications.               |
| Family clients of qualifying family offices                         | Qualify based on the family office's qualification.       | Confirm family office qualifies. Confirm client relationship.        |
| Trusts with more than \$5M assets (not formed for specific purpose) | Qualify based on trust assets. Trustee analysis required. | Trust financial statements. Confirm not formed for specific purpose. |

## Verifying Accredited Investor Status Under Rule 506(c)

The verification obligation is where the accredited investor framework becomes operationally demanding, and where the choice between Rule 506(b) and Rule 506(c) has its most direct practical consequence. Under 506(b), sponsors may rely on investor representations and questionnaire responses. Actual document review is not required. Under 506(c), actual documentation must be reviewed and the verification must produce a reasonable basis for concluding that the investor qualifies. The verification obligation under 506(c) is not a formality. It is the foundational condition that makes general solicitation permissible.

## Permitted Verification Methods: Income, Net Worth, and Third Party

The SEC's Rule 506(c) adopts a principles based standard for what constitutes reasonable steps to verify accreditation, supplemented by several non-exclusive safe harbor methods. Using a safe harbor method provides a legal presumption of compliance. Using a non-safe harbor method that nonetheless constitutes reasonable steps is also permissible, but the analysis of what is reasonable is more fact specific.

**Income based verification.** The safe harbor requires review of copies of any IRS form that reports income (W-2s, 1099s, K-1s, Schedule C) for the two most recent fiscal years showing income above the applicable threshold, plus a written representation from the investor confirming their reasonable expectation of reaching the same income level in the current year. Both years of IRS forms plus the current year representation together constitute the required package. A single year of tax returns, even showing very high income, does not satisfy the two year look back.

**Net worth based verification.** The safe harbor requires review of bank statements, brokerage account statements, tax assessments for real property owned by the investor, and a credit report, sufficient together to establish that the investor's net worth (excluding the primary residence) exceeds \$1 million. The documentation must be dated within 90 days of the verification to be current. Both the asset side (account statements) and the liability side (credit report) must be reviewed. An asset statement alone, without a liability check, does not permit the full net worth calculation.

**Professional certification verification.** For FINRA licensees, the safe harbor permits confirmation of active registration through BrokerCheck. This is the simplest verification method operationally. A BrokerCheck lookup confirming active Series 7, Series 65, or Series 82 registration is all that is required.

**Third party professional confirmation.** The safe harbor permits reliance on written confirmation from a licensed attorney, CPA, registered investment advisor, or registered broker dealer that they have reviewed the investor's financial situation and confirmed accredited status within the prior three months. The confirming professional must have actually reviewed the investor's financial information. A pro forma letter confirming accreditation based solely on the investor's representations to the professional is not adequate. The professional is attesting that they personally reviewed documentation and concluded the investor qualifies.

**Prior 506(c) investor exception.** For investors who previously invested in a prior Rule 506(c) offering from the same issuer and were verified as accredited at that time, the safe harbor under Rule 506(c)(2)(ii)(D) allows the issuer to rely on a written certification from the investor confirming continued accredited status. This exception is available only for the same issuer's prior 506(c) offerings and requires the investor's current certification, not simply reliance on the

prior offering's subscription materials. It does not apply to investors who were previously admitted under Rule 506(b), because 506(b) did not require third party verification in the first instance.

## The 2025 Minimum Investment Verification Approach

On March 12, 2025, the SEC Division of Corporation Finance issued a no action letter (in response to a request from Latham & Watkins) that established a streamlined verification method based on minimum investment amounts. Under this approach, an issuer may treat an investor as accredited if (1) the natural person investor commits at least \$200,000 (or the legal entity investor commits at least \$1,000,000), (2) the investor provides written representations that they are accredited and that the investment is not financed by a third party for the specific purpose of making the investment, and (3) the issuer has no actual knowledge of facts indicating the investor is not accredited or that the investment was so financed. The 2025 no action letter does not eliminate the underlying verification requirement. It identifies one additional method that the staff will not recommend enforcement against, provided the conditions are met.

For sponsors raising capital at investment minimums above the no action letter's thresholds, this approach can significantly reduce the documentation burden of 506(c) verification while still satisfying the reasonable steps standard. For sponsors raising at investment minimums below those thresholds, the traditional safe harbor methods (income documentation, net worth documentation, third party professional confirmation, or registration check for licensees) remain the operative verification framework.

## Third Party Verification Services

The practical standard for accreditation verification in most investment platforms has converged on the use of third party verification services. These are firms that review investor documentation, make the accreditation determination, and issue verification letters that the sponsor can rely upon as confirmation of reasonable steps. These services have been integrated into most professional investment platforms, allowing verification to be completed as part of the digital investor onboarding flow.

Third party verification letters are valid for a defined period, typically 90 days from the date of the underlying documentation review, after which the verification must be renewed before the investor can participate in a new offering or make additional investments in an ongoing offering. The 90 day period tracks the SEC's reference in Rule 506(c)(2)(ii)(C) to a third party confirmation made within the prior three months. Sponsors who rely on verification letters from a prior offering for a subsequent offering, without confirming that the letters remain current, have not taken reasonable steps for the new offering.

The selection of a third party verification service is itself a compliance decision. The service must actually review the documentation it claims to review and make a genuine determination of accredited status, not simply issue a verification letter based on investor self-certification submitted through a digital form. A verification letter from a service that does not actually perform the document review it purports to perform does not satisfy 506(c)'s reasonable steps standard, regardless of what the service's marketing materials claim.

## Documentation and Recordkeeping

Documentation of the accreditation verification process must be retained for a period sufficient to establish that verification was properly conducted. The SEC's guidance suggests retaining verification documentation for at least five years from the date of the last sale in the offering, though counsel should advise on the appropriate retention period for the specific offering and jurisdiction.

What must be retained: the specific documents reviewed (tax returns, account statements, credit reports, professional certification confirmations), the date of review, the name and credentials of the person or service who performed the review, the accreditation determination made, and the basis for that determination. For third party verification services, the verification letter is the documentation, but the underlying documentation reviewed by the service should also be retained where possible.

The verification documentation is evidence, both of the sponsor's compliance and of the investor's eligibility. A verification program that lacks documentation is a program that cannot defend itself. Design the recordkeeping system before the first investor subscriptions are accepted, not as a retroactive effort to reconstruct what was done.

### **⚠ Verification Must Be Completed Before the Investor Participates in the Offering**

*A common sequencing error is closing the offering and accepting investor subscriptions while some investors' accreditation verification is still pending. The verification must be completed, and the sponsor must have the required documentation, before an investment is accepted from any investor under 506(c).*

*An investor who commits capital before their verification is complete has participated in a 506(c) offering without verification. A subsequent successful verification does not cure the failure. The sequence of events is the problem, and it cannot be retroactively corrected. The compliance obligation runs from the first moment the investor participates, which in a syndication context is when the subscription is accepted.*

*Build the verification process into the subscription workflow so that verification completion is a condition precedent to accepting any subscription, not a parallel task that runs concurrently.*

## Non-accredited Investors Under Rule 506(b)

The accredited investor standard is not a universal requirement for private securities offerings. Rule 506(b) provides a pathway for up to 35 non-accredited investors to participate in a private placement, subject to specific conditions. Understanding the scope of this allowance, what it requires, and why most sponsors choose not to use it despite its theoretical availability is essential context for any sponsor operating under Rule 506(b).

### The 35 Non-accredited Investor Allowance

Rule 506(b) permits up to 35 non-accredited investors to participate in a private offering, provided each of those investors has such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment. This is the sophistication standard, a subjective assessment of investment expertise rather than an objective financial threshold.

The 35 investor cap is a firm aggregate limit across the entire offering. Not per closing, not per calendar year, but across the entire life of the offering. If a 506(b) offering involves multiple closings over time, non-accredited investors in early closings count against the same cap as those in later closings. The 36th non-accredited investor cannot be admitted without jeopardizing the exemption. Once the cap is reached, no additional non-accredited investors may be admitted regardless of their sophistication. The exemption simply does not provide for it.

The cap also applies to secondary transfers. If a non-accredited investor in a 506(b) offering transfers their interest to another non-accredited investor, the count does not increase. The position moves but the aggregate number stays the same. If an accredited investor transfers to a non-accredited investor, the count increases. The transfer restriction provisions of the operating agreement must be designed to track and enforce this cap, which requires knowing the accreditation status of both transferors and transferees on every proposed secondary transfer.

### Sophistication Requirements

The sophistication standard is not the same as the accredited investor standard and cannot be satisfied by wealth or income alone. A wealthy investor who does not understand how private

real estate investments work is not a sophisticated investor for 506(b) purposes, regardless of their net worth. The assessment turns on investment knowledge and experience: does this investor have the background to evaluate the specific investment being offered?

The SEC has never provided a bright line definition of sophistication, which creates genuine subjectivity in the analysis. Factors that support a sophistication determination include experience as a principal or senior executive in real estate businesses; prior participation in private real estate investments; a professional background in finance, law, or accounting; current engagement of qualified investment advisors; and demonstrated engagement with complex financial instruments or investments. None of these is automatically sufficient. The assessment is holistic.

The sophistication determination requires a substantive review of the investor's background, not collection of a questionnaire alone. A questionnaire that asks the investor to self-certify sophistication, without the sponsor's independent assessment of whether the background described supports that conclusion, does not satisfy the requirement. The sponsor must actually evaluate whether the investor qualifies, not simply record that the investor said they did.

### **Additional Disclosure Obligations for Non-accredited Investors**

When non-accredited investors participate in a 506(b) offering, the disclosure obligations increase substantially. Issuers must provide non-accredited investors with certain information typically required in registered offerings, specifically financial statements, information about material risks, and disclosure of material relationships between the issuer and its principal parties in the form that would be required in a registered offering of the same type.

This additional disclosure requirement applies to each non-accredited investor in the offering and must be provided a reasonable time before the investor subscribes. It is not optional. Failing to provide the required disclosures to a non-accredited investor in a 506(b) offering creates both a disclosure failure and a potential exemption deficiency. The additional disclosure obligation is one of the most significant practical reasons why most sponsors conducting 506(b) offerings deliberately limit participation to accredited investors, even though the rule technically permits non-accredited participation.

The other practical reasons are equally compelling: the 35 investor cap is administratively burdensome to track across the life of a multi closing offering; the sophistication assessment creates subjective exposure that accreditation verification does not; and the additional disclosure obligations add legal cost and complexity that is rarely worth the incremental capital that might come from non-accredited investors. The theoretical availability of non-accredited investor participation under 506(b) is used far less frequently than the rule's text would suggest.

## **Sophisticated Investors: A Higher Standard for Non-accredited Participants**

The sophisticated investor standard, used to qualify non-accredited investors under Rule 506(b), is distinct from the accredited investor standard and is often misunderstood by sponsors who encounter it. Understanding the distinction matters both for sponsors who are actively considering admitting non-accredited investors and for sponsors who want to understand why this pathway is more demanding than it looks.

Sophistication is a functional assessment: is this investor capable of evaluating the merits and risks of this particular investment? It is not a financial assessment, and it is not a static status that an investor either has or does not have. An investor who is sophisticated enough to evaluate a single asset multifamily syndication may not be sophisticated enough to evaluate a complex fund level investment with multiple asset classes, leverage structures, and waterfall mechanics. The relevant question is always about the specific investment being offered.

The sponsor's obligation is not just to collect information about the investor's background. It is to actually assess whether that background supports a sophistication conclusion for the specific offering. An investor who reports that they have participated in several prior real estate investments, holds a graduate degree in business, and is regularly advised by a licensed financial advisor provides a stronger basis for a sophistication determination than an investor who self describes as sophisticated without supporting background. The sponsor's assessment of the investor's background must be documented.

A further nuance: the sophistication standard can be satisfied by a non-accredited investor using a qualified representative with knowledge and experience sufficient to evaluate the investment on the investor's behalf. If the investor has a financial advisor who meets the sophistication standard and who is advising the investor on the specific investment, that advisory relationship can support the investor's participation even if the investor themselves would not independently qualify as sophisticated. The qualified representative concept gives the SEC's sophistication test its most expansive reading, but it requires documenting the representative's qualifications and their role in advising the specific investor on the specific investment.

## **Investor Questionnaires: Design and Best Practices**

The investor questionnaire is the primary tool through which sponsors collect information about investor eligibility. Under Rule 506(b), the questionnaire, combined with the sponsor's review of the responses, is often the entirety of the verification process. Under Rule 506(c), the questionnaire is the starting point, but it must be supplemented by actual documentation review.



Understanding what a well designed questionnaire accomplishes, and what it cannot accomplish by itself, is essential for sponsors building their investor qualification process.

### **What the Questionnaire Must Establish**

For accredited investor eligibility, a well designed investor questionnaire establishes the basis for the investor's accredited status (income, net worth, or professional certification), the investor's investment experience and sophistication, their understanding of the nature and risks of private real estate investments, and any factors that might affect their suitability for the specific offering.

For 506(b) offerings, the questionnaire should collect enough background information to support the sponsor's independent sophistication assessment: prior investment experience in real estate and other private securities, professional background, the nature of any advisory relationships, understanding of illiquid investments, and the investor's investment objectives. For non-accredited investors, the questionnaire is the primary record of the sophistication analysis.

For 506(c) offerings, the questionnaire establishes the basis for the investor's claimed accreditation and identifies which verification method will be used. It does not, however, satisfy the verification obligation. It identifies what documentation needs to be collected, but the collection and review of that documentation is a separate step that must be completed before the subscription is accepted.

### **What the Questionnaire Cannot Do**

A questionnaire cannot verify accreditation under 506(c). An investor who checks a box confirming they are accredited, answers questions about their income or net worth, and signs the questionnaire has self-certified, which satisfies 506(b) but not 506(c). The distinction is not a technicality. It is the legal line between the two exemptions, and it is the line that sponsors most frequently blur in practice.

A questionnaire also cannot establish sophistication through self-certification alone. An investor who describes themselves as sophisticated, without providing background that the sponsor independently evaluates and finds sufficient, has not been properly qualified as a sophisticated non-accredited investor. The questionnaire is evidence that must be evaluated, not a self-executing qualification instrument.

### **Questionnaire Design Best Practices**

- Require investors to identify the specific basis for their accredited status (income, net worth, professional license, or entity category) rather than simply confirming accredited status generally. The specific basis matters for determining which verification documentation to collect.



- For 506(c) offerings, clearly state in the questionnaire that completion of the questionnaire does not itself establish accredited status and that documentation review is required before the subscription can be accepted. This prevents investors from believing they have completed the qualification process when they have only completed the first step.
- Collect specific factual background for the sophistication assessment, including years of experience in real estate investing, number and types of prior private investments, professional background, and the nature of any advisory relationships, rather than asking the investor to self-assess sophistication in general terms.
- Include representations about the investor's ability to sustain a total loss of the investment and their understanding that the investment is illiquid. These representations establish important elements of the investor's suitability for the specific offering, independent of accreditation.
- Require investors to update their questionnaire responses if their circumstances change before the closing, particularly their accreditation basis, which could change in the period between questionnaire submission and actual closing.
- Have securities counsel review the questionnaire before it is used. The questionnaire is a legal document whose design determines whether the sponsor can defend its qualification process. A questionnaire designed without counsel review is a questionnaire whose adequacy has not been assessed.

## Ongoing Investor Qualification: When Status Changes After the Closing

In a conventional securities offering, investor qualification is typically a one-time event. The investor qualifies at subscription, and subsequent secondary transfers are governed by the operating agreement's transfer restrictions but rarely involve systematic requalification of the transferring investor. The transferee must qualify, but the transferor's current status is generally not re-verified on each transfer.

Private real estate syndications are long term investments. A sponsor who closes a \$20 million equity raise today has investors who will hold their membership interests for five to seven years or longer. During that time, investors' circumstances change: income falls, net worth declines, professional licenses lapse, family entities are restructured. Understanding what those changes mean for the offering's compliance posture, and what obligations they create for the sponsor, is an ongoing compliance responsibility that most sponsors underestimate.

### When an Investor's Accreditation Status Changes After Closing

An investor who qualified as accredited at the time of subscription and loses that status afterward does not create retroactive liability for the sponsor. The subscription was lawfully made at a time when the investor was accredited, and that subscription remains valid. The loss of accredited status does not undo the initial investment.

What the loss of accredited status does affect is more nuanced. If the offering involves subsequent closings or capital calls, and the formerly accredited investor is asked to make additional contributions, the sponsor must evaluate whether the investor currently qualifies before accepting the additional investment. An investor who was accredited at the first closing but is not at the second closing cannot be admitted to the second closing on the basis of their first closing qualification.

For secondary transfers, the picture is similarly nuanced. The legality of a secondary sale by a former accredited investor depends primarily on the eligibility of the buyer, not the current status of the seller. If a formerly accredited investor sells to a verified accredited buyer, and the transfer otherwise complies with the operating agreement and the applicable exemption's requirements, the transfer can generally proceed. The seller's current status matters primarily for whether they can make new primary investments, not for whether they can transfer interests they lawfully acquired when accredited.

## **Transfer Restrictions and Ongoing Eligibility**

The operating agreement's transfer restriction provisions must be designed to account for ongoing eligibility changes across the investor population. At minimum, any proposed transfer of a membership interest must be reviewed for the transferee's accredited investor status (required for any transfer in a Regulation D offering), compliance with the applicable exemption's requirements (including verification under 506(c) if the offering requires it), and compliance with the operating agreement's transfer conditions (manager consent, right of first refusal, and other contractual limitations).

Sponsors who rely solely on the subscription stage qualification, without a systematic process for reviewing proposed secondary transfers, are creating compliance exposure with each unreviewed transfer. Every secondary transfer is a new securities transaction that must have its own exemption basis. The seller's original exemption does not automatically carry over to the buyer. The buyer must independently qualify under an applicable exemption.

## **Building a Systematic Post-closing Compliance Process**

A systematic post-closing compliance process for investor qualification should include the elements described below.

- A documented transfer review process for every proposed secondary transfer, identifying who reviews it, what is reviewed, what documentation is required from the proposed transferee, and how the review is documented.
- A periodic communication to investors reminding them of their obligation to notify the sponsor if their accreditation status or entity composition changes in ways that would affect their qualification.
- A process for re verifying investor qualification before any subsequent capital call, ensuring that investors being asked for additional capital currently qualify for the offering's exemption.
- Documentation of every transfer review, including the basis for the determination that the proposed transferee qualifies and the documentation reviewed. This documentation is the evidence in any subsequent regulatory review or investor dispute.

## Investor Eligibility Tiers: The Broader Framework

The accredited investor standard sits within a broader hierarchy of investor eligibility tiers that arise across different regulatory contexts. Sponsors who encounter institutional investors, registered investment advisers, or family offices in their investor base may encounter references to these higher standards. Understanding where they apply is important for sponsors whose offerings target more sophisticated capital.

| Tier                | Standard                                                                                               | Applicable Context                                                                                   | Financial Threshold                                                                                     |
|---------------------|--------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------|
| General Public      | No financial qualification required. Investment limits apply for non-accredited under Reg A+.          | Regulation A+ (non-accredited), Regulation CF.                                                       | No minimum. Investment limits tied to income or net worth.                                              |
| Accredited Investor | Financial or professional criteria under Rule 501(a).                                                  | Regulation D (506(b) and 506(c)). Most private placements.                                           | \$200,000 / \$300,000 income or \$1 million net worth. Qualifying entity. Or FINRA Series 7, 65, or 82. |
| Qualified Client    | Higher financial threshold under the Investment Advisers Act, adjusted for inflation every five years. | Required for performance fees charged by registered investment advisers.                             | \$2.7 million net worth or \$1.4 million in AUM with the adviser (effective June 29, 2026).             |
| Qualified Purchaser | Highest financial threshold under the Investment Company Act, measured in "investments" owned.         | Required for the 3(c)(7) fund exemption. Enables unlimited investor count (subject to other limits). | \$5 million in investments (individual). \$25 million in investments (institutional).                   |

### Qualified Client Thresholds Increased in 2026

*On April 28, 2026, the SEC issued a final order adjusting the qualified client thresholds under Rule 205-3 of the Investment Advisers Act for inflation. The assets under management threshold increased from \$1.1 million to \$1.4 million, and the net worth threshold increased from \$2.2 million to \$2.7 million. The new thresholds took effect on June 29, 2026.*

*The new thresholds apply only to new investment advisory contracts and new fund investments entered into on or after the effective date. Investors who met the prior qualified client thresholds and were already invested in a 3(c)(1) fund or under an existing advisory contract are generally grandfathered. Sponsors of new performance fee funds and registered investment advisers entering new advisory contracts should ensure subscription documents, questionnaires, and qualified client representations reference the updated thresholds.*

*These adjustments are required to be made every five years under Section 205(e) of the Advisers Act and use the Personal Consumption Expenditures price index, with results rounded to the nearest \$100,000. The next inflation adjustment is expected in 2031.*

For most real estate syndications, the operative tier is accredited investor. The qualified client and qualified purchaser standards arise in more specific contexts. Qualified client status is relevant when a registered investment adviser charges performance based compensation, and qualified purchaser status is relevant when a private fund relies on the Section 3(c)(7) Investment Company Act exemption to avoid registration. Sponsors who are uncertain whether any of these higher standards apply to their specific offering structure should address the question with securities counsel before the offering launches, not after an institutional investor raises it.

## Building a Legally Sound Accreditation Verification Program

The accreditation verification program is not just a compliance obligation. It is a legal defense. Sponsors who can demonstrate a well designed, consistently executed verification program are in a fundamentally different position than those whose verification records are incomplete or inconsistent when a regulatory review or investor dispute arises. A verification program that was built as evidence, not just as an onboarding process, provides meaningful protection that an improvised program cannot.

A complete verification program for a private real estate offering should have five components, all of which must be designed before the first investor subscription is accepted.

## Written Verification Procedures

The sponsor or manager entity should have written verification procedures that describe the acceptable verification methods for each accreditation category, the document types accepted for each method, the validity period for third party verification letters, the process for handling investors whose verification is pending at the time of a closing, and the recordkeeping requirements for the program. These procedures should be reviewed by securities counsel for consistency with the SEC's guidance on reasonable verification steps under 506(c) and should be updated when the regulatory framework changes.

## Integrated Verification Workflow

The verification workflow should be integrated into the investor onboarding flow, not a separate process that investors must complete through a different channel. Investors who can complete accreditation verification, questionnaire submission, and subscription agreement execution through a single cohesive workflow experience a materially better onboarding experience than those who must navigate multiple disconnected steps. Investor dropout rates at the qualification stage are significantly higher when the process is fragmented, which means qualification workflow design is not just a compliance question. It is a capital raising efficiency question as well.

## Documentation Retention

Every verification document (tax returns, account statements, professional certification confirmations, third party verification letters) should be retained for at least five years from the date of the last sale in the offering. The documentation must be organized in a way that allows a specific investor's verification record to be retrieved and reviewed quickly. A filing system that requires reconstructing what was reviewed, when it was reviewed, and what determination was made does not function as a compliance record. Design the recordkeeping system at the outset with the understanding that retrieval speed matters.

## Credential and Verification Renewal

Verification does not last forever. Third party verification letters are typically valid for 90 days from the underlying documentation date. In an offering with subsequent closings or capital calls extending over months or years, investors who subscribed at the first closing may need to re-verify before participating in later closings. The compliance calendar should include notification triggers for verification renewals, set at a point before-expiration that gives investors adequate time to complete the renewal process.

Proactive renewal management, with reminders and an accessible renewal workflow, is far easier to build at the beginning of the offering than to retrofit when renewal failures become a

problem. An investor who cannot make an additional investment because their prior verification has lapsed, and who did not receive advance notice that renewal was needed, is an investor who will call with a complaint that the sponsor could have prevented.

## Annual Eligibility Review

At least annually, the sponsor should review the investor population for potential changes in eligibility status: investors who have notified the sponsor of significant financial changes, investors whose professional certifications may have lapsed, and entities whose equity ownership structure may have changed in ways that affect their accreditation status. This review should be documented and retained as part of the offering's compliance record. The annual review demonstrates an ongoing commitment to the qualification standards that the offering relies upon, and creates documentation of that commitment.

### **⚠ The Verification Program Is Evidence. Design It With That in Mind.**

*If a regulatory inquiry or investor dispute ever focuses on whether a specific investor was properly verified as accredited, the verification program is the evidence. A well documented, consistently executed program, with written procedures, retained documentation, verification renewal records, and annual eligibility reviews, is a strong defense.*

*A verification program that consisted of collecting self-certification questionnaires without underlying documentation review, or that accepted subscriptions before verification was complete, is much harder to defend. The program's adequacy is judged by what was actually done, not by what the onboarding materials described.*

*Design the verification program from the outset with the understanding that it is being built as a compliance record, not merely as an onboarding process. Every decision about what documentation to collect, how to retain it, and when to require renewal is a decision about the evidentiary quality of the program.*

## Practical Takeaways

- The accredited investor definition under Rule 501(a) is specific and detailed. Individual investors qualify based on the income test (\$200,000 individual or \$300,000 joint in each of the two most recent years with reasonable current year expectation), the net worth test (\$1 million excluding primary residence), or active FINRA professional certifications (Series 7, 65, or 82). Wealth and sophistication are not the same thing, and the professional certification expansion means investment expertise is now independently qualifying.

- The primary residence exclusion in the net worth test is frequently misapplied. The home's fair market value is excluded from both assets and liabilities up to its value, but any mortgage balance exceeding the home's fair market value is a liability that reduces net worth. In borderline cases, have the investor work with a licensed professional to prepare the net worth calculation before the verification is submitted.
- Entity accreditation depends on the entity type. Entities formed specifically to make the investment in question cannot qualify on the \$5 million total assets basis. They must qualify as all accredited equity owner entities, which requires verifying each equity owner individually. This analysis must happen before the subscription is accepted, not after questions arise.
- Under Rule 506(c), accreditation must be verified through actual third party documentation review, not investor self-certification. The verification must be completed, and the sponsor must have the required documentation, before any investment is accepted. Subscriptions accepted before verification is complete are not cured by subsequent successful verification.
- The 2025 SEC no action letter provides a streamlined verification approach based on minimum investment amounts: \$200,000 for natural persons and \$1,000,000 for legal entities, combined with written representations from the investor regarding accreditation and the absence of third party financing. For sponsors raising at investment minimums above these thresholds, the no action letter materially reduces the documentation burden of 506(c) verification.
- Third party verification letters are typically valid for 90 days from the date of the underlying documentation, tracking the SEC's three month reference in Rule 506(c)(2)(ii)(C). In multi closing or capital call offerings, investors may need to re verify before later closings. Build verification renewal into the compliance calendar and investor communication workflow from the beginning.
- The prior 506(c) investor exception under Rule 506(c)(2)(ii)(D) allows reliance on a current written certification from an investor who was previously verified in a Rule 506(c) offering of the same issuer. It applies only to the same issuer's prior 506(c) offerings, not to prior 506(b) offerings.
- Rule 506(b)'s 35 investor allowance for sophisticated non-accredited investors is a firm aggregate cap across the entire offering, including secondary transfers. The sophistication assessment requires the sponsor's independent evaluation of the investor's background, not self-certification. The additional disclosure obligations and administrative complexity of admitting non-accredited investors explain why most sponsors conducting 506(b) offerings limit participation to accredited investors.
- When an investor loses accredited status after closing, the original subscription remains valid. Their ability to participate in subsequent closings or capital calls requires current

accreditation. Secondary sales to verified accredited buyers can generally proceed regardless of the seller's current status. What matters is the buyer's current eligibility.

- Every proposed secondary transfer of a membership interest is a new securities transaction that requires its own exemption basis and transferee qualification. The seller's original exemption does not automatically carry over to the buyer. Build a documented transfer review process into the offering infrastructure before the first secondary transfer is proposed.
- The investor questionnaire establishes the basis for the accreditation determination but does not satisfy 506(c)'s verification obligation. The questionnaire identifies what documentation to collect. Collecting and reviewing that documentation is a separate step that must precede acceptance of the subscription.
- Qualified client thresholds under the Investment Advisers Act increased on June 29, 2026 to \$2.7 million net worth and \$1.4 million AUM with the adviser. Sponsors and registered investment advisers entering new advisory contracts or accepting new investors in 3(c)(1) performance fee funds after that date must apply the new thresholds. Existing investors and existing advisory contracts are generally grandfathered.
- The accreditation verification program is legal evidence. Design it to function as a compliance record: written procedures, documentation retention for at least five years, an integrated onboarding workflow, a credential renewal calendar, and an annual review of the investor population for status changes. A verification program that cannot be reconstructed and presented as evidence is a program that will not survive regulatory scrutiny.



## CHAPTER FIFTEEN

# Private Placement Memorandum: What It Is and Why It Matters

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The private placement memorandum is the document that separates a professionally structured securities offering from a casual capital raise. It is where every material fact about the investment is supposed to appear: the sponsor, the property, the business plan, the economics, the fees, the risks, the governance rights, and the transfer restrictions. Its purpose is disclosure, meaning giving investors everything they need to make an informed decision before they commit capital.

That purpose sounds straightforward. In practice, the gap between what a PPM should contain and what many real estate syndication PPMs actually contain is one of the most consistent patterns in the private real estate securities market. Sponsors use templates that were designed for different deal types. Attorneys adapt documents from prior transactions without tailoring them to the specific offering at hand. Risk factors are copied wholesale from prior PPMs without evaluating whether they describe the risks of this specific property, this specific sponsor, and this specific market. The result is a document that provides the appearance of disclosure without its substance.

The consequences are specific and predictable. Material omissions from a PPM are not merely technical failures. They are antifraud violations under Section 17(a) of the Securities Act and Rule 10b-5 under the Securities Exchange Act. When an investor suffers losses and retains counsel to evaluate their claims, the PPM is the first document reviewed. The question is always the same: was there information material to the investment decision that was not disclosed? If the answer is yes, the PPM failed its purpose, and the sponsor bears the consequences.

This chapter covers the purpose of a PPM and its relationship to the antifraud provisions, when a PPM is required versus when it is prudent regardless of strict legal requirement, the core components that every real estate PPM should contain, the fund specific provisions that distinguish a fund PPM from a single asset offering document, the antifraud standard that governs what must appear in the document, how to update the PPM when circumstances change, and the most common PPM mistakes that real estate sponsors make. Throughout, the chapter identifies not just what the documents should say but why each requirement exists, because understanding the purpose of each provision is what makes it possible to execute it correctly.

## The Purpose of a PPM

The private placement memorandum serves three distinct purposes simultaneously. It is a disclosure document, a compliance mechanism, and a liability protection tool. Understanding all three is essential for sponsors who want to use the document as the strategic asset it is, rather than treating it as a bureaucratic formality.

## Disclosure of Material Facts

The PPM's primary purpose is informational. It delivers to prospective investors the information they need to make an informed decision about whether to commit capital to the offering. That information includes everything that a reasonable investor would consider important in deciding whether to invest: the nature of the investment, the qualifications of the people managing it, the economic terms and how they work, the fees being charged and by whom, the risks that could cause the investment to underperform or fail, the governance rights investors hold, and the conditions under which their investment can be transferred or redeemed.

Materiality is the standard. A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. This is a broad standard that covers far more ground than sponsors typically appreciate when they first draft offering documents. The financial risks that appear obvious to a real estate professional (leverage risk, interest rate risk, occupancy risk, execution risk) may be highly nonobvious to a physician, attorney, or business executive investing their first private real estate deal. The PPM's disclosure obligation is calibrated to the likely investor, not to the sophisticated real estate practitioner.

## Antifraud Compliance

The second purpose of the PPM is compliance with the antifraud provisions of federal securities law. Section 17(a) of the Securities Act prohibits any material misstatement or omission in connection with the offer or sale of securities. Rule 10b-5 under the Securities Exchange Act extends substantially the same prohibition to any purchase or sale of securities. These provisions apply regardless of the exemption used, regardless of the sophistication of the investors, and regardless of whether the offering is registered or private.

A PPM satisfies the antifraud provisions by delivering comprehensive, accurate disclosure before investors commit capital. The document creates a written record of what was disclosed, when it was disclosed, and to whom. An investor who received the PPM before subscribing, and whose subscription agreement confirms that receipt, has a much more difficult time arguing that they were deprived of material information than an investor who received only marketing materials and verbal representations. The PPM is not just disclosure to investors. It is documentation that disclosure occurred.

The antifraud standard applies to omissions as well as affirmative misstatements. A PPM that accurately describes every fact it discloses but that omits a material fact (a pending lawsuit, a prior regulatory action against the sponsor, a material deficiency in the property's condition, a conflict of interest in the fee structure) violates the antifraud provisions through what it does not say. This is the aspect of PPM drafting that most frequently produces inadequate documents. Sponsors and their counsel focus on what the document says, when the antifraud standard also requires attention to what it leaves out.

## Liability Protection for the Sponsor

The third purpose of a comprehensive PPM is to protect the sponsor from investor claims. A PPM that comprehensively discloses all material risks, including risks that materialized and caused investor losses, provides the sponsor's primary defense against fraud claims. If the risk that caused the investment to underperform was specifically disclosed in the risk factors section, and the investor signed a subscription agreement acknowledging receipt of the PPM and that they understood the risks, the investor faces a much higher burden in establishing that the sponsor defrauded them.

This liability protection function is why cost minimizing approaches to PPM preparation (using the shortest document that satisfies some minimal threshold, avoiding deal specific risk factors that might make the offering look less attractive, omitting uncomfortable disclosures about the sponsor's prior track record) are counterproductive from a risk management standpoint. The additional cost of preparing a comprehensive, deal specific PPM is modest compared to the litigation cost of defending an inadequate disclosure claim. More fundamentally, a PPM prepared with liability protection in mind consistently produces a better document than one prepared with minimalism as the goal.

## When a PPM Is, and Is Not, Required

The technical answer to whether a PPM is legally required is nuanced in ways that can mislead sponsors into thinking they have more flexibility than they do. Regulation D does not mandate a PPM for all offerings. Rule 506(b) requires that non-accredited sophisticated investors receive certain specific information that effectively amounts to a PPM like document. It does not impose that specific requirement when all investors are accredited. Rule 506(c) requires verified accreditation and a Form D filing, but says nothing specific about the form of disclosure document that must accompany the offering.

The practical answer is that the absence of a technical PPM mandate in Regulation D does not reduce the legal obligation to disclose all material information to investors before they subscribe. The antifraud provisions apply regardless of exemption and require comprehensive disclosure. The PPM is not just a compliance response to a specific rule. It is the organized mechanism

through which the issuer delivers and documents the comprehensive disclosure that the antifraud provisions demand.

Any sponsor who foregoes a PPM in a private real estate offering is accepting undocumented exposure to securities fraud claims that a comprehensive disclosure document would have addressed. The cost of preparing a PPM is a known, bounded expense, typically \$10,000 to \$50,000 in legal fees depending on deal complexity, plus the time required for the sponsor to provide the deal specific information the document requires. The cost of defending an investor fraud claim arising from inadequate disclosure is neither known nor bounded. It includes litigation costs, settlement costs, and reputational damage whose full extent depends on factors the sponsor cannot control at the time the decision not to prepare a PPM was made.

### **⚠ The Absence of a Mandatory PPM Requirement Does Not Mean Disclosure Is Optional**

*Sponsors who interpret the absence of a specific PPM requirement in Regulation D as permission to proceed without comprehensive written disclosure are misunderstanding the securities laws. The antifraud provisions require that investors receive all material information before they invest, regardless of whether a specific document type is mandated.*

*Marketing materials, pitch decks, and verbal representations are not adequate substitutes for a PPM. They are not comprehensive, they are not systematically organized, and, most importantly, they do not create the kind of documented disclosure record that the PPM creates. In an investor dispute, the question is always what was disclosed in writing before the subscription was accepted. A pitch deck with a return projection and a conference call with the sponsor is not disclosure. A comprehensive PPM is.*

*A well prepared PPM is the sponsor's primary protection against claims that material information was withheld. The decision not to prepare one is a decision to operate without that protection.*

## **Core Components of a Real Estate PPM**

A professionally prepared real estate PPM contains a defined set of sections, each serving a specific disclosure function. The sections described below represent the standard architecture of a private real estate offering document. The specific content within each section varies by deal, sponsor, and market, but the absence of any of these sections signals a document that was not prepared for the purpose of comprehensive disclosure.

## Cover Page and Offering Summary

The cover page and offering summary establish the basic parameters of the offering: the name of the issuer, the securities being offered, the total offering amount, the minimum investment, the offering price per unit or interest, the applicable securities exemption, the offering period, and contact information for the issuer. The cover page should include the required legends: that the securities have not been registered with the SEC, that they are being offered pursuant to the specified exemption, and that the document is confidential and not to be reproduced or shared without the issuer's consent.

The offering summary provides a brief overview of the key economic terms that is designed to orient the reader before they encounter the detail of the full document. It is not a substitute for the full disclosure. The subscription agreement should confirm that the investor reviewed the entire document, not just the summary, but the summary helps investors orient themselves and provides a quick reference for key terms.

## Risk Factors: Comprehensive and Deal Specific

The risk factors section is the most important section of the PPM from a liability protection standpoint, and it is consistently the section where disclosure is most inadequate. Two qualities distinguish an adequate risk factors section from a deficient one: comprehensiveness and deal specificity.

Comprehensiveness means covering every category of material risk: real estate market risk, financing risk, execution risk, regulatory risk, tax risk, management risk, and any other category of risk that could cause the investment to underperform or fail. A risk factors section that lists general real estate risks without addressing the specific risks of the particular deal type, property, market, and sponsor is not comprehensive. It is a boilerplate list that provides the appearance of risk disclosure without its substance.

Deal specificity means tailoring the risk factors to the specific offering. A value add multifamily syndication in Austin faces different risks from a ground up development in Phoenix. A first time sponsor faces different risks from an established operator with a twenty deal track record. A property with a floating rate bridge loan faces different risks from one with fixed rate agency financing. Each of these differences should be reflected in the risk factors section. A PPM with identical risk factors to every other offering the attorney has produced is a PPM that has not been prepared for this offering.

Risk factors should be specific enough that an intelligent investor reading them understands the nature of the risk, how it could affect their investment, and, where relevant, what the sponsor has done to mitigate it. A one sentence risk factor stating that real estate markets are subject to fluctuation does not satisfy this standard. A risk factor that describes the specific market

conditions that could adversely affect occupancy at the subject property, the specific leverage level and its implications for loss exposure, and the specific assumptions in the financial projections whose failure would impair investor returns does.

## **Description of the Offering and Use of Proceeds**

The offering description section specifies what is being sold: membership interests in the LLC, limited partnership units, or whatever interest form the offering uses. It describes the total equity being raised, the number of interests being offered, the price per interest, the minimum investment, the offering period, and the conditions under which the offering may be terminated or extended. It should also describe the mechanics of closing: when subscriptions are accepted, when capital is deployed, and when the offering is considered complete.

The use of proceeds section specifies where investor capital will go. For a single asset acquisition, this typically includes acquisition price, transaction costs (title, escrow, legal, financing fees), reserves (capital expenditure reserve, operating reserve, interest reserve), renovation budget (for value add deals), organization and offering expenses, and working capital. Every material use of proceeds should appear with sufficient specificity that an investor can evaluate whether the allocation is appropriate.

The use of proceeds section is where the management fee, acquisition fee, and other sponsor compensation paid at closing appear as specific line items. A use of proceeds that buries sponsor compensation in a broad organization and offering expenses category without itemizing the specific amounts has not provided adequate disclosure of how investor capital is being used. Each fee paid from offering proceeds should be identified separately, with the dollar amount and the party receiving it.

## **Business Plan and Property Description**

The business plan and property description section provides the substantive investment thesis for the offering. For a single asset acquisition, it describes the property in detail: location, physical characteristics, current occupancy and rental rates, competitive market analysis, historical financial performance, and the sponsor's plan for improving or maintaining the property's performance over the hold period. The property description should be based on due diligence actually conducted, not on marketing representations from the seller.

The business plan describes what the sponsor intends to do with the property and why that plan is expected to generate the projected returns. For a value add strategy, it describes the renovation scope, the timeline, the expected impact on occupancy and rental rates, and the assumptions underlying those expectations. For a core or core plus strategy, it describes how the existing cash flows will be maintained and what the exit strategy is. The business plan

section is where the connection between the financial projections and the operational reality is established, or where it is revealed to be tenuous.

## **Management and Sponsor Information and Track Record**

The management section discloses who is responsible for managing the investment and what their qualifications are. It should cover the individuals and entities who will be making investment and operational decisions, their relevant experience in real estate investment and management, their track record with prior investments of a similar type, and any relevant background that would affect investors' assessment of their competence and reliability.

Track record disclosure is one of the most sensitive and most important components of the management section. The sponsor's prior investment history is material information, both the successes and the failures. A track record presentation that highlights successful exits while omitting investments that are underperforming, that have been restructured, or that have resulted in investor losses is selectively presenting material information in a way that can constitute a material misrepresentation.

Track record disclosure should be complete: the number of investments made, the total capital raised, the performance of investments that have been sold (with actual realized returns, not projected returns), the current status of investments that are still in the portfolio, and any investments that resulted in investor losses or that were materially restructured. The antifraud standard does not permit a sponsor to present only their best deals as evidence of their track record. It requires presenting enough information that investors can form an accurate picture of the sponsor's historical performance.

## **Compensation and Fee Disclosure**

Every fee that the sponsor or any affiliated entity may earn in connection with the offering must be disclosed. This includes fees paid at closing (organization fees, acquisition fees, due diligence fees), ongoing fees (asset management fees, property management fees, construction management fees), event specific fees (refinancing fees, disposition fees), and the promote or carried interest structure. For each fee, the disclosure must specify the calculation basis, the party receiving it, the timing of payment, and the dollar amount where it can be calculated at the time of the offering.

The compensation disclosure section should also address the promote structure in sufficient detail that investors can calculate what the sponsor will receive under different performance scenarios. A promote description that states the sponsor will receive 20% of profits above the preferred return, without explaining how the waterfall calculation works, what a catch up provision means, or what the effective promote percentage is after accounting for the catch up,



has not provided adequate disclosure of how sponsor compensation interacts with investor returns.

Fees paid to affiliated entities, including property management fees to an affiliated management company, construction oversight fees to an affiliated construction entity, and financing fees arranged through an affiliated source, are conflicts of interest that must be disclosed both in the compensation section and in the conflicts of interest section. The same arrangement may need to appear in both places with cross references, because the nature of the conflict (the sponsor is on both sides of the transaction) is as important as the amount of the fee.

## **Conflicts of Interest Disclosure**

The conflicts of interest section is where arrangements in which the sponsor's interests diverge from investors' interests are specifically identified and described. The antifraud standard requires affirmative disclosure of conflicts. Sponsors cannot rely on investors to identify conflicts from the arrangement's description alone. The disclosure must identify the conflict specifically: who has the conflicting interest, what the conflicting interest is, how it creates a divergence from investors' interests, and what (if anything) has been done to manage or mitigate the conflict.

Common conflicts in real estate syndications that require specific disclosure: affiliated property management arrangements where the sponsor earns fees from the SPV for services it controls; construction management arrangements where the sponsor benefits from a larger renovation scope; cross deal conflicts where the sponsor manages multiple simultaneous investments and must allocate their time and deal flow among competing obligations; and fee structures where the sponsor earns significant income regardless of investment performance, reducing the alignment that the promote is supposed to create.

Conflict disclosures should be specific and honest. A generic statement that conflicts of interest may arise, without identifying the specific conflicts that actually exist in this offering, does not satisfy the antifraud disclosure standard. It provides the legal language of conflict disclosure without its substance, which is precisely the type of technically present but substantively inadequate disclosure that produces investor claims.

## **Financial Projections and Assumptions**

Financial projections (projected cash flows, projected returns, projected equity multiples and IRRs) are among the most consequential disclosures in the PPM because they directly shape investor expectations. They are also among the most litigation prone, because projections that turn out to be materially inaccurate become the foundation of investor claims that they were misled about the investment's expected performance.



Projections must be presented as projections, not as representations of likely outcomes. Every projection should be accompanied by a clear statement of the assumptions on which it is based and a disclosure that actual results may differ materially from the projections. The assumptions should be specific enough to be meaningful: occupancy assumptions, rental rate assumptions, expense assumptions, exit cap rate assumptions, and financing assumptions. Projections based on undisclosed or unstated assumptions cannot be evaluated by investors and cannot be defended as adequate disclosure if the projections prove inaccurate.

The PPM should also include sensitivity analysis or scenario analysis that shows investors how the projected returns change if key assumptions prove incorrect. A multifamily syndication projection that shows robust returns under the base case but does not disclose that a 200 basis point increase in the exit cap rate (a realistic scenario in many market environments) would eliminate investor returns has not provided investors with the information they need to evaluate the investment's risk adjusted return profile.

## **Investment Terms and Distribution Waterfall**

The investment terms section describes the economic agreement between the sponsor and investors: the preferred return, the catch up (if any), the promote structure, the distribution waterfall, and the timing and conditions for distributions. This section should be detailed enough that investors can calculate, from the PPM alone, approximately what they would receive under various performance scenarios. A waterfall description that uses general terms without providing enough specificity to calculate the distribution at each tier is not adequate disclosure.

The investment terms section should cross reference the operating agreement provisions that implement the economic terms. The PPM describes the economics. The operating agreement governs them. Investors should be directed to review the operating agreement, and specifically its waterfall provisions, for the legally binding implementation of the economic terms described in the PPM.

## **Exit Strategy and Disposition Plans**

The PPM should describe the sponsor's anticipated exit strategy for the investment: the projected hold period, the anticipated exit mechanism (sale, refinancing, or both), the conditions under which the hold period might be extended, and the process by which the disposition decision will be made. For fund structures, the exit strategy section should address how individual asset dispositions will be handled and how disposition proceeds will flow to investors.

Exit strategy disclosure is important because investors need to understand the illiquidity timeline they are accepting. A projected three to five year hold period that actually extends to seven or eight years because market conditions did not support an exit at the projected price is not necessarily a default, but investors who had planned around a five year liquidity event will have

been materially affected by the difference. Disclosing the conditions under which the hold period might be extended, and the governance process for making that decision, gives investors information they need before committing capital.

## **Legal Matters and Pending Litigation**

The legal matters section discloses any pending or threatened legal proceedings involving the issuer, the sponsor, or their principals that are material to the offering. A sponsor who is a defendant in investor litigation from a prior deal, a regulatory investigation, a contract dispute with a property manager, or any other material legal proceeding must disclose it in the PPM. The antifraud standard does not permit selective disclosure of favorable legal history.

Materiality is the governing standard. Not every minor dispute must be disclosed, but any legal matter that a reasonable investor would consider important in evaluating the offering must appear in the PPM. The general principle: if the sponsor would be embarrassed to have the legal matter described in the PPM, that reaction is a signal that it may be material. The time to make the disclosure is before investors commit capital, not after they ask about it directly.

## **Tax Considerations Summary**

The tax considerations section provides investors with a general overview of the tax treatment of the investment: pass through taxation, depreciation benefits, capital gains treatment at exit, the passive activity loss implications, and any transaction specific tax features such as 1031 exchange suitability or other features of the specific deal structure. The section should be based on the actual tax structure of the offering, reviewed for accuracy by tax counsel.

The tax considerations section must include a specific disclaimer that the discussion is general in nature and does not constitute tax advice, that the tax consequences will vary by investor based on individual circumstances, and that each investor should consult their own tax advisor before committing capital. This disclaimer is not merely protective language. It is accurate, because the tax consequences of a real estate investment do vary materially based on the investor's tax situation, particularly with respect to the passive activity loss rules and the investor's ability to benefit from the depreciation deductions the investment generates.

## **ERISA Considerations**

Private real estate syndications frequently attract capital from investors who are subject to the Employee Retirement Income Security Act of 1974: pension plans, profit sharing plans, 401(k) plans, IRAs, and other benefit plan investors. The PPM must address ERISA considerations with specificity, because the consequences of getting ERISA wrong, at both the offering structure level and the disclosure level, are severe and can affect the entire investor pool, not just the benefit plan investors who participate.

ERISA's relevance to a real estate syndication depends on whether the assets of the SPV or fund will be treated as plan assets of the benefit plan investors. Under ERISA's plan asset regulations, if benefit plan investors own a significant percentage of the equity in an entity that is not a publicly traded company or a qualified real estate entity, the entity's underlying assets may be deemed to be plan assets of those benefit plans. When plan assets are involved, ERISA's fiduciary duty requirements, prohibited transaction rules, and reporting obligations apply to anyone who exercises discretion over the management of those assets, including the sponsor.

### **The Plan Asset Rules and the Significant Participation Test**

Under the Department of Labor's plan asset regulations, an entity is not subject to plan asset treatment, and ERISA's requirements do not flow through to the entity's managers, if benefit plan investors hold less than 25% of the value of each class of equity interests in the entity, measured immediately after the most recent acquisition of any equity interest. This is the significant participation threshold. If the total ownership by benefit plan investors in any class of equity is below 25%, the entity's assets are generally not treated as plan assets, and the sponsor is not subject to ERISA's fiduciary and prohibited transaction rules in managing the investment.

The 25% threshold is calculated separately for each class of equity interests and is measured at the time each new investor is admitted. For a simple LLC syndication with a single class of membership interests, the calculation is straightforward: the percentage of total membership interests held by benefit plan investors must remain below 25% at all times. If it approaches or exceeds that threshold, the sponsor must either limit the amount of benefit plan capital it accepts or structure the offering to qualify for one of ERISA's exemptions, such as the real estate operating company (REOC) or venture capital operating company (VCOC) exception.

The definition of benefit plan investors for this calculation is broader than most sponsors initially appreciate. ERISA Section 3(42), added by the Pension Protection Act of 2006, defines benefit plan investor to include all ERISA covered employee benefit plans, all plans that are not subject to ERISA but that are subject to Section 4975 of the Internal Revenue Code (which includes IRAs and Keogh plans), and any entity whose underlying assets include plan assets, in which case the entity counts toward the threshold to the extent of the percentage of its assets that are plan assets, not the full amount of its investment. This look through rule means that a family office or fund of funds that includes a significant portion of benefit plan capital could contribute disproportionately to a sponsor's benefit plan investor percentage.

**⚠ The 25% Benefit Plan Investor Threshold Must Be Monitored Throughout the Offering**

*The plan asset analysis is not a one-time calculation at the initial closing. It must be performed at each subsequent closing, each time a new investor is admitted, and whenever an existing investor transfers interests to a benefit plan investor.*

*A sponsor who accepts benefit plan capital up to 24% at the initial closing and then admits additional benefit plan investors at a subsequent closing, crossing the 25% threshold, has created a situation where the entity's assets are now plan assets. The ERISA fiduciary and prohibited transaction rules apply from the moment the threshold is crossed, and the sponsor is now subject to those requirements without necessarily having the compliance infrastructure to satisfy them.*

*The subscription agreement should collect representations from investors about whether they are benefit plan investors and what percentage of their capital consists of plan assets. This information is essential for monitoring the threshold. Sponsors who accept benefit plan capital without tracking their benefit plan investor percentage are operating without the information necessary to know whether ERISA applies to their offering.*

## The Operating Agreement's ERISA Provisions

For offerings that accept benefit plan capital, the operating agreement should address ERISA explicitly. Standard provisions in operating agreements designed to accommodate benefit plan investors include a representation by each investor that they are or are not a benefit plan investor (and if they are, the percentage of their investment that constitutes plan assets); a covenant by benefit plan investors to notify the manager if their plan asset percentage changes materially; and a right for the manager to require the transfer or redemption of interests if admission of a new investor would cause the benefit plan investor threshold to be exceeded.

The operating agreement should also include specific provisions addressing ERISA's prohibited transaction rules, which prohibit certain transactions between a plan and a party in interest, including service providers, fiduciaries, and persons who own 50% or more of the entity. Affiliated transactions that would be permissible in a non ERISA context, such as the manager's affiliated entity providing property management services to the SPV, may require a specific exemption or may be prohibited outright if the SPV's assets constitute plan assets.

## What the PPM Must Disclose About ERISA

The PPM's ERISA section must specifically address the items described below.

- Whether the offering is designed to qualify for the significant participation exemption by limiting benefit plan investor ownership to below 25% of each class of equity, and how that limitation will be enforced.

- Whether the offering is instead structured to qualify as a real estate operating company (REOC) or venture capital operating company (VCOC), the two alternative exceptions to plan asset treatment that apply based on the nature of the entity's activities and its management rights, and why the sponsor believes the entity qualifies.
- If neither exception applies, because plan asset treatment is unavoidable or has been accepted, a disclosure of the consequences: the ERISA fiduciary duty obligations that apply to the manager, the prohibited transaction rules that constrain certain affiliated transactions, and the additional administrative obligations (including Form 5500 reporting considerations) that may apply.
- A representation that benefit plan investors should consult with their own ERISA counsel before investing, and that the PPM does not constitute ERISA advice.
- For IRA investors specifically: a disclosure of the prohibited transaction concerns that arise when an IRA invests in an entity where the account owner provides services or has other relationships that could constitute self-dealing under the Internal Revenue Code's prohibited transaction rules.

## **ERISA and Unrelated Business Taxable Income**

A separate but related ERISA consideration that must be addressed in the PPM is unrelated business taxable income (UBTI). Tax exempt investors, including pension plans, endowments, IRAs, charitable foundations, and similar entities, are generally exempt from federal income tax on their investment returns. However, if a tax exempt investor's share of income from a pass through entity is attributable to debt financed income, meaning income generated by property acquired with borrowed funds, that income may constitute UBTI, which is taxable even in the hands of tax exempt investors.

Because virtually every real estate syndication uses mortgage financing, tax exempt investors in leveraged real estate syndications may receive allocations of UBTI. The amount depends on the debt to equity ratio of the underlying property. The higher the leverage, the larger the UBTI allocation as a proportion of total income. For an IRA investor, UBTI is taxed at the trust income tax rates applicable to the IRA, which can be significant for IRAs that receive substantial UBTI allocations from multiple investments.

The PPM should disclose the likelihood that the investment will generate UBTI for tax exempt investors, the general factors that determine the amount of UBTI (primarily the leverage ratio), and the recommendation that tax exempt investors consult their own tax and ERISA counsel about the UBTI implications of the investment before subscribing. Self-directed IRA investors, who are increasingly common in private real estate syndications, should specifically be informed of the UBTI risk, because many are not aware of it and the IRA's tax exempt status creates a false impression that the investment's income is entirely tax advantaged.

### **⚠ ERISA and IRA Investors Require Specific PPM Disclosure. General Tax Disclaimers Are Not Sufficient.**

*A tax considerations section that generally disclaims that tax consequences vary by investor and recommends consulting a tax advisor does not satisfy the ERISA disclosure obligation for offerings that accept benefit plan capital. ERISA is not merely a tax consideration. It is a separate regulatory framework with its own fiduciary duty requirements, prohibited transaction rules, and administrative obligations.*

*The ERISA section of the PPM should be drafted with input from ERISA counsel who understands both the plan asset rules and the prohibited transaction framework. Real estate securities counsel may be familiar with the general framework but may not have the specific ERISA expertise to assess whether a particular affiliated transaction or fee structure creates a prohibited transaction exposure that requires specific disclosure or restructuring.*

*Sponsors who accept benefit plan capital without ERISA specific disclosure and without ERISA counsel reviewing the offering structure are accepting the risk that they have unknowingly created prohibited transactions or violated fiduciary duty obligations they did not know applied to them.*

## **Fund Specific PPM Provisions**

A fund PPM, meaning one prepared for a closed end or open end real estate fund rather than a single asset syndication, contains all of the sections described above, plus a set of provisions that are specific to the fund context. These provisions address matters that do not arise in a single asset offering: what the fund will invest in, how investment decisions will be made, what happens when the sponsor wants to raise a competing fund, and how the governance rights that limited partners hold can be exercised.

### **Investment Objectives and Strategy Disclosure**

The fund's investment objectives and strategy section describes what the fund will invest in, how it will identify and evaluate investments, what its target returns are, and what its general investment approach is. This section is the specification of the mandate the sponsor is asking investors to trust them to execute. Investors are committing capital to a pool that will be deployed over time into assets they have not yet seen. The investment objectives section describes what they are committing to.

The investment strategy disclosure must be specific enough to be meaningful. A fund described as investing in value add real estate assets in high growth markets has not described its strategy with sufficient specificity to allow investors to evaluate what they are committing to. The strategy should describe the target asset class or classes, the target geographic markets, the investment strategies pursued (value add, core, development), the target investment size, the target leverage levels, and the target hold period for individual assets. Where the fund has flexibility to invest outside its primary mandate, those exceptions should be described and the conditions under which they apply should be specified.

### **Blind Pool Risk Disclosure**

A fund that raises capital before identifying specific investments, which describes the structure of most real estate funds, is a blind pool offering. Investors are committing capital without knowing what specific properties the fund will acquire, which means they cannot independently evaluate the specific investments they are funding. This is a material characteristic of the offering that must be specifically disclosed.

The blind pool risk disclosure must be honest about its implications. Investors are relying entirely on the sponsor's judgment to identify, evaluate, and execute investments that meet the fund's stated criteria. They cannot independently verify that the properties acquired will match the investment strategy description, that the underwriting is sound, or that the purchase prices are appropriate. The principal protection against these risks is the quality of the sponsor's judgment, track record, and process, and the disclosure should describe those factors specifically enough that investors can evaluate them.

### **Management Discretion and Investment Guidelines**

The fund PPM must describe the extent of the manager's discretion in making investment decisions and the investment guidelines that constrain that discretion. If the fund has concentration limits (no single investment may exceed a specified percentage of committed capital), leverage limits, geographic restrictions, or asset class restrictions, those constraints must be described in the PPM. Violations of disclosed investment guidelines are not just investment mistakes. They are breaches of the fund's governing documents with legal consequences.

The investment guidelines section should also address how conflicts between the fund's strategy and specific investment opportunities are handled, specifically whether the sponsor manages other funds or investment vehicles that might compete for the same opportunities, and how allocation among competing investment vehicles is managed. An allocation policy that systematically routes better deals to a newer fund at the expense of an older one is a breach of



the sponsor's fiduciary obligations. The PPM should describe the allocation framework clearly enough that investors understand how this conflict is managed.

## **Fund Governance and LP and Member Rights**

The fund governance section describes the rights investors hold in the fund's governance: what decisions require investor approval, what decisions require LPAC approval, what removal rights investors hold, and what key person protections apply. This section should cross reference the LP agreement or operating agreement provisions that implement these rights.

Particular attention should be given to the removal rights disclosure: what conditions trigger the right to remove the manager, what vote threshold is required, and what happens to the manager's economic interests after removal. Institutional investors pay close attention to removal provisions. The LPAC structure, the conditions for cause removal, and the availability of no fault removal are among the most actively negotiated provisions in institutional fund documents, and investors who cannot identify these provisions in the fund PPM have not received adequate disclosure of their governance rights.

## **The Antifraud Standard: What Must Be Disclosed**

The antifraud standard, derived from Section 17(a) of the Securities Act and Rule 10b-5 under the Exchange Act, establishes what must appear in a PPM through a deceptively simple principle: all material information must be disclosed, and nothing material may be misstated. Every PPM drafting decision is governed by this standard, and the standard's application to specific facts is not always obvious.

## **Material Facts and Material Omissions**

A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. This definition is broader than sponsors typically appreciate. It covers not only information that would cause an investor to decline the investment (a property that has failed an environmental inspection, a sponsor with prior regulatory sanctions) but also information that would cause an investor to negotiate different terms, ask additional questions, or invest a different amount. The materiality threshold is lower than information that would change the investment decision and higher than information that some investor, somewhere, might find interesting.

Material omissions, meaning the failure to disclose material information, are as much a violation as material misstatements. A PPM that accurately describes every fact it discloses but leaves out the sponsor's prior securities enforcement action, the property's current zoning violation, or the conflict of interest created by the affiliated property management arrangement has a material omission that creates the same fraud exposure as an affirmative misrepresentation.



The obligation is not just to avoid lying. It is to affirmatively disclose everything a reasonable investor would want to know.

The obligation to disclose runs continuously through the offering period. Information that becomes material after the PPM is initially distributed must be disclosed, through an amendment to the PPM or a supplemental disclosure document, before any additional investors subscribe. A PPM that was accurate when distributed but becomes inaccurate due to subsequent developments (a material change in the property's condition, a change in key management personnel, a significant financing development) must be updated before the offering continues.

## Forward Looking Statements and Projections

Financial projections, including return estimates, occupancy projections, and exit cap rate assumptions, are forward looking statements that require specific treatment. The antifraud provisions do not prohibit forward looking statements. They require that those statements be genuinely based on a reasonable basis, accompanied by adequate disclosure of the assumptions on which they rest, and qualified with disclosure that actual results may differ materially.

A projection that is not grounded in supportable analysis (a projected occupancy rate that materially exceeds what the property has historically achieved, a projected sale price derived from a cap rate that is not supported by market data) is not protected by the label projection. The antifraud provisions extend to forward looking statements that the sponsor knew, or should have known, had no reasonable basis. The protection against projection based fraud claims is not a disclaimer. It is projections that were actually prepared with care.

The PPM should present financial projections in a format that allows investors to evaluate them: base case, downside case, and ideally upside case, with the specific assumptions stated for each. A single scenario projection that shows only the expected outcome does not give investors the information they need to evaluate how sensitive the returns are to changes in the key assumptions. This transparency is both better disclosure and, counterintuitively, a more effective marketing tool, because investors who can see that the investment generates adequate returns even under conservative assumptions have more confidence in the sponsor's underwriting than investors who see only the optimistic case.

## Updating the PPM: When and How

A PPM is not a static document. It is accurate as of the date it is prepared, and it remains accurate as long as the facts it describes remain accurate. When material facts change (the property's condition deteriorates, a key management person departs, the financing structure is

modified, a new conflict of interest arises), the PPM must be updated to reflect those changes before additional investors subscribe.

The obligation to update the PPM is a continuous obligation that runs through the entire offering period, not a one-time commitment that is satisfied when the initial document is completed.

Sponsors who distribute a PPM, begin raising capital, and then experience material developments without updating the document are distributing stale disclosure to new investors, a disclosure failure that creates the same antifraud exposure as an inaccurate initial disclosure.

Updates should be made through a formal amendment process: a written amendment to the PPM that identifies the section being changed, describes the change and the reason for it, and is distributed to all new investors before their subscriptions are accepted. Existing investors who have already subscribed should receive notice of material changes that could affect their investment decision, not necessarily an opportunity to rescind, but information sufficient to keep them informed of developments material to their investment.

The most common triggering events for PPM updates in real estate syndications are departure of a key management person, material change in the property's condition or operating performance, change in the financing structure (interest rate changes for floating rate loans, lender changes, refinancing), new legal proceedings involving the sponsor or the SPV, and material changes in the investment strategy or the business plan. The test is materiality: would a reasonable investor consider the change important? If yes, the PPM needs updating.

## Common PPM Mistakes

The following mistakes appear with sufficient frequency in real estate PPMs to warrant specific attention. Each represents a disclosure deficiency that creates legal exposure for the sponsor and inadequate information for investors.

### Mistake 1: Using a Generic Template Without Deal Specific Tailoring

The most common PPM mistake is using a standard template, whether provided by an online document service, adapted from a prior deal, or borrowed from another sponsor, without tailoring the substantive content to the specific offering at hand. Template PPMs are designed to provide the form of disclosure without necessarily providing the substance, because they cannot know the specific risks, property characteristics, sponsor background, or market conditions of the particular deal being offered.

A template based PPM is identifiable by its risk factors. They are generic, they apply equally to virtually any real estate syndication, and they do not describe the specific risks of the specific property, sponsor, and market. A template risk factor section is not adequate disclosure. It is the

appearance of disclosure without its substance. Every significant risk factor should be specific to the offering.

### **Mistake 2: Incomplete or Selective Track Record Presentation**

Track record disclosure that presents only successful exits, that omits investments currently in distress or underperforming, or that attributes the success of investments to the sponsor when the sponsor was a minor participant is a material omission that creates specific fraud exposure. Investors who make investment decisions based on a track record that was selectively presented have a fraud claim grounded directly in the incompleteness of the disclosure.

The correct approach to track record disclosure is complete presentation: all investments of the same type that the sponsor has managed, with their actual realized returns for completed investments and their current status and performance for investments still in the portfolio. Investments that resulted in investor losses should be disclosed, with a factual description of what happened and why. Investors who understand the complete track record, including the failures, are making a genuinely informed decision. Investors who see only the successes are being misled.

### **Mistake 3: Inadequate Risk Factors That Do Not Match the Deal**

A risk factors section that could be copy pasted into any other real estate syndication PPM has not been prepared for this offering. Deal specific risk factors should describe the specific risks of the specific property (its age and condition, its market position, its current occupancy and historical performance), the specific financing (floating versus fixed rate, bridge loan versus permanent financing, the lender's transfer restriction provisions), the specific sponsor (first time sponsor versus established platform, team depth, key person concentration), and the specific market (growth market versus stable market, competitive supply pipeline, employment base and diversification).

### **Mistake 4: Financial Projections Without Adequate Assumption Disclosure**

Projections that show investors an expected return without disclosing the assumptions that produce it are not adequate disclosure. Every projection should be accompanied by a table or narrative description of the key assumptions: occupancy ramp up timeline, stabilized occupancy assumption, rental rate growth assumption, exit cap rate assumption, renovation cost assumption, and financing assumption. The sensitivity of the projections to changes in key assumptions (what happens to projected IRR if the exit cap rate is 50 basis points higher than assumed) is information that gives investors meaningful insight into the investment's risk profile.

### **Mistake 5: Generic Conflict of Interest Disclosure**

A conflicts section that states in general terms that conflicts of interest may arise, without identifying the specific arrangements that create conflicts in this offering, does not satisfy the antifraud disclosure obligation. Every specific conflict must be identified: the affiliated property management arrangement and the rate charged, the construction management arrangement and the basis for concluding it is at market rates, the cross deal conflicts that arise from the sponsor's other investment activities, and the fee structures that create compensation independent of investment performance. The identification must be specific enough that investors understand what the conflict is and how it affects the alignment of the sponsor's interests with theirs.

### **Mistake 6: Failure to Update the PPM for Material Developments**

A PPM distributed to investors in the first closing of a multi closing offering may be stale for investors in subsequent closings if material developments have occurred in the interim. Sponsors who raise capital over an extended period (six months, a year, or longer) must maintain the PPM as a current, accurate document throughout the offering period. Material changes in the property, the team, the financing, the market, or the business plan must be reflected in an updated document before new investors subscribe.

## **A Pre-Launch PPM Checklist**

The following checklist identifies the most common disclosure deficiencies in real estate PPMs. Reviewing this list before the offering is launched, not after the first investor raises a question, provides an opportunity to identify and correct gaps before they create legal exposure.

### **PPM Pre-launch Checklist**

1. Does the PPM contain substantive risk factors specific to this property, this sponsor, this market, and this financing structure? Or are the risk factors generic?
2. Does the track record disclosure include all investments of the same type that the sponsor has managed, including underperforming and failed investments?
3. Does the compensation and fee disclosure identify every fee paid to the sponsor or any affiliated entity, with the dollar amount, calculation basis, and timing?
4. Does the conflicts of interest section identify every specific conflict (not just state that conflicts may arise) and describe what each conflict is?
5. Do the financial projections state the specific assumptions on which they are based and include sensitivity analysis or scenario analysis?
6. Does the use of proceeds section identify every material use of investor capital, including itemized sponsor compensation paid at closing?

7. Does the waterfall description provide enough specificity that investors can calculate approximate distributions under different performance scenarios?
8. Does the exit strategy section describe the conditions under which the hold period might be extended, and the governance process for the exit decision?
9. Does the legal matters section disclose any pending or threatened proceedings involving the sponsor or its principals that are material to the offering?
10. For fund offerings: does the PPM describe the blind pool risk, the investment guidelines, and the governance rights investors hold with specificity?
11. Has the PPM been reviewed by securities counsel with specific real estate syndication experience, not merely general real estate or corporate experience?
12. Is there a process for updating the PPM before additional subscriptions are accepted if material developments occur during the offering period?

## Practical Takeaways

- The PPM is not just a compliance document. It is the organized mechanism through which the sponsor delivers and documents comprehensive disclosure to investors. Its three purposes are distinct and mutually reinforcing: disclosure of material facts, compliance with the antifraud provisions, and liability protection for the sponsor. None of these purposes is served by a generic, template based document.
- The absence of a specific PPM mandate in Regulation D for accredited only 506(b) and 506(c) offerings does not reduce the obligation to comprehensively disclose all material information. The antifraud provisions apply regardless of exemption, and a PPM is the practical mechanism for satisfying that obligation. Sponsors who proceed without a PPM are accepting unquantified legal exposure in exchange for a modest cost saving.
- The risk factors section is the most important liability protection component of the PPM and the section where disclosure most commonly fails. Risk factors must be deal specific, describing the risks of this property, this sponsor, this market, and this financing structure, not generic descriptions that could apply to any real estate syndication.
- Track record disclosure must be complete. Presenting only successful exits while omitting underperforming or failed investments is a material omission that creates specific fraud exposure. The antifraud standard does not permit selective presentation of favorable history.
- Fee and conflict disclosures must be specific. A conflicts section that generically states that conflicts may arise, without identifying the specific conflicts that actually exist in this

offering, does not satisfy the antifraud standard. Each specific conflict must be identified and described.

- Financial projections must disclose the assumptions on which they are based and must be qualified as projections with meaningful risk disclosure. Projections that are not grounded in supportable analysis are not protected by the projection label.
- For offerings that accept benefit plan capital (pension plans, 401(k) plans, IRAs, Keogh plans), the ERISA disclosure obligations are specific. The PPM must address how the offering qualifies for the significant participation exemption (under 25% benefit plan investor ownership), the REOC or VCOC exception, or how plan asset treatment will be managed if it applies. Tax exempt investors must also receive specific disclosure of the UBTI exposure that debt financed real estate income creates.
- Fund PPMs require specific additional provisions: investment objectives and strategy with sufficient specificity to be meaningful, blind pool risk disclosure that is honest about its implications, investment guidelines with enough detail to identify when they are violated, and governance rights described with enough specificity that investors understand what rights they hold.
- The PPM must be updated when material facts change during the offering period. A document distributed to initial investors in a multi closing offering may be stale for later investors if material developments have occurred in the interim. The obligation to provide accurate disclosure is continuous.
- The most consequential PPM mistakes (generic risk factors, selective track record presentation, inadequate conflict disclosure, unqualified projections, and failure to update) are all preventable with a qualified attorney reviewing a document specifically prepared for the offering at hand, not adapted from a template or a prior deal.
- Securities counsel with specific real estate syndication experience produces a qualitatively different PPM from counsel who practices general real estate law or general corporate law. The difference is not just in the document's legal adequacy. It is in the counsel's ability to identify the deal specific risks, the disclosure gaps, and the potential investor claims that a generalist may not recognize.

**CHAPTER SIXTEEN**

# Subscription Agreements

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The subscription agreement is where the investor formally crosses the line from prospect to participant. Everything before it (the PPM, the marketing materials, the investor meetings, the due diligence questions) is preparation. The subscription agreement is the moment of commitment. It records the investor's capital obligation, confirms their legal eligibility to participate in this specific offering, and documents the representations on which both parties will rely if a dispute ever arises about whether the offering was properly structured and the investor was properly admitted.

Subscription agreements are routinely underestimated by sponsors who treat them as boilerplate, meaning standard documents that get signed at the end of the process and filed away. That treatment is a mistake. The subscription agreement is a legal compliance record, not a commercial formality. In a regulatory review, it is the document that proves each investor was eligible before the offering was made to them. In investor litigation, it is the document that establishes what the investor represented about themselves, what risks they acknowledged, and what transfer restrictions they accepted. A subscription agreement that does not do these things, that uses generic language, omits required representations, or fails to specifically document the investor's acknowledgment of material risks, is a document that will not perform its protective function when that function is needed most.

This chapter covers the purpose and function of the subscription agreement in a private real estate offering, the key investor representations and warranties that must appear in any well drafted document, the issuer representations that complete the mutual agreement, the acceptance and rejection mechanics that govern how subscriptions are processed, anti-money laundering and OFAC compliance provisions, lock up period and transfer restriction acknowledgments, power of attorney provisions, and the most common subscription agreement mistakes that undermine the document's legal effectiveness.

## The Purpose and Function of the Subscription Agreement

The subscription agreement serves four distinct functions in a private securities offering, and a well drafted document serves all four simultaneously.

### Documenting the Capital Commitment

The subscription agreement specifies the amount the investor is committing, when it must be funded, and what ownership interest the investor receives in exchange. For a single asset

offering, the investor commits a specific dollar amount and receives a defined membership interest or units at a stated price. For a fund structure with unfunded commitments and capital calls, the investor commits to a maximum capital amount and agrees to fund it in installments as capital is called over the investment period.

The subscription agreement must address both the obligation to fund and the consequences of failing to fund. For capital call structures, the agreement should cross reference the operating agreement's defaulting investor provisions, meaning the penalties and remedies that apply if the investor fails to fund a capital call when required. An investor who does not understand that their commitment creates a legally enforceable obligation with specific consequences for nonperformance has not fully understood what they signed, and a subscription agreement that does not clearly communicate that reality has failed part of its function.

The subscription agreement should also address the timing of ownership interest delivery relative to capital receipt. For most single asset offerings, the investor's membership interest is effective upon the manager's acceptance of the subscription, but the investor should not be treated as a holder for distribution purposes until their capital is confirmed as cleared and received. The sequence (subscription, acceptance, capital receipt, interest effectiveness) should be specified in the agreement and in the operating agreement to ensure they are consistent.

### **Confirming Investor Eligibility**

Every subscription agreement requires investors to represent that they meet the eligibility requirements of the applicable securities exemption. For a Regulation D offering limited to accredited investors, this means the investor represents their accredited status and identifies the specific basis for qualification: income test, net worth test, professional FINRA certification, or entity category. For a 506(b) offering that may include sophisticated non-accredited investors, the agreement must include the sophistication representation as well.

The eligibility representations in the subscription agreement are the legal foundation of the offering's exemption. The exemption is available only because every investor qualifies, and the evidence that every investor qualifies is the subscription agreement's eligibility representations combined with whatever verification documentation was collected. A subscription agreement with vague or generic eligibility representations, including one that simply asks investors to check a box without identifying the specific basis for their qualification, provides weak evidentiary support for the offering's exemption claim.

### **Acknowledging Investment Risks**

The subscription agreement includes investor representations acknowledging that the investor has reviewed the PPM, understands the risks of the investment, has had the opportunity to ask questions and consult advisors, and is making an investment decision based on their own



analysis. These acknowledgments serve as evidence that the investor received the material disclosures in the PPM before committing capital, which is the heart of the antifraud disclosure obligation.

Specific risk acknowledgments (not merely a general statement that the investor has reviewed the PPM, but specific acknowledgments identifying the material risks described in the PPM) are more protective than general acknowledgments. If the PPM describes specific risks that are material to this offering (a floating rate bridge loan with interest rate risk, a first time sponsor with limited track record, a value add strategy with execution risk), the subscription agreement's acknowledgment should specifically reference those risk categories. An investor who signed a subscription agreement specifically acknowledging the floating rate risk has a much harder time arguing they were not warned about it when rates subsequently moved against the investment.

### Establishing the Acceptance Mechanism

The subscription agreement is not effective until the manager accepts it. The acceptance mechanism, meaning the provision confirming that the investor is admitted to the offering only upon the manager's formal acceptance, is operationally important and legally necessary. It preserves the manager's ability to reject subscriptions for legitimate business reasons, to confirm that all eligibility conditions have been satisfied before an investor is admitted, and to manage the offering's investor composition as the offering progresses.

Before accepting any subscription, the manager should confirm that the investor's eligibility documentation is complete, that any required accreditation verification has been conducted, that the investor's KYC and AML screening has cleared, and that the investor's subscription has been reviewed for any red flags that would affect their admission. Acceptance should occur after these conditions are confirmed, not concurrently with subscription execution, and not in advance of verification.

## Key Investor Representations and Warranties

The investor representations and warranties in a subscription agreement are the legal foundation on which the offering's exemption rests. They are not formalities. They are the evidentiary record that proves the offering complied with the applicable exemption's requirements. Each representation should be drafted with specificity sufficient to actually establish the fact it purports to establish.

### Accredited Investor Representations

The accredited investor representation must be calibrated to the specific exemption governing the offering, either Rule 506(b) or Rule 506(c), because the applicable legal standard is different and the required documentation differs accordingly.

**Under Rule 506(b):** The investor self certifies their accredited status. The representation should identify the specific basis for qualification, meaning the income test (\$200,000 individual or \$300,000 joint), net worth test (\$1 million excluding primary residence), professional certification (active Series 7, 65, or 82 license), or entity category (regulated entity, \$5 million assets, all accredited equity owners, family office). A representation that merely states the investor is accredited, without identifying the qualifying basis, is weaker evidence than one that identifies the specific test met and the facts supporting it.

**Under Rule 506(c):** The investor's self-certification is a starting point, not an endpoint. The subscription agreement must include the investor's agreement to provide the documentation required for accreditation verification, identification of the type of documentation they will provide (IRS forms for income based, account statements and credit report for net worth based, BrokerCheck confirmation for professional certification), and their consent to the verification service reviewing and retaining that documentation. The agreement should also specify that the investor's subscription cannot be accepted until the verification is complete.

Sponsors who rely on the March 2025 SEC no action letter (which permits verification of accredited status based on a minimum investment amount of at least \$200,000 for natural persons or \$1,000,000 for legal entities, combined with written representations from the investor) should include the no action letter representations directly in the subscription agreement. Specifically, the investor should represent that they are accredited and that the funds being used to make the investment are not financed by a third party for the specific purpose of making this investment. Sponsors using this verification method should confirm with counsel that the offering's investment minimum, written representations, and screening procedures all align with the conditions of the no action letter.

In all cases, the investor should represent that their accreditation status is accurate as of the date of signing, that they will promptly notify the sponsor if their status changes materially during the offering period, and that they understand the offering is available only to investors who qualify under the applicable eligibility standard. The notification obligation is particularly important for multi closing offerings where an investor's status could change between their subscription and a subsequent closing at which they might make an additional investment.

### **Investment Intent and Holding Period**

The subscription agreement should include the investor's representation that they are acquiring their investment interest for their own account, for investment purposes only, and not with a view to distribution or resale in violation of the securities laws. This investment intent representation is a condition of the offering's exemption from registration. The securities laws' private placement exemption is premised on the investor holding the interest for investment, not acquiring it with the purpose of immediately reselling it to others.

The holding period representation acknowledges that the investment is a long term commitment, typically specifying the projected hold period of the investment, and that the investor is acquiring the interest with the understanding that there is no established market for the interests and that transfers are restricted. This representation should be specific about the applicable transfer restrictions: the operating agreement's transfer restriction provisions, any required holding period under securities law, and the conditions under which transfers may be permitted with the manager's consent.

For fund offerings with unfunded commitments, the subscription agreement should also include the investor's acknowledgment that their commitment is legally binding and that failure to fund capital calls when required will trigger the defaulting investor provisions of the operating agreement. Investors who treat a capital commitment as an expression of interest rather than a legal obligation are creating future problems. The subscription agreement is the opportunity to establish their understanding of the commitment's binding nature.

## **Risk Acknowledgment**

The risk acknowledgment section is where the investor specifically confirms their receipt and review of the PPM and their understanding of the material risks described in it. A general acknowledgment of PPM receipt is the minimum. A well drafted risk acknowledgment specifically identifies the material risk categories described in the PPM by name, establishing a clear evidentiary record that the investor was informed of each identified risk before committing capital.

Specific risk acknowledgments that should appear in a real estate syndication subscription agreement include the items below.

- The investment is illiquid. Investors may not be able to sell or transfer their interests, and they should expect to hold the investment for the full projected hold period without access to their capital.
- The investment involves leverage, and the use of debt financing increases the risk of loss. A leveraged real estate investment can lose all investor equity even if the underlying property retains some value, if the outstanding debt exceeds the net proceeds available from a sale.
- Returns are not guaranteed. The financial projections in the PPM are estimates based on assumptions that may not prove accurate. Actual results may differ materially from projections, and investors may receive less than their invested capital.
- The investment is subject to real estate market risks including changes in interest rates, local market conditions, tenant occupancy, and property values, any of which could adversely affect the investment's performance.

- The sponsor has a limited or defined track record, and past performance does not guarantee future results. For first time sponsors, the risk acknowledgment should specifically reference the lack of prior investment history.
- Tax consequences are uncertain and vary by investor. The investor should consult their own tax advisor regarding the tax implications of the investment, including passive activity loss limitations, depreciation recapture, and the tax treatment of distributions and exit proceeds.

For each material risk that is specific to the particular offering (a floating rate loan in a rising rate environment, a specific ground up development risk, a specific market concentration risk), there should be a corresponding specific acknowledgment in the subscription agreement. Generic risk acknowledgments that could apply to any real estate investment are less protective than deal specific ones.

### Independent Legal and Tax Advice Acknowledgment

The subscription agreement should include the investor's representation that they have had the opportunity to consult with their own legal counsel and tax advisor before signing, or that they have chosen not to do so after being advised of the opportunity. This representation is protective for the sponsor. An investor who acknowledged the opportunity to seek independent advice has a weaker claim that the offering documents were confusing or inadequate than one who received no such acknowledgment.

The independent advice acknowledgment should be specific about what advice the investor had the opportunity to seek: securities law advice about the nature of the investment and their rights as an investor; tax advice about the tax consequences of the investment, including depreciation benefits, passive activity loss limitations, and exit tax treatment; and ERISA advice if the investor is a benefit plan investor or is investing retirement plan assets.

The acknowledgment should not represent that the investor actually consulted advisors. That may not be true for every investor. It should represent that the investor had the opportunity to do so and that they are signing the subscription agreement knowingly and voluntarily, with or without having exercised that opportunity. The distinction between the opportunity to consult and the actual consultation matters. A representation that the investor consulted qualified counsel, when the investor did not, is itself a misrepresentation in the subscription agreement.

## Issuer Representations and Warranties

Subscription agreements are mutual. The investor makes representations to the issuer and the issuer makes representations to the investor. The issuer representations in a private real estate

syndication subscription agreement are typically brief but legally meaningful, and they should be specifically tailored to the offering rather than lifted wholesale from a generic template.

### **The Offering Is Duly Authorized**

The issuer represents that the offering of the interests has been duly authorized by the manager and that the interests, when issued upon acceptance of the subscription and receipt of capital, will be validly issued and will represent the investor's interest in the entity as described in the operating agreement. This representation establishes that the manager has the authority to admit the investor and issue the interests, a point that matters if there is any question about the manager's authority under the operating agreement.

### **The PPM Is Accurate as of Its Date**

The issuer should represent that the PPM was accurate in all material respects as of its date and that no material developments have occurred since the PPM's date that would make any material statement in the PPM false or misleading. This representation is the contractual analog of the ongoing disclosure obligation. The issuer is warranting to the investor that the document they reviewed is accurate, not stale.

For multi closing offerings where the PPM may be distributed over an extended period, this representation creates a specific obligation on the issuer. If material developments have occurred since the PPM's date, the issuer cannot honestly make this representation without first updating the PPM. The issuer representation in the subscription agreement is therefore an implicit quality control mechanism. It should prompt the issuer's counsel to confirm that the PPM remains current before accepting each subscription.

### **No Other Representations**

The issuer should include a representation, or more precisely a negative warranty, that the issuer has not made, and is not making, any representations or warranties to the investor other than those contained in the PPM and the subscription agreement. This provision establishes that the investment is made on the documented terms, not on the basis of any verbal representations, side letters, or informal commitments made during the marketing process.

Investors who claim that the sponsor made specific representations in investor meetings (promising a higher return, guaranteeing a shorter hold period, committing to specific property management practices) will find their claims harder to sustain if the subscription agreement they signed specifically states that no representations outside the PPM and subscription agreement are part of the investment. This does not prevent investors from making such claims, but it significantly weakens the evidentiary foundation for them.

## Acceptance and Rejection of Subscriptions

The subscription agreement's acceptance mechanism is one of its most important provisions and one of the most frequently neglected in template documents. The provision must establish clearly that the investor's subscription is an offer to invest, not a completed investment; the manager has the right to accept or reject any subscription for any reason or no reason; and the investor's interest in the offering is effective only upon formal acceptance by the manager.

### The Manager's Right to Reject

The manager's right to reject subscriptions without cause, or with limited explanation, is legally important for several reasons. First, it preserves the manager's ability to manage the composition of the investor base: to decline investors whose participation would create concentration issues, whose investment amounts would complicate the offering's structure, or whose backgrounds raise concerns that were not apparent from the subscription agreement's representations. Second, it gives the manager flexibility to decline investors whose eligibility verification is incomplete or whose accreditation verification raises questions.

The right to reject should be unconditional, not conditioned on the discovery of specific facts or the investor's failure to satisfy specific requirements. A conditional rejection right is more limited than an unconditional one, and sponsors should not limit their flexibility unnecessarily. The right to reject should also specify that rejected subscriptions will have their capital returned promptly and in full, with no penalty or interest. Holding an investor's capital while deciding whether to accept their subscription creates its own legal and fiduciary issues.

### Minimum and Maximum Subscription Amounts

The subscription agreement should specify the minimum subscription amount for the offering and whether the manager has discretion to accept subscriptions below the stated minimum. It should also address whether there is a maximum subscription amount, which is particularly important for offerings where the manager wants to maintain investor diversification or avoid concentration that could create control issues.

For 506(b) offerings that may admit up to 35 sophisticated non-accredited investors, the acceptance mechanism must include the manager's evaluation of whether the investor qualifies as sophisticated, a determination that cannot be made by the investor alone and must be completed before acceptance. The subscription agreement should make clear that acceptance for non-accredited investors is contingent on this evaluation and that a positive determination of sophistication is a condition of acceptance, not a formality.

### Closing Mechanics

For offerings with a single closing, the subscription agreement should specify when the closing will occur, what conditions must be satisfied for the offering to close (minimum capital raise, completion of all investor verifications, manager satisfaction with the investor composition), and what happens to subscriptions if the offering does not close. For offerings with multiple closings, the agreement should specify the conditions for each closing and how investors at different closings will be treated for purposes of the economic terms, particularly for preferred return accrual and the equalization of subsequent closing investors.

## Anti-money Laundering Representations and OFAC Compliance

Anti-money laundering and OFAC (Office of Foreign Assets Control) compliance provisions have become standard components of subscription agreements for private securities offerings, and their presence in the subscription agreement reflects both legal obligations and practical risk management.

### AML Representations

The investor should represent, in substance, the matters listed below.

- The funds being used to make the investment are not derived from, and are not being used to facilitate, any illegal activity, including money laundering, drug trafficking, terrorism financing, or any other criminal enterprise.
- The investor is the beneficial owner of the funds being invested, or, if subscribing on behalf of an entity, is an authorized representative of the entity and has disclosed the entity's beneficial ownership information in connection with the subscription.
- The source of the funds is legal under the laws of the investor's country of residence and under United States law.
- The investor has not been notified that they are, and is not aware that they are, the subject of any investigation or proceeding relating to money laundering, terrorist financing, or financial crimes.

These representations are not merely self-protective for the sponsor. They create the legal basis for the KYC and AML verification process that the sponsor conducts on the investor's information. When the sponsor screens the investor's information against sanctions databases and adverse media sources, they are relying on the investor's representations about their identity and the source of their funds. If those representations are false and the investor is using illegal funds, the investor's misrepresentation is evidence that the sponsor acted in good faith and was itself a victim of the investor's fraud.



## OFAC and Sanctions Compliance

The investor must represent that they are not, and are not acting on behalf of any person or entity that is, on any list maintained by OFAC, specifically the Specially Designated Nationals and Blocked Persons (SDN) list, or otherwise subject to U.S. economic sanctions. For entity investors, this representation should extend to beneficial owners and controlling persons of the entity.

OFAC compliance is not optional and is not discretionary. Transactions with sanctioned persons are prohibited regardless of whether the sponsor knew the counterparty was sanctioned. The OFAC representation in the subscription agreement, combined with the KYC and AML screening process, creates the framework within which the sponsor can demonstrate compliance with OFAC's requirements. A subscription agreement without OFAC representations leaves a gap in the compliance record that cannot be retroactively filled.

The subscription agreement should also include the investor's covenant to promptly notify the sponsor if their OFAC status changes, including if they become subject to sanctions, if their beneficial owners change in ways that affect the OFAC analysis, or if they become aware of any information that would make their OFAC representation inaccurate. This ongoing covenant extends the OFAC compliance obligation beyond the initial subscription through the duration of the investment.

## The Manager's Right to Withhold Distributions for Compliance

The subscription agreement should include a provision authorizing the manager to withhold distributions, freeze interests, or compel the transfer of interests if the manager receives credible information suggesting that compliance with applicable AML or OFAC requirements requires such action. This provision is the contractual basis for compliance driven administrative actions that might otherwise be characterized as interference with the investor's property rights.

This provision works in tandem with the operating agreement's manager authority provisions. Both documents should authorize the same actions, with the subscription agreement establishing the investor's specific consent to those actions at the time of subscription. A manager who needs to freeze an investor's interests for OFAC compliance reasons but whose subscription agreement and operating agreement are silent on the topic is in a difficult legal position. The provision anticipates this scenario and establishes the contractual framework before it arises.

## Lock Up Period and Transfer Restriction Acknowledgments

Transfer restriction acknowledgments are among the most consequential provisions in the subscription agreement, and among the most frequently handled inadequately. Investors who



subsequently want to transfer their interests and find themselves blocked by restrictions they did not understand they accepted will consistently claim they were not adequately informed of those restrictions. A well drafted transfer restriction acknowledgment forecloses that claim.

## Rule 144 and the Holding Period

For Regulation D offerings, the securities laws impose a holding period before restricted securities can be resold without registration. Under SEC Rule 144, restricted securities acquired in a private placement cannot be resold for 12 months from the date of acquisition. The subscription agreement must specifically disclose this holding period, explain when it begins (at the date of acquisition, meaning the closing date, not the subscription signing date), and confirm that the investor acknowledges and accepts this restriction.

The disclosure should be specific about what happens after the 12 month period expires. The expiration of the Rule 144 lockup does not mean interests become freely transferable. It means secondary transfers may become possible subject to the operating agreement's transfer restriction provisions, the manager's consent requirements, and any applicable state securities law transfer requirements. The lockup is one of several conditions that must be satisfied for a secondary transfer to be permissible, and the subscription agreement should describe the full framework, not just the lockup component.

### Rule 144 Holding Period: Key Points for Investors

#### When does it start?

The 12 month holding period runs from the date the investor acquires their membership interest, typically the closing date, not the subscription date. Subscription signing and capital funding may occur before closing.

#### For capital call structures

Interests acquired at different closings have separate holding periods. Interests from the first closing become transferable 12 months after that closing. Interests from a second closing six months later become transferable six months after the first tranche's lockup expires.

#### What happens after 12 months?

The Rule 144 lockup expires, but secondary transfers remain subject to the conditions below.

- Manager consent requirements in the operating agreement
- Right of first refusal provisions, if any
- Transferee eligibility requirements (must be an accredited investor)
- Lender consent requirements if the loan documents restrict transfers

- State securities law requirements in some jurisdictions

**Important**

The lockup expiration enables secondary transfers. It does not make membership interests freely tradeable. The full transfer restriction framework in the operating agreement continues to apply.

## Operating Agreement Transfer Restrictions

Beyond the Rule 144 holding period, the subscription agreement should specifically acknowledge the transfer restrictions in the operating agreement. These typically include the requirement of manager consent for any transfer; the right of first refusal held by the LLC or the other members; the prohibition on transfers to persons who are not accredited investors or who do not otherwise qualify under the applicable exemption; and any specific consent requirements imposed by the senior lender's loan documents.

Each of these restrictions should be described specifically in the subscription agreement, not simply incorporated by reference to the operating agreement. An investor who signed a subscription agreement acknowledging specific transfer restrictions by name (manager consent requirement, right of first refusal, accredited investor requirement for transferees) has acknowledged those restrictions in a way that is clearly documented. An investor who signed a subscription agreement that incorporated the operating agreement by reference, without specifically identifying the transfer restrictions, has a more colorable argument that they did not fully understand the restrictions they were accepting.

## Transfers to Benefit Plan Investors

For offerings that have structured their investor base to remain below the ERISA benefit plan investor threshold (maintaining benefit plan investor ownership below 25% of each class of equity to avoid plan asset treatment), the subscription agreement should include a transfer restriction specifically prohibiting transfers to benefit plan investors without the manager's prior written consent. This restriction protects the offering's ERISA compliance posture by ensuring that secondary transfers do not inadvertently push the benefit plan investor percentage above the significant participation threshold.

## Power of Attorney Provisions

Many subscription agreements include a limited power of attorney granted by the investor to the manager (or to the manager's designated representative), authorizing the manager to execute certain documents on the investor's behalf in connection with the offering and the investment's

ongoing administration. Understanding what a power of attorney provision does, why it is used, and what its limits are is important for sponsors preparing subscription agreements and for investors reviewing them.

### **What the Power of Attorney Authorizes**

The power of attorney in a real estate syndication subscription agreement is typically limited to specific, enumerated purposes related to the investment's administration. Common authorizations include the items below.

- Executing the operating agreement and any amendments on the investor's behalf, to facilitate closings where not all investors can execute simultaneously.
- Executing any documents required to effect the admission of new investors or the transfer of existing investors' interests, in connection with secondary transfers that have been approved under the operating agreement's transfer restriction provisions.
- Executing documents required in connection with the disposition of the investment (the purchase and sale agreement, settlement documents, and post-closing adjustments) where investor signatures are technically required but individual investor execution is impractical.
- Executing documents required by applicable law or regulatory authorities in connection with the offering's ongoing compliance obligations.

The power of attorney should be limited in scope, specific to the identified purposes, and should not be open ended authorization for the manager to act on the investor's behalf in any circumstance. An overly broad power of attorney creates unnecessary investor concern and provides the manager with authority that is difficult to justify. The power of attorney should be drafted by securities counsel who understands both its utility and its appropriate limitations.

### **Durability and Revocability**

Powers of attorney in subscription agreements are typically drafted as durable, meaning they remain effective even if the investor later becomes incapacitated, and as coupled with an interest, meaning they are irrevocable for the duration of the investor's ownership of the investment interest. The durable and irrevocable characteristics are appropriate for the investment administration purposes served by the power of attorney. They ensure that the manager retains the ability to perform necessary administrative functions for the offering even in circumstances where an individual investor becomes unavailable.

The subscription agreement should clearly disclose these characteristics to investors. An investor who does not understand that the power of attorney they are granting is irrevocable for the duration of their investment has not fully understood what they signed. The disclosure of the

power of attorney's scope, durability, and irrevocability should be prominent in the subscription agreement, not buried in fine print or incorporated by reference to the operating agreement.

## Common Subscription Agreement Mistakes

The following mistakes appear with sufficient frequency in private real estate syndication subscription agreements to warrant specific attention. Each creates a gap in the offering's compliance record that may matter when the document is needed most.

### Mistake 1: Generic Accredited Investor Representations

A subscription agreement that simply asks investors to check a box confirming their accredited status, without identifying the specific basis for qualification, provides weak evidentiary support for the offering's exemption. If the offering's exemption is ever challenged, the sponsor must be able to demonstrate that each investor actually qualified. A check box confirmation that the investor is accredited, without identification of the specific qualifying test and the facts supporting it, does not establish that the investor understood what they were certifying.

The accredited investor representation should require the investor to identify the specific basis for their qualification and to represent the specific facts that support it. For income based accreditation: the approximate amount of qualifying income in each of the two prior years and the reasonable basis for the current year expectation. For net worth based: the approximate net worth amount excluding the primary residence. For entity qualification: the entity type and the specific qualifying basis. The specificity creates a stronger compliance record and also helps the sponsor identify any representations that raise questions requiring follow up.

### Mistake 2: Inadequate Risk Acknowledgments

A generic risk acknowledgment, meaning a statement that the investor acknowledges that the investment involves risk and that they may lose all or part of their investment, is minimally adequate but strategically weak. An investor who suffers losses from a specific risk that was disclosed in the PPM but not specifically acknowledged in the subscription agreement has more room to argue that the risk was not adequately communicated.

Deal specific risk acknowledgments that name the material risks described in the PPM (the floating rate loan risk, the first time sponsor risk, the construction execution risk, the specific market concentration risk) create a clearer evidentiary record that the investor understood the specific risks of this specific offering. Preparing these acknowledgments requires the securities counsel drafting the subscription agreement to have reviewed the PPM, understood the material risks identified in it, and translated them into specific acknowledgment language. That coordination is time consuming, but it produces a document that does its protective job.

### **Mistake 3: Missing or Inadequate Transfer Restriction Acknowledgments**

Many subscription agreement templates include transfer restriction language that addresses the Rule 144 holding period without describing the operating agreement's transfer restriction framework. An investor who completes the Rule 144 holding period and then attempts to transfer their interest, only to discover that the operating agreement's transfer restrictions require the manager's consent and a right of first refusal procedure, will feel surprised and will have grounds to argue that the subscription agreement did not adequately inform them of the full scope of the transfer restrictions they accepted.

The transfer restriction acknowledgment should describe the complete framework: the Rule 144 holding period (with clarity about when it starts), the operating agreement's manager consent requirement, any right of first refusal, the transferee eligibility requirements, any lender consent requirements, and any other specific conditions that apply. Investors who understand the complete picture at subscription have no reasonable basis for claiming surprise when the transfer restriction framework operates as described.

### **Mistake 4: Incomplete AML and OFAC Provisions**

Subscription agreements that include a perfunctory OFAC representation (the investor is not on any sanctions list) without the full AML representation framework create a gap in the offering's compliance record. The AML representations should address the source of funds, the beneficial ownership of the investing entity, and the ongoing notification obligation. A subscription agreement with only OFAC representations but without source of funds and beneficial ownership representations has incomplete AML documentation.

### **Mistake 5: Power of Attorney Without Adequate Disclosure**

A power of attorney buried in the subscription agreement's fine print, or one that grants authority significantly broader than the investment's actual administration needs, creates investor relations problems and potential legal exposure. Investors who discover they granted a power of attorney without understanding what they authorized will raise concerns that range from requests for clarification to demands for rescission. The power of attorney should be disclosed prominently, scoped narrowly, and described clearly.

### **Mistake 6: Failure to Match the Subscription Agreement to the Offering's Specific Terms**

Using a subscription agreement template from a prior offering without tailoring it to the current offering's specific terms is a mistake that produces a document containing inaccurate representations. A subscription agreement that describes the Rule 144 lockup period as six months when the applicable period is twelve months, or that references a preferred return rate different from the current offering's rate, or that identifies a securities exemption different from

the one actually being relied upon, contains misrepresentations that could affect the offering's legal position. Every subscription agreement should be reviewed for consistency with the PPM and the operating agreement before it is distributed to investors.

## The Subscription Agreement as a Compliance Record

A point that deserves emphasis beyond its treatment in the mistakes section: the subscription agreement is not just a commercial document recording an investment transaction. It is a legal compliance record that the sponsor will rely on if a regulatory inquiry or investor dispute ever questions whether the offering was properly structured and the investor was properly admitted.

In a regulatory examination of a private real estate offering, the examiner will ask to review subscription agreements to confirm that investor eligibility was established before the offering was made, that accreditation was verified through appropriate means, that investors were informed of material risks before subscribing, and that transfer restrictions were adequately disclosed. If any of these elements is missing from the subscription agreement, the compliance record has a gap. A thorough examiner will identify it. An investor's attorney in a fraud dispute will exploit it.

The subscription agreement should be designed with this compliance record function in mind from the beginning. Every required representation should appear in its own clearly labeled section, making it straightforward to locate and document in a regulatory review. Every material risk acknowledgment should be specific and named, making it impossible for an investor to later claim they were not warned. Every transfer restriction should be described, making it clear that the investor accepted the full restriction framework at the time of subscription.

### Subscription Agreement Pre-launch Review Checklist

1. Do the eligibility representations identify the specific basis for each investor's qualification, not just confirm accredited status generally?
2. For 506(c) offerings: does the agreement include consent to verification (whether through documentation review, third party confirmation, or the minimum investment representations under the March 2025 no action letter) and specify that acceptance is conditioned on verification completion?
3. Do the risk acknowledgments specifically name the material risks described in the PPM for this specific offering, not just general real estate risks?
4. Does the investment intent representation address the holding period commitment and the illiquidity of the investment?

5. Does the agreement include a specific independent legal and tax advice acknowledgment, including ERISA advice for benefit plan investors?
6. Are the issuer representations specifically tailored to this offering, including confirmation that the PPM is accurate as of its date?
7. Does the acceptance mechanism clearly establish that the investor is admitted only upon manager acceptance and that acceptance is conditioned on eligibility verification being complete?
8. Do the AML and OFAC provisions include source of funds representations, beneficial ownership disclosure for entities, and an ongoing notification obligation?
9. Does the transfer restriction acknowledgment describe the complete restriction framework: Rule 144 lockup (with timing clarity), operating agreement consent requirements, right of first refusal, and transferee eligibility requirements?
10. Is the power of attorney (if included) specifically scoped, prominently disclosed, and consistent with the manager's actual authority needs?
11. Is the subscription agreement consistent with the PPM and the operating agreement? Do the economic terms, the securities exemption, the transfer restrictions, and the hold period match across all three documents?
12. Has the subscription agreement been reviewed by securities counsel with specific real estate syndication experience before distribution to investors?

## Digital Execution and Document Integration

Most private real estate offerings today integrate subscription agreement execution into a digital onboarding flow. Investors complete the subscription documents electronically through an investor portal or document management platform, with the platform capturing signatures, timestamps, and document versions in a way that creates a legally sufficient signed agreement.

Electronic signatures executed through a reputable platform (DocuSign, Adobe Sign, or equivalent) are legally enforceable in the United States under the Electronic Signatures in Global and National Commerce Act (ESIGN) and the Uniform Electronic Transactions Act (UETA). The subscription agreement does not need to be physically signed to be enforceable, and the investor's attestation through an investor portal can constitute a valid subscription, provided the authentication and documentation requirements are met.

### Documentation Requirements for Electronic Execution

- The executed subscription agreement, including all pages, exhibits, and signature pages, must be retained in retrievable form for the duration of the offering and for the



applicable post offering retention period. PDF or other electronic format with embedded signature data is adequate, provided it is stored in a system from which it can be retrieved and produced on demand.

- The specific version of the subscription agreement that each investor executed must be determinable. If the subscription agreement is updated between closings (to reflect material changes in the offering, amendments to the operating agreement, or corrections to prior disclosures) the sponsor must be able to confirm which version each investor signed.
- The investor's identity must be authenticated sufficiently to establish that the person who signed the subscription agreement electronically is the person whose eligibility was evaluated and verified. Integration between the e signature platform and the KYC and AML verification process, where the verified identity is linked to the signing session, is the best practice for creating this linkage.
- For entity investors who sign through an authorized representative, the signatory's authority to bind the entity must be documented, through a certificate of authorization, an operating agreement excerpt, or a resolution confirming the signatory's authority.

### **⚠ The Electronic Subscription Execution Must Be Linked to the Identity Verification Record**

*An investor who completes KYC and AML verification through one workflow and signs the subscription agreement through a separate, unlinked workflow creates a documentation gap. There is no evidence that the person who was verified is the same person who signed the agreement.*

*Integrated platforms that link identity verification to the signing session, capturing the verified identity as part of the electronic signature audit trail, close this gap. Sponsors who use separate systems for verification and document execution should implement a documented reconciliation process to confirm that the verified investor and the signatory are the same person before the subscription is accepted.*

*The connection between identity verification and subscription execution is particularly important for 506(c) offerings where the accreditation verification must be completed before acceptance. A subscription agreement executed by an investor whose verification is still pending should not be accepted until verification is confirmed.*

## **Practical Takeaways**



- The subscription agreement is a legal compliance record, not a commercial formality. Every required representation should be clearly labeled and specifically stated. Every material risk acknowledgment should be deal specific and named. Every transfer restriction should be described with enough specificity that the investor cannot later claim they did not understand what they accepted.
- Accredited investor representations must identify the specific basis for each investor's qualification, not just confirm accredited status generally. The specific basis (income test, net worth, professional certification, entity type) matters both for compliance documentation and for identifying any representations that require follow up or additional verification.
- For 506(c) offerings, the subscription agreement must include the investor's consent to accreditation verification and should specify that subscription acceptance is conditioned on verification completion. Subscriptions should not be accepted, and interests should not be issued, until the verification is confirmed. For sponsors using the March 2025 no action letter approach, the agreement should include the minimum investment representations and the third party financing representation that the no action letter requires.
- Risk acknowledgments should specifically name the material risks described in the PPM for this specific offering. Generic risk acknowledgments that could apply to any real estate investment provide weaker protection than deal specific acknowledgments that name the floating rate loan risk, the first time sponsor risk, the value add execution risk, or whatever specific risks are material to this particular offering.
- Transfer restriction acknowledgments must describe the complete restriction framework: the Rule 144 holding period with clarity about when it starts, the operating agreement's consent requirements, any right of first refusal, transferee eligibility requirements, and any lender consent provisions. Describing only the Rule 144 lockup without the operating agreement framework leaves investors without the full picture of the restrictions they accepted.
- AML and OFAC provisions must include source of funds representations, beneficial ownership disclosure for entity investors, and an ongoing notification covenant. A subscription agreement with only OFAC representations, without the full AML framework, has incomplete compliance documentation.
- The manager's acceptance mechanism should clearly establish that the investor is admitted only upon formal acceptance, that acceptance is conditioned on eligibility verification being complete, and that the manager has the right to reject any subscription without cause. The acceptance mechanism is what preserves the manager's ability to manage the offering's investor composition and compliance posture.

- Powers of attorney should be specifically scoped to investment administration purposes, prominently disclosed, and clearly explained. An investor who does not understand the power of attorney they granted will raise questions, and the time to address those questions is before the subscription is signed, not after.
- Digital execution of subscription agreements is legally enforceable under ESIGN and UETA but requires specific documentation: the executed version retained in retrievable form, the specific document version traceable to each investor, and the connection between the investor's identity verification and the signing session established.
- The subscription agreement must be consistent with the PPM and the operating agreement. Economic terms, the securities exemption, transfer restrictions, hold period, and all other material provisions should match across all three documents. A subscription agreement that contains terms different from the PPM or the operating agreement creates inconsistencies that investors and their counsel will exploit in disputes.

## CHAPTER SEVENTEEN

# Operating Agreements and Limited Partnership Agreements

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Ask any experienced real estate securities attorney what the most important document in a syndication is, and you will get the same answer every time: the operating agreement. Not the PPM, which describes the investment. Not the subscription agreement, which admits investors. The operating agreement, which governs the ongoing relationship between the sponsor and the investors for the entire life of the investment, from the day the entity is formed until the day the property is sold and the final distributions are made.

That answer reflects a reality that first time sponsors frequently underestimate. The PPM and subscription agreement perform their critical functions at the offering stage, but the offering stage is brief. The operating agreement, or the limited partnership agreement in an LP structure, is the document that governs every material event that occurs during the investment's hold period: distributions, major decisions requiring investor consent, capital calls, refinancings, management fee calculations, the sponsor's compensation on exit, and disputes between the sponsor and investors about how the waterfall should be applied. It is the legal framework within which the investment relationship actually operates.

The quality of the operating agreement determines the quality of that framework. A well drafted operating agreement with precise language on manager authority, distribution mechanics, investor protections, and transfer restrictions produces an investment structure that operates predictably and that provides clear answers to the questions that arise during the hold period. A poorly drafted operating agreement (one that uses vague language, that omits important provisions, or that adapts a template without tailoring it to the specific deal) produces uncertainty, disputes, and legal costs that are orders of magnitude more-expensive than the incremental cost of getting the document right at the outset.

This chapter covers the operating agreement's role as the governing document, manager authority and the structuring of decision making rights, the economic provisions that translate the PPM's economic terms into legally binding mechanics, investor protections and governance rights, transfer restriction provisions, and the disposition and dissolution framework. The chapter addresses both LLC operating agreements (the dominant structure for single asset syndications) and limited partnership agreements, which remain common for fund structures and for certain tax planning strategies.

## Why the Governing Agreement Is the Most Important Document

The operating agreement or LP agreement is the document that defines what the investment relationship actually is, as opposed to what the marketing materials described it might be. The PPM describes the investment's terms. The subscription agreement records the investor's commitment to those terms. The operating agreement governs the parties' rights and obligations under those terms for as long as they hold their interests. It is the only one of the three documents that has a continuous operative effect throughout the investment's life.

In a real estate syndication, the material events that occur during the hold period are typically more legally consequential than the initial closing. Refinancings that change the capital structure. Value add renovations that consume more capital than budgeted, triggering requests for additional investor contributions or reducing the preferred return coverage. Property underperformance that triggers difficult conversations about exit timing. A key person departure that raises questions about management continuity. A dispute about whether a specific decision requires investor consent. In every one of these situations, the operative document is the operating agreement. It either provides a clear answer, because it was well drafted, or it produces a dispute, because it was not.

A further consideration that sponsors frequently overlook: the operating agreement is the document that investors and their counsel will scrutinize most carefully during secondary transfers and in any dispute resolution context. An investor who sells their interest to a new buyer does so subject to the operating agreement. The buyer will want to review it before committing. An investor whose investment is not performing as projected will retain counsel who will read the operating agreement to identify what rights the investor holds and whether any of those rights have been violated. A sponsor who has cut corners on the operating agreement is creating problems for a future version of themselves.

## Manager Authority and Decision Making

The manager authority provisions of the operating agreement establish the fundamental governance structure of the syndication: what decisions the manager can make unilaterally, what decisions require investor consent, and what process governs decisions that fall somewhere between those poles. Getting these provisions right is the single most consequential drafting decision in the operating agreement.

### Sole Manager Authority Versus Major Decision Consent Rights

The baseline principle in a manager managed LLC is that the manager has broad authority to manage the company's business and affairs. For a real estate syndication, this means the

manager (the sponsor or a sponsor affiliated entity) controls day to day property management, leasing decisions within defined parameters, ordinary capital expenditures, minor financing modifications, and the full range of operational decisions that are necessary to run the property. Investors accept this structure as the price of passive investment. They want returns, not operational involvement.

But not every decision is operational. Decisions that materially alter the investment's risk profile, its capital structure, its economic terms, or its fundamental character (the decisions that an investor would most want to participate in) are a different category. These are major decisions, and a well drafted operating agreement defines them specifically and requires investor consent before they can be taken.

The tension between manager efficiency and investor protection is real. Too broad a major decision definition creates an investment that cannot be managed effectively. Too narrow a definition leaves investors without meaningful protection against decisions that materially affect their investment. The right calibration depends on the specific deal. A stabilized core property with predictable operations can accept broader manager authority. A value add development with material execution risk and significant capital exposure should have more robust consent requirements. Template operating agreements that apply the same major decision definition regardless of deal type are calibrated for neither.

## Defining Major Decisions and the Investor Veto

Major decisions in a typical real estate syndication operating agreement include some combination of the following, with the specific thresholds and parameters negotiated based on the deal's characteristics.

- Sale of the property or a material portion of it. Any sale that constitutes a disposition of the core asset requires either manager discretion within defined parameters (hold period, minimum return thresholds) or affirmative investor consent.
- Refinancing of the primary debt. Modifications that materially change the capital structure (new debt above a defined threshold, extension of the maturity beyond the projected hold period, addition of personal guarantees) typically require investor consent.
- Major capital expenditures above a defined threshold. Renovation scopes that significantly exceed the original budget, or capital expenditures that affect the property's fundamental character, are distinguished from ordinary maintenance and upkeep.
- Amendment of the operating agreement itself. Changes to the economic terms, the governance provisions, the transfer restrictions, or the investor rights provisions require

supermajority or unanimous member consent to prevent unilateral alteration by the manager.

- Admission of new members. In most syndications, the manager controls the composition of the investor group through the subscription process, but the operating agreement may reserve to investors the right to consent to admissions that would dilute existing interests beyond defined thresholds.
- Material changes to the investment strategy. For fund structures, departures from the stated investment strategy (geographic expansion, asset class changes, leverage policy modifications) require investor consent at the LPAC level or through a member vote.

Each major decision category should include a specific definition of what constitutes a triggering event (for capital expenditures, a dollar threshold; for debt modifications, a defined magnitude of change; for sales, a minimum return threshold below which manager discretion is limited) and a specific consent mechanism (majority vote of interests, supermajority, unanimous consent, or LPAC approval). Vague major decision definitions (ones that require consent for decisions that materially affect investors without defining materiality) invite disputes about whether consent was required in any specific situation.

## Manager Removal and Replacement Provisions

The manager removal provisions are among the most consequential in the operating agreement, and they are consistently among the most heavily negotiated by sophisticated investors. The removal framework determines what investors can do if the manager is failing to perform, and the answer to that question fundamentally affects the investment's risk profile from the investor's perspective.

For cause removal is available in virtually every operating agreement. The manager can be removed upon the occurrence of specified for cause events: fraud, willful misconduct, material breach of the operating agreement that remains uncured after a defined notice period, bankruptcy of the manager entity, or criminal conviction of the manager's principals. For cause removal is typically triggered by a supermajority vote of the investors (often two thirds or more). The operating agreement must specify what happens to the manager's economic interests upon for cause removal: whether the promote is forfeited, reduced, or preserved, and whether removal affects the manager's co-investment or management fee accruals.

No fault removal (the ability to remove the manager without cause) is available in some operating agreements and represents a materially different risk allocation. No fault removal provisions typically require a higher vote threshold than for cause removal (often 75% or more of interests), may require a defined notice period and wind down process, and typically preserve the manager's economic interests in investments made through the removal date. The economic treatment of no fault removal is one of the most heavily negotiated points in

institutional fund documents. Managers prefer full economic preservation. Investors prefer significant forfeiture as an incentive for continued performance.

Key person provisions are a related but distinct mechanism. Rather than removing the manager, key person provisions suspend the manager's authority to make new investments if specified key persons (the named principals of the sponsor entity) are no longer actively involved in the investment's management. A fund with a key person clause may require a majority investor vote to continue the investment program if the key person departs, giving investors the ability to halt new commitments while preserving the existing portfolio.

### **⚠ Manager Removal Provisions Must Be Specific, Not General**

*Operating agreements that describe manager removal rights in vague terms (providing removal for cause without defining cause, or requiring a material breach without specifying what constitutes material) create disputes rather than resolving them. When investors want to exercise removal rights, a vaguely drafted removal provision will generate litigation about whether the condition has been satisfied.*

*Removal provisions should define: the specific events that constitute cause, the vote threshold required for each removal category, the notice and cure period available to the manager before removal is effective, the economic consequences of each type of removal for the manager's promote and accrued fees, and the process for appointing a replacement manager. Specificity protects both sides. Investors know what rights they actually hold, and managers know the conditions under which their authority can be terminated.*

## **Economic Terms in the Operating Agreement**

Investment terms in a real estate syndication do one thing: they define how money moves. How it comes in, how it is accounted for, how it accrues, and eventually how it flows back out. The preferred return, the distribution waterfall, the promote, and the catch up are not concepts that belong primarily to financial analysis or real estate underwriting. They are legal terms. They live in the operating agreement. Their meaning, their calculation methodology, and the remedies available when they are not honored are all determined by the specific language of that document.

The economic provisions of the operating agreement translate the PPM's description of the investment's financial structure into legally binding mechanics. The difference between a PPM summary and the operating agreement's implementation is the difference between a description and the actual contract, and they must match precisely, because any discrepancy creates a

disclosure failure with antifraud implications. In well drafted governing documents, these terms are defined with enough precision that both parties can calculate the outcome of any distribution event without ambiguity. In poorly drafted documents, they generate the disputes that end up in arbitration and litigation.

## **Ownership Interests, Units, and Capital Accounts**

An investor's ownership interest in a manager managed LLC is documented in the operating agreement and reflected in the fund administrator's capital account records. Those interests can be expressed as ownership percentages (Investor A holds a 12.5% non-managing membership interest) or as units, where total outstanding units across all holders equals 100% of the membership.

Unit based structures have a practical advantage for deals with irregular investment amounts. If Investor A contributes \$250,000 and Investor B contributes \$375,000 in a \$1,000,000 raise, expressing their interests as 250,000 and 375,000 units out of 1,000,000 total units is mathematically cleaner than carrying six decimal ownership percentages across every distribution calculation. Either approach is legally sound. What matters is that the operating agreement defines the methodology clearly and applies it consistently.

Whatever form the interests take, the operating agreement must define the total number of interests or units authorized for issuance, the percentage each holder represents, and how pro rata calculations are performed at each tier of the waterfall. Ambiguity in any of these foundational definitions propagates through every downstream calculation.

## **Capital Accounts: The Accounting Record That Governs Everything**

The capital account is the running accounting record of each investor's economic position in the entity. It starts at the investor's initial capital contribution and is adjusted over the life of the investment by allocations of income and loss, additional contributions, and distributions received. At any point in time, each investor's capital account reflects their economic stake in the fund after all adjustments.

Capital accounts matter for three independent reasons. First, the distribution waterfall is typically calculated by reference to capital account balances, not the original contribution amount, particularly for preferred return calculations and return of capital determinations. Second, capital accounts are the basis for tax allocations: the entity's income, loss, and deductions are allocated to investors' capital accounts and reported on their Schedule K-1s. Third, on dissolution, each investor typically receives distributions equal to their positive capital account balance after all other claims are satisfied.



The operating agreement's capital account provisions must also be precise about which of three distinct measures governs which calculation. The capital account balance tracks the accounting position of each investor's interest, adjusted for allocations and distributions, and is used for waterfall calculations and K-1 preparation. Book value is the accounting value of the entity's assets (typically cost basis reduced by accumulated depreciation), and it diverges substantially from fair market value over time as depreciation reduces book basis while the property appreciates. Fair market value is what a willing buyer would pay in an arm's length transaction, and is used for buying out departing investors, triggering buy sell mechanisms, and calculating NAV in open end fund structures. Using the wrong measure in a calculation governed by the operating agreement produces incorrect results. An operating agreement that uses book value to determine a departing investor's buyout price in an LLC holding appreciated real estate will systematically underpay the departing investor.

The capital account is maintained by the fund administrator and must be updated accurately at every distribution event and allocation cycle. Capital accounts maintained incorrectly (because the fund administrator is not applying the operating agreement's allocation methodology correctly, or because distributions are being recorded against wrong investor accounts) produce incorrect K-1s and incorrect waterfall calculations at exit. Both outcomes are far more-expensive to correct after the fact than to prevent through competent fund administration from the beginning.

## Preferred Returns: The Mechanics That Matter

The preferred return (the pref) is the annualized return that investors are entitled to receive on their invested capital before the sponsor participates in profits. It is the first hurdle in the distribution waterfall, the gating mechanism that ensures investors receive a minimum specified return before the sponsor earns any carried interest. Expressed as a percentage of invested capital, an 8% preferred return means investors receive an 8% annualized return before the sponsor earns any promote.

The legal mechanics (accrual, calculation, payment) are defined in the operating agreement and calculated by the fund administrator. Getting these mechanics right requires precision that many template operating agreements do not provide. The most consequential drafting decisions in the preferred return provisions concern two questions: cumulative or non-cumulative, and simple or compounding.

**Cumulative versus non-cumulative.** A cumulative preferred return means that unpaid preferred return accrues. If a deal generates insufficient cash flow to pay the full preferred return in a given year, the unpaid amount carries forward and continues to accrue. Investors must receive all cumulative accrued preferred return before the sponsor participates in profits. A non-cumulative preferred return means unpaid amounts do not carry forward. That year's shortfall is

simply lost to investors. The vast majority of private real estate syndications use a cumulative preferred return. Investors who see an 8% preferred return in offering materials assume cumulative accrual. If the operating agreement implements a non-cumulative preferred return, that divergence must be specifically disclosed in the PPM. A sponsor who presents an 8% preferred return in marketing materials and implements a non-cumulative structure in the governing documents has created a disclosure gap that constitutes a material omission under the antifraud standard.

**Simple versus compounding accrual.** Simple accrual applies the preferred return to the outstanding invested capital balance only. An 8% simple preferred return on a \$1,000,000 investment accrues \$80,000 per year regardless of whether distributions have been made. Compounding accrual applies the preferred return to the outstanding accrued balance, so accrued but unpaid preferred return itself earns the preferred return rate in subsequent periods. Over a five year hold with no interim distributions, a \$1,000,000 investment at 8% generates \$400,000 in simple preferred return but approximately \$469,000 under annual compounding, a 17% difference. Most private real estate syndications use simple accrual because it is easier to calculate and explain. The operating agreement should specify simple or compounding accrual explicitly. Silence on this point creates ambiguity whose resolution will favor whoever has more leverage in the dispute.

For fund structures with institutional investors, IRR based hurdles are increasingly expected in place of or in addition to simple preferred return thresholds. An IRR hurdle is more technically precise because it accounts for the timing of cash flows, not just their amount. An 8% IRR hurdle means investors must achieve an 8% annualized return on their actual invested capital over the actual investment period before the sponsor participates. IRR hurdles require more sophisticated calculation by the fund administrator but provide a more accurate picture of the investment's performance relative to the timing of capital deployment and return.

#### **⚠ Non-cumulative Preferred Returns Require Specific Disclosure**

*Most investors who see an 8% preferred return in offering materials assume cumulative accrual, meaning that unpaid amounts carry forward and must be satisfied before the sponsor earns any promote. If the operating agreement implements a non-cumulative preferred return, that divergence from market standard must be specifically disclosed in the PPM, not embedded in the operating agreement's definition section where most investors will not read it carefully.*

*The economic value of a cumulative preferred return over a multi-year hold is substantially greater than a non-cumulative return. Investors who would have required different terms or declined the investment had they understood the distinction have a valid basis for a*

*rescission claim. The disclosure obligation is affirmative. The sponsor must ensure investors understand this fundamental characteristic of their return structure, not rely on being asked.*

## Distribution Waterfalls: Structure and Precision

The distribution waterfall is the sequencing mechanism that determines who gets paid, in what order, and in what proportion. It is the most economically significant provision in the operating agreement, and the provision that generates the most disputes when it is ambiguous, internally inconsistent, or inadequately explained to investors before they commit capital.

The standard four tier structure in a real estate syndication waterfall follows the sequence below.

**Tier 1, Return of invested capital.** Investors receive distributions equal to their original contributed capital. The operating agreement must specify whether return of capital means the original contribution, the current capital account balance, or some other defined amount, and whether interim operating distributions during the hold period reduce this obligation at exit.

**Tier 2, Preferred return.** Investors receive the accrued and unpaid preferred return on their capital, the amount earned over the hold period at the agreed rate, reduced by any preferred return distributions already made during the hold period. This calculation must be performed with precision. The contribution date of each investor's capital, the accrual start date, and the amount of any interim preferred return payments all affect the final calculation.

**Tier 3, Catch up (if present).** The sponsor receives distributions until reaching a defined proportion of total distributions made, typically structured so the sponsor recovers the carried interest that would have been earned if the promote had applied from dollar one of profit.

**Tier 4, Residual profit split.** Remaining profits are divided between investors and sponsor according to the agreed promote ratio, commonly 80/20, 75/25, or 70/30 in favor of investors.

The waterfall must also specify its priority as between operating distributions (cash flow from property operations during the hold period) and liquidating distributions (sale or refinancing proceeds). These are typically governed by the same waterfall logic, but the preferred return calculation, the capital return sequence, and the catch up mechanics interact differently with operating versus liquidating events. The operating agreement that is silent on this question will produce disputes when the distribution context matters.

## Worked Example: Standard Waterfall on a \$10 Million Exit

### Assumptions

- Investor equity: \$4,000,000
- Preferred return: 8% simple cumulative
- Hold period: 4 years
- Operating distributions during hold: \$800,000
- Promote: 80/20 in favor of investors, with institutional standard full catch up
- Net sale proceeds at exit: \$10,000,000

### Tier 1: Return of Capital

\$4,000,000 to investors

### Tier 2: Preferred Return

Earned:  $8\% \times \$4,000,000 \times 4 \text{ years} = \$1,280,000$

Less: \$800,000 distributed during hold period

Remaining at exit: \$480,000 to investors

### Tier 3: Sponsor Catch Up

Calibrated so that, after the catch up, the sponsor has received 20% of the sum of investors' preferred return plus the catch up itself.

Catch up =  $\$1,280,000 \times (20\% \div 80\%) = \$320,000$  to sponsor

### Tier 4: Residual Split (80/20)

Remaining:  $\$10,000,000 - \$4,000,000 - \$480,000 - \$320,000 = \$5,200,000$

Investors (80%): \$4,160,000

Sponsor (20%): \$1,040,000

### Totals

Total investor distributions at exit: \$8,640,000

Total investor distributions including hold: \$9,440,000

Total sponsor distributions: \$1,360,000

Total profits (investor and sponsor): \$6,800,000

Sponsor share of profits:  $\$1,360,000 \div \$6,800,000 = 20.0\%$

*Note: When the catch up is calibrated to the institutional standard (the catch up rate equals  $\text{promote} \div (1 - \text{promote})$ , here 25%), the sponsor reaches exactly the stated promote percentage of total profits. Some operating agreements use nonstandard catch up structures that produce a different sponsor effective share. The calibration approach must be specified in the operating agreement and explained in the PPM.*

### **⚠ Waterfall Ambiguity Is a Future Dispute**

*Every ambiguous provision in the distribution waterfall is a future dispute that will be resolved either through negotiation, where the sponsor holds more operational information and leverage, or through litigation, which is expensive for everyone.*

*The most common waterfall ambiguities: the interaction between interim operating distributions and the preferred return calculation at exit; the treatment of investors who contributed capital at different times and therefore have different accrual periods; whether the catch up applies to operating distributions or only to exit proceeds; the calibration of the catch up (a catch up rate of  $\text{promote} \div (1 - \text{promote})$  brings the sponsor to exactly the promote percentage; other rates produce different sponsor effective shares); and the calculation methodology when multiple investors have different capital balances at different tiers.*

*These are predictable scenarios that arise in most multi-year syndications. An operating agreement that does not address them specifically is not a well drafted governing document.*

## **The Promote (Carried Interest): Structure and Alignment**

The promote (carried interest) is the mechanism by which the sponsor participates in the investment's upside disproportionate to any capital they have contributed. Twenty percent is the most common market convention: sponsors receive 20% of profits above the preferred return, and investors receive 80%. Sponsors with strong track records may maintain this percentage. Sponsors with thinner track records may offer 15% or lower to attract capital. Ground up development deals sometimes feature 25% to 30% promotes in exchange for elevated execution risk.

The promote aligns sponsor and investor interests by making the sponsor's primary economic upside contingent on investor performance. A sponsor whose promoted interest is worth nothing unless investors first receive their capital back and their preferred return has a direct financial incentive to maximize investment performance, not because they are ethically obligated to, but because their own economics depend on it. This alignment is real but imperfect. Affiliated fees (acquisition fees, asset management fees, property management fees) are earned regardless of investment performance. A sponsor who generates most of their income from fees rather than from promoted interest has weaker performance alignment, and the ratio of fee income to promote income is a legitimate analytical question for sophisticated investors.

Tiered waterfall structures add additional performance thresholds and promote percentages above the base preferred return. A common structure might have three tiers: investors receive

their pref; sponsor receives a 20% promote up to a 12% IRR; sponsor receives a 25% promote up to an 18% IRR; sponsor receives a 30% promote on returns above 18% IRR. Each tier provides incremental upside to the sponsor as performance improves, aligning interests across a wider range of return outcomes. Tiered waterfalls add significant complexity to the waterfall calculation, which must be performed with precision at each distribution event. Each tier boundary requires a precise definition of how the threshold is measured, how prior distributions are treated at the boundary, and how the catch up (if any) works at each tier.

## Catch Up Provisions

A catch up provision accelerates the sponsor's economics after the preferred return threshold is satisfied. Under a full catch up, once investors have received their preferred return, the sponsor receives 100% of subsequent distributions until the sponsor has received an amount such that, taken together with the preferred return paid to investors, the sponsor's share of distributions above return of capital equals the promote percentage. With a 20% promote, this calibration produces a catch up rate of 25% (that is, \$0.25 of catch up per \$1.00 of preferred return), which brings the sponsor to exactly 20% of profits when the residual is divided 80/20.

The sponsor catch up recovers, in a concentrated burst, the carried interest that would have been earned on distributions that went entirely to investors during the preferred return phase. As the worked example illustrates, a properly calibrated full catch up brings the sponsor to the stated promote percentage of total profits, no more and no less. Some operating agreements use a nonstandard catch up rate (for example, applying the promote percentage rather than  $\text{promote} \div (1 - \text{promote})$  to the catch up calculation) that produces a sponsor effective share higher than the stated promote. That outcome is a function of specific drafting choices, not a feature of full catch ups generally, and a sponsor effective share above the stated promote percentage must be specifically disclosed in the PPM as a divergence from market standard.

Whether and how to structure the catch up is a legitimate negotiating point. Investors focused on total return often prefer a full catch up calibrated to the promote, because it gives the sponsor a strong incentive to maximize performance beyond the preferred return threshold while preserving the agreed economic split. Investors focused on the timing of cash flows may prefer a partial catch up (where the sponsor receives a portion greater than zero but less than 100% during the catch up tier) or no catch up at all, with the promote applied proportionally from the first dollar of profit above the preferred return. The operating agreement must specify which structure applies with enough precision that the fund administrator can perform the calculation without interpretation.

## Clawback Provisions: Protecting Investors from Over Distribution

A clawback provision requires the sponsor to return previously received carried interest if, on a cumulative basis at the end of the fund's life, the sponsor has received more than the promote percentage it was entitled to earn. Clawback provisions are most relevant in fund structures with deal by deal (American) waterfalls, where carry is paid on profitable early exits before the fund's overall performance is established, but they can also apply in structures where interim distributions resulted in the sponsor receiving carry before final accounting confirmed entitlement.

A well drafted clawback provision addresses four specific questions that generic clawback language typically leaves open.

- Calculation methodology. Is the clawback calculated on a deal by deal basis, or only at final fund wind down comparing total carry received to total carry earned on the cumulative portfolio? The answer produces very different clawback obligations and must be specified before any carry is distributed.
- Pre-tax versus post-tax calculation. A sponsor who received \$1 million in carry, paid \$350,000 in taxes, and retains \$650,000 faces very different financial hardship depending on whether the clawback obligation is \$1 million (Pre-tax) or \$650,000 (post-tax). Most institutional fund clawbacks are calculated on a net after tax basis.
- Timing of the obligation. Is the clawback owed at fund wind down? Or is it triggered on a rolling basis as individual deals are realized? Rolling calculations impose more frequent obligations but prevent the sponsor from retaining carry on strong early performers if later assets underperform significantly.
- Security for the obligation. Is the sponsor required to maintain a funded reserve (a portion of received carry held in escrow) to secure the clawback? Or is the clawback simply a contractual promise the sponsor is expected to honor from personal assets? Institutional investors increasingly require funded reserves or other security, particularly for sponsors whose principals may not have sufficient personal liquidity to fund a significant clawback obligation at wind down.

## IRR and Equity Multiple: The Performance Metrics

The two most commonly used performance metrics in private real estate (IRR and equity multiple) measure different dimensions of investment performance and should both be disclosed in offering materials. Understanding what each measures, and what each misses, is essential for sponsors presenting returns and investors evaluating them.

IRR is the annualized discount rate at which the present value of all investment cash flows equals zero. In plain terms, it is the annualized rate of return accounting for both the magnitude and the timing of every dollar invested and received. IRR's time sensitivity is both its strength and its principal limitation. A deal that returns 2x equity in two years has a dramatically higher



IRR than the same 2x return over six years, even though total profit is identical. IRR rewards speed of return and can create misaligned incentives. A sponsor focused primarily on maximizing IRR might prefer an early exit at lower total return over a longer hold at higher total return if the IRR calculus favors the earlier exit.

The equity multiple is total distributions received divided by total equity invested. A \$1,000,000 investment generating \$2,100,000 in total distributions has a 2.1x equity multiple. The equity multiple does not account for time. A 2.0x multiple achieved in two years looks identical to a 2.0x over ten years, making it a complement to IRR rather than a substitute. Presenting both metrics together, alongside the expected hold period, gives investors the most complete return picture. Presenting IRR alone without the equity multiple, or the equity multiple without the expected hold period, is incomplete disclosure that favors whichever metric makes the specific deal look most attractive.

| Dimension                      | IRR (Internal Rate of Return)                                          | Equity Multiple                                               |
|--------------------------------|------------------------------------------------------------------------|---------------------------------------------------------------|
| What it measures               | Annualized return accounting for the precise timing of all cash flows  | Total capital returned divided by total capital invested      |
| Time sensitivity               | Very high. Same total profit generates higher IRR when received sooner | None. 2.0x in 3 years looks identical to 2.0x in 10 years     |
| Typical use                    | Institutional comparisons. Tiered waterfall trigger points             | Individual investor communications. Total return storytelling |
| Key limitation                 | Can incentivize early exit over total value maximization               | Provides no information about the timing of returns           |
| Typical benchmarks (value add) | 13% to 18% net IRR over a 4 to 6 year hold                             | 1.8x to 2.2x net equity multiple over a 4 to 6 year hold      |

## Capital Calls, Defaulting Investors, and Pro Rata Rights

In fund structures with unfunded commitments, capital calls are the central mechanism through which the investment relationship operates throughout the investment period. A capital call is a legal obligation. Investors who have committed to the fund must contribute the called amount within the notice period (typically ten business days) or face the consequences specified in the operating agreement's defaulting investor provisions.

Capital call commitments should be understood as genuine financial obligations, not expressions of intent. A fund that is counting on committed capital to close an acquisition and has investors who cannot fund on time faces a failed closing, a damaged broker relationship, and potential seller liability. The operating agreement's capital call notice must specify the amount called, the purpose of the call, the funding deadline, and wiring instructions. It should



also specify the consequences of non-funding, because the commitment is only as meaningful as those consequences.

Common defaulting investor provisions include the mechanisms listed below.

- **Forfeiture.** Some or all of the defaulting investor's existing interest is forfeited as a penalty for the default.
- **Dilution.** The defaulting investor's ownership percentage is reduced by formula, with the diluted portion allocated to investors who fund the call at a price favorable to the funding investors.
- **Forced loan.** The fund borrows the defaulting investor's portion from other investors at a specified interest rate, and the defaulting investor is obligated to repay with interest.
- **Interest and fees.** The defaulting investor pays interest on the unfunded amount at a specified rate (often the preferred return rate plus a margin) from the date the call was due.
- **Exclusion from future investments.** The defaulting investor loses the right to participate in future capital calls, and their interest is limited to their existing funded position.

The appropriate severity of defaulting investor provisions depends on the fund's capital needs and investor base. Whatever the specific terms, they must be disclosed in the PPM. Investors who do not understand the consequences of failing to fund a capital call before they commit are investors who will be surprised by those consequences, and surprised investors become litigious investors.

Pro rata rights give existing investors the right to participate in future capital calls or additional investment opportunities in proportion to their current ownership percentage. Pro rata participation in each capital call preserves each investor's proportional ownership. An investor who cannot or does not exercise their pro rata right loses ownership percentage to investors who fund the additional capital. The operating agreement must specify the notice period for exercising pro rata rights, the mechanics of how the right is exercised, and what happens to the pro rata allocation of an investor who does not participate.

## Fee Provisions and the Alignment Question

Every fee that the sponsor or any affiliated entity earns from the investment must appear in the operating agreement, with the same specificity required in the PPM's fee disclosure. The operating agreement is the legally binding authorization for each fee. Any fee paid that is not specifically authorized by the operating agreement is an unauthorized distribution to the sponsor. Fee provisions that use vague language (a reasonable management fee, or compensation for services as determined by the manager) create disputes and provide investors with no way to evaluate the appropriateness of the compensation before they invest.

The common affiliated fee categories that must be authorized and disclosed are described below.

**Management fees.** The recurring annual fee paid to the sponsor for managing the fund, meaning the ongoing compensation for the investment management function separate from the carried interest. Most commonly expressed as a percentage of committed capital during the investment period (typically 1.5% to 2.0%), transitioning to a percentage of invested capital or NAV after the investment period ends (typically 1.0% to 1.5%). The distinction matters. During the investment period, the fee is calculated on committed capital including both deployed and undeployed amounts.

**Management fee offsets.** One of the most important and most frequently negotiated aspects of the management fee. Offset provisions reduce the annual management fee by some percentage of affiliated fees that the manager or its affiliates earn from the fund's portfolio. The logic: if the sponsor is also earning acquisition fees, asset management fees, and property management fees, charging the full management fee on top creates double compensation. Fee offset structures range from 50 cents on the dollar (common in sponsor friendly terms) to 100 cents on the dollar (preferred by institutional investors). The offset percentage and the fee categories subject to offset must be specified with precision.

**Acquisition fees.** Paid at the time a property is acquired, typically ranging from 0.5% to 2.0% of the acquisition price, compensating the sponsor for deal sourcing, underwriting, and closing work.

**Asset management fees.** Ongoing fees paid to the sponsor or an affiliate for managing the portfolio. In a fund context, if the management fee is intended to cover asset management functions, a separate asset management fee may represent double compensation unless specifically offset against the management fee, a relationship that must be clearly explained in the PPM.

**Property management fees.** Paid to the sponsor or an affiliate for managing day to day property operations. If the sponsor self manages, this fee should be competitive with what a third party manager would charge for the same services. Sponsors who charge above market property management fees while simultaneously earning a management fee on the same assets create alignment concerns that sophisticated investors will scrutinize.

**Construction and renovation management fees.** Compensate the sponsor for overseeing capital improvement programs, typically expressed as a percentage of the renovation budget. In value add strategies where renovation is central to the investment thesis, this fee can be substantial and must be disclosed with specificity about what services it covers and how it is calculated.

**Disposition fees.** Paid upon the sale of a property, typically 0.5% to 1.0% of the sale price. Because disposition fees and promoted interest are both paid at disposition, the sponsor receives two forms of compensation simultaneously at the moment of maximum fund liquidity, a structure worth examining carefully in the PPM's fee disclosure.

The fundamental concern with affiliated fees is alignment. The promote aligns sponsor and investor interests by making the sponsor's primary upside contingent on performance. Affiliated fees are paid regardless of performance. This does not make them impermissible. It means they must be transparent, reasonable, and properly offset where appropriate. A sophisticated investor, fully informed of the complete fee structure, should be able to conclude that each fee represents reasonable compensation for genuine services and that the total fee load, taken together with the promote, creates appropriate alignment.

## Fund Specific Economic Terms and Governance

The terms in the preceding section apply to both single asset syndications and fund structures. The terms in this section apply primarily to multi asset closed end fund structures, meaning those raising capital for a portfolio of properties rather than a single acquisition. Sponsors building a fund platform need to understand these terms as well as the core economic terms above. These are the provisions where institutional investors spend most of their negotiating time and where the quality of the legal documentation most directly signals the sponsor's institutional maturity.

### Fund Term and Investment Period

The fund term is the total operating life of the fund, from the initial close of capital commitments to the final distribution and dissolution. For closed end real estate funds, the standard term is eight to twelve years, long enough to acquire properties, execute value add programs, and sell at favorable market timing. Most fund documents provide for one or two one year extensions of the fund term at the manager's election, with investor consent or LPAC approval required for extensions beyond that. The fund term matters to investors because it defines how long their capital is committed. An investor in a ten year fund with two one year extensions is potentially committing capital for twelve years, and that duration needs to be disclosed clearly and understood before the commitment is made.

The investment period is the window during which the fund may make new investments (acquire new properties and call capital for those acquisitions). It typically spans the first half of the fund term. A ten year fund might have a five year investment period during which new acquisitions are made, followed by five years of asset management and disposition. After the investment period expires, the fund can manage and improve existing assets but cannot make new acquisitions or call new capital for investment purposes (capital calls after this point can only be

made for follow on investments in properties already owned, if permitted, or to cover fund level expenses).

The investment period matters for several reasons that must be addressed in the operating agreement or LP agreement: it constrains the manager's discretion (the manager cannot make new acquisitions after the investment period expires without investor consent); it defines the period during which the management fee is calculated on committed capital rather than invested capital; and a key person event during the investment period triggers suspension of the investment period (the fund cannot call capital or close new deals until investors vote on whether to continue or wind down the fund).

### **Subsequent Closings and Equalization Mechanics**

Most real estate funds raise capital in a series of closings rather than a single closing. The initial closing (the first point at which the manager accepts investor commitments and begins deploying capital) is followed by one or more subsequent closings that admit additional investors. The mechanics of subsequent closings must address a fairness problem. Investors who committed at the initial closing have their capital at risk from the moment investments are made and are therefore entitled to preferred return accrual from that date, while investors who join at a subsequent closing benefit from the initial closing investors' earlier deployment without having had their capital at risk for the same period.

The standard solution is an interest charge on late investors, often called a subscription equalizer or equalization interest. Investors who participate in a subsequent closing typically pay interest on their committed capital from the date of the initial closing (or the date of the first investment) through the date of their actual subscription. This equalizes the economic position between early and late investors and prevents late investors from free riding on the appreciation generated before they joined. The operating agreement or LP agreement must specify the equalization rate (typically the preferred return rate), the calculation methodology, and whether the equalization payment is made to the fund or pro rata to the initial closing investors.

### **LPAC: The Limited Partner Advisory Committee**

Fund structures (particularly those using the LP form) typically include a Limited Partner Advisory Committee composed of a subset of limited partners who are given specific oversight and consent rights not extended to all limited partners. The LPAC structure is the primary governance mechanism through which major fund decisions (approval of affiliated transactions, resolution of conflicts of interest, consent to amendments, review of the general partner's performance) are reviewed and approved without requiring a vote of all limited partners.

The LPAC's composition, authority, procedures, and relationship to the general partner's decision making authority must be specifically addressed in the LP agreement. LPAC provisions

that are vague about the LPAC's authority or that fail to specify a clear process for LPAC consultation create disputes when the general partner wants to act and LPAC members disagree. LPAC provisions that give the LPAC genuine authority (with defined consent rights, adequate notice, and a reasonable consultation period) provide a meaningful governance mechanism that sophisticated investors find valuable.

Typical LPAC authority includes approval of transactions between the fund and entities affiliated with the general partner; consent to certain amendments to the LP agreement; review of the general partner's valuation methodology for NAV calculations; and authority to waive specific provisions of the investment policy on a transaction by transaction basis. The LPAC does not manage the fund (that remains exclusively the general partner's role) but it serves as a check on specific categories of decision where the general partner's interests may diverge from the limited partners' interests.

### **Fee Provisions and Conflicts of Interest in the Operating Agreement**

For affiliated service arrangements (property management by an affiliated company, construction management by an affiliated contractor, financing arranged through an affiliated source) the operating agreement must specifically authorize the arrangement and should include a representation that the terms are at least as favorable as those available from unaffiliated providers. The operating agreement should also address the manager's authority to modify affiliated service arrangements (whether those modifications require investor consent or LPAC approval) and the investor's right to receive information about affiliated service provider compensation.

## **Investor Protections**

Investor protections in the operating agreement are the provisions that give investors meaningful rights and recourse beyond simply waiting for distributions. A syndication that is structured purely for manager convenience (with unlimited manager authority, no reporting obligations, no removal rights, and no information access) is one in which investors have accepted terms that significantly weaken their legal position if something goes wrong. Well-structured investor protections are not just investor friendly. They signal to sophisticated investors that the sponsor is willing to be held accountable and is confident in their ability to deliver on the investment's terms.

### **Information Rights and Reporting Obligations**

Information rights establish what financial and operational information investors are entitled to receive, on what schedule, and in what format. These rights serve a dual function. They give investors the information they need to monitor the investment's performance, and they create a

record of the sponsor's performance that is available in any dispute about whether the investment was managed competently.

Minimum information rights in a real estate syndication operating agreement should include the items below.

- Quarterly financial reports. Operating statements for the property or fund, distributions paid, capital expenditures, debt service, and a comparison to the underwriting assumptions. Quarterly reports allow investors to identify underperformance trends before they become material.
- Annual financial statements. Audited or reviewed financial statements for the SPV, prepared by an independent CPA. For larger offerings and for fund structures, audited financial statements are the standard. For smaller single asset syndications, reviewed statements may be acceptable but should be specified in the operating agreement.
- Annual K-1s. Schedule K-1s for each investor's allocated share of the entity's income, loss, deductions, and credits, issued no later than the extended due date of the entity's tax return (September 15 for calendar year partnerships). Late K-1s are one of the most consistent investor relations problems in real estate syndications, and the operating agreement should establish the deadline clearly and include consequences for material delay.
- Transaction notices. Prompt written notice of material events including property sales, major refinancings, significant casualty events, material litigation, and significant departures from the business plan. The notice provision should specify the timeline (typically within 5 to 15 business days of the triggering event, depending on materiality) and the information that must be included.
- Annual reports for fund structures. A comprehensive annual report describing the fund's portfolio, individual investment performance, the sponsor's assessment of each investment's trajectory, and the fund's status relative to its stated investment objectives.

## Audit Rights

Audit rights give investors (or a specified subset of investors, such as the LPAC) the right to engage an independent auditor to review the entity's books and records. The existence of an audit right is important even when it is rarely exercised. It creates an accountability mechanism that deters inaccurate reporting and gives investors legal recourse if they discover that financial information has been misrepresented.

The operating agreement's audit right provisions should specify the frequency with which an audit can be requested (typically once per year for each investor, or collectively for investors representing a minimum percentage of interests), the cost allocation (typically borne by the investors requesting the audit, unless the audit reveals material inaccuracies in the manager's

reports, in which case the cost is charged to the entity), and the manager's obligation to cooperate with the audit by providing access to books, records, and key personnel.

## Transfer Restrictions

Transfer restriction provisions govern when, how, and to whom investors can transfer their membership interests. These provisions serve two distinct purposes: maintaining compliance with the securities laws' resale limitations on privately placed securities, and preserving the sponsor's control over the composition of the investor group. Both purposes are legitimate, and a well drafted transfer restriction section addresses both without either prioritizing one to the complete exclusion of the other.

### Lock Up Periods and Holding Requirements

The primary securities law transfer restriction applicable to Regulation D offerings is the Rule 144 holding period. Restricted securities may not be resold for 12 months from the date of their acquisition from the issuer. This restriction should appear explicitly in the operating agreement's transfer restriction section, stated in terms of the member's acquisition date and the 12 month period running from that date.

The operating agreement should specify what happens at the end of the Rule 144 holding period: that transfers remain subject to the operating agreement's other transfer restriction provisions, including the manager consent requirement and the transferee eligibility conditions. The expiration of the Rule 144 lockup does not make interests freely transferable. It removes one of the conditions for permitted transfer, while the other conditions continue to apply.

For capital call fund structures where interests are acquired at multiple points in time as capital calls are funded, the holding period must be tracked separately for each tranche. Interests acquired at the second or third capital call have a holding period that runs from the date of that acquisition, not from the date of the first capital call. The operating agreement should address how the holding period is calculated in tranching acquisition structures to prevent disputes about when specific interests become transferable.

### Manager Consent Requirements

Beyond the Rule 144 holding period, the operating agreement should require the manager's prior written consent for any transfer of membership interests. The manager consent requirement serves the sponsor's legitimate interest in controlling who becomes a member of the LLC: screening potential transferees for suitability, ensuring they meet investor eligibility requirements, and preventing transfers to parties whose admission would create conflicts of interest or other concerns that the securities law framework does not address.



The manager's consent to transfers should not be unreasonably withheld based solely on the transferee's financial qualifications. If a proposed transferee is an accredited investor, satisfies all applicable eligibility requirements, and has no other disqualifying characteristics, the manager should not withhold consent as a way of preventing investors from exiting the investment. The operating agreement can provide the manager with defined grounds for withholding consent (transferee does not meet eligibility requirements, transfer would violate securities law, lender consent not obtainable) without granting unlimited discretion to block transfers that the manager simply prefers not to permit.

### **Right of First Refusal**

A right of first refusal (ROFR) gives the entity, the manager, or the other members the right to purchase an investor's interest before the investor completes a transfer to a third party. The ROFR is a common provision in closely held business operating agreements and serves the function of preserving existing members' ability to maintain their proportionate interest in the entity without admitting unknown third parties.

The operating agreement's ROFR provision should specify: who holds the right (the entity, the manager, existing members, or some combination), in what sequence (entity first, then manager, then members), the exercise period (typically 30 to 60 days from receipt of the transfer notice), the pricing methodology (the third party offer price or a formula based value), and what happens if the right is not exercised (the transferor may complete the transfer to the third party on the same terms offered to the right holders, subject to all other transfer conditions being satisfied).

### **Transferee Eligibility Requirements**

Every proposed transferee must satisfy the same eligibility requirements as the original investors in the offering. For Regulation D offerings, this means the transferee must be an accredited investor. The operating agreement should specify this requirement explicitly, describe the documentation that must be provided to establish the transferee's eligibility, and make the manager's consent to the transfer conditional on the transferee's eligibility being confirmed.

For offerings with ERISA benefit plan investor restrictions (where the offering has structured its investor base to maintain benefit plan investor ownership below the 25% significant participation threshold) the operating agreement should include a transfer restriction specifically prohibiting transfers to benefit plan investors without the manager's prior analysis of whether the transfer would cause the threshold to be exceeded. The manager should have the right to withhold consent to transfers that would push the benefit plan investor percentage above the threshold, and this right should be explicitly preserved in the transfer restriction provisions.



## Operating Agreement Transfer Restriction Framework: Key Components

### Securities Law Compliance

- Rule 144 holding period: 12 months from acquisition date (not subscription date)
- For capital call structures: separate holding period per tranche
- Transferee must be an accredited investor and satisfy all exemption requirements
- Transfer must qualify under an independent exemption from registration

### Contractual Restrictions

- Manager prior written consent required for any transfer
- Right of first refusal: entity, then manager, then members (typical sequence)
- Minimum transfer amount (typically \$5,000 to \$25,000 of investment value)
- No transfer to benefit plan investors without ERISA threshold analysis
- Lender consent required where loan documents impose transfer restrictions

### Permitted Transfers (typically without full consent process)

- Transfers to revocable living trusts for the investor's estate planning
- Transfers to wholly owned entities (IRAs, 401(k)s, LLCs) of the investor
- Transfers to family members for estate planning purposes
- All permitted transfers still require notice, accreditation confirmation, and the transferee's assumption of all obligations under the operating agreement

## Lender Consent Considerations for Transfers

Real estate debt is almost always structured with transfer restriction covenants: provisions in the loan agreement that restrict transfers of ownership interests in the borrowing entity. These covenants exist because lenders make underwriting decisions based on who controls the borrowing entity, and they have a legitimate interest in preventing control from being transferred to parties they did not underwrite.

In a conventional syndication where secondary transfers of membership interests are rare and individually negotiated, lender consent provisions are manageable. The manager seeks consent for each proposed transfer, the lender evaluates the proposed transferee, and consent is granted or withheld on a case by case basis. This process works adequately when transfers are infrequent.

As real estate syndications increasingly offer secondary market access through online platforms, the lender consent question becomes more structurally significant. A syndication that

envisions active secondary trading must confirm that the loan agreement's transfer restriction covenants are compatible with that activity before the offering is launched.

## Understanding the Loan Agreement Transfer Restriction

Loan agreement transfer restrictions vary widely in their scope. Some restrict only transfers of majority control: a change that results in a different party controlling more than 50% of the LLC's membership interests. Others restrict any transfer of membership interests above a de minimis threshold. The operating agreement should document the applicable loan restriction and confirm that the transfer restriction provisions of the operating agreement are at least as restrictive as the loan agreement requires.

Before a syndication is structured, the loan agreement's transfer restriction provisions must be reviewed by counsel who understands both the loan document's technical requirements and the mechanics of any planned secondary market activity. A secondary market program that constitutes systematic breach of the loan covenants is not a viable offering structure. Lenders can call the loan for covenant violations, creating an existential risk for the offering and catastrophic exposure for the sponsor.

## Approaches to Lender Consent

Several approaches are available to address lender consent requirements for syndications that anticipate secondary transfer activity.

- Obtain explicit lender consent to defined secondary trading parameters as part of the acquisition financing: negotiate a carveout from the transfer restriction covenant for secondary transfers that satisfy specified conditions (transferee accreditation, manager consent, minimum transfer amount, no single transferee exceeding a defined ownership percentage). Lenders who understand the syndication structure may be willing to grant these carveouts, particularly if the operating agreement's transfer restriction provisions provide meaningful controls over who can become a member.
- Obtain lender consent for specific transfer threshold carveouts: many lenders will consent to secondary trading provided no single investor acquires more than a specified percentage of total membership interests (typically 49%), and that the original sponsor entity retains a minimum ownership threshold (typically 20% or more). These thresholds give the lender assurance that the effective control of the entity does not change through secondary trading.
- Limit secondary market access for offerings on leveraged properties: accept that secondary transfers will require case by case lender consent review and disclose this limitation to investors prominently in the PPM and subscription agreement. Investors who plan to hold for the full term are not affected. Investors who want early exit options need to understand the constraint.

### **⚠ Confirm Lender Consent Before Describing Secondary Liquidity in Marketing Materials**

*A syndication that describes secondary transfer opportunities in its PPM or marketing materials, without having confirmed that the loan agreement's transfer restriction covenants permit those transfers, is creating investor expectations that may not be satisfiable.*

*The analysis of whether the loan agreement permits planned secondary transfers must be completed at the offering design stage, before the PPM is drafted, before the subscription agreement is signed, and before any investor is told that secondary transfers may be available. The consequences of discovering a lender consent problem after investors have committed capital, and after marketing materials have described secondary liquidity as a feature, are significantly worse than identifying the issue during the offering design process.*

## **Voting Rights and Member Governance**

The voting provisions of the operating agreement establish the mechanics through which investors exercise the consent rights described in the major decisions section. A well drafted voting provision specifies the matters requiring member approval, the vote threshold for each, the notice requirements before a vote, the record date mechanism, the quorum requirement (if any), and the method of collecting and tabulating member votes.

### **Vote Thresholds for Different Decision Categories**

Different categories of decisions warrant different vote thresholds based on their significance and their impact on investors. A typical governance structure in a real estate syndication operating agreement might provide the thresholds below.

- Simple majority (greater than 50% of interests). Approval of ordinary major decisions that do not alter the fundamental terms of the investment: property improvements above the budget threshold, refinancings within defined parameters, or changes to the operating agreement that do not affect economic terms.
- Supermajority (typically two thirds to 75% of interests). Decisions with more significant impact: property sale outside the projected hold period, material changes to the investment strategy, for cause removal of the manager.
- Supermajority or unanimity for economic term amendments. Any amendment to the distribution waterfall, the preferred return rate, the promote percentage, or the fee

schedule (the economic provisions that investors relied on when making their investment decisions) should require the highest vote threshold in the operating agreement.

## Notice and Record Date Mechanics

Before any member vote, the manager must provide adequate notice of the matter to be voted upon. The operating agreement should specify the notice period (typically 10 to 30 days before the vote), the information that must be included in the notice (a description of the matter, the proposed action, and the manager's recommendation), and the mechanism for delivering notice (email to the address in the investor's subscription agreement, or through the investor portal).

The record date (the date as of which membership interest holdings are determined for voting purposes) should be specified in the notice. Establishing a record date prevents transfers that occur after notice is given from affecting the vote outcome. The operating agreement should specify how the record date is set (typically a number of days before the vote), who establishes it, and what source is used to determine membership interest holdings at the record date.

## Disposition, Dissolution, and Wind Down Provisions

The disposition and dissolution provisions govern how the investment ends: the sale of the property, the final distribution waterfall, and the formal dissolution of the entity. These provisions are less often read during the hold period and more often read at the moment they matter most: when the sponsor announces a sale and investors want to know exactly how the proceeds will be divided.

### Manager Authority Over Disposition Timing

The operating agreement should address the manager's authority to determine when and at what price to sell the property, and the conditions under which that authority is constrained. For most single asset syndications, the manager has broad discretion over exit timing and pricing. The investment thesis is built around the manager's judgment about when to sell, and constraining that judgment with an investor vote for every sale decision would be operationally difficult.

But unfettered manager discretion over exit timing can harm investors who have planned around a specific hold period. The operating agreement should address: the projected hold period and the circumstances under which the manager can extend it beyond the projection; the conditions under which investors can compel a sale (typically through a supermajority vote after a defined minimum hold period has elapsed); and the process for deciding whether to accept a specific offer when market conditions create time pressure.

### Final Distribution Waterfall

The final distribution waterfall provisions (the sequence of payments that governs how net sale proceeds are divided among the parties) must be stated precisely and completely in the operating agreement. The waterfall as applied to liquidating distributions may include additional steps or different parameters than the waterfall for operating distributions, and any differences should be explicitly addressed.

The operating agreement should specify what is deducted from gross sale proceeds before the waterfall calculation is applied: the disposition fee (if any), selling costs and closing expenses, debt repayment, any required reserves or escrow holdbacks, and any other deductions that reduce gross proceeds to net proceeds before the waterfall begins. Each deduction should be specifically identified, and the waterfall should explicitly state that it applies to net proceeds after these deductions, not to gross proceeds.

For value add investments where the renovation was funded in part by operating cash flow or investor contributions beyond the original equity, the waterfall must address how additional capital contributions are treated relative to original contributions. Investors who made additional contributions after the initial closing are entitled to a return of their additional capital consistent with the priority structure they agreed to when making those contributions.

## Dissolution Mechanics

After the final distribution is confirmed as complete, the LLC must be formally dissolved in accordance with the applicable state LLC Act. Formal dissolution requires filing articles of dissolution or the state equivalent, completing the wind down of the entity's affairs (resolving any outstanding obligations, distributing any remaining assets, and notifying creditors), and maintaining records for the applicable post dissolution retention period.

The operating agreement should authorize the manager to execute all necessary dissolution steps following the final distribution and should specify the manager's obligations during the dissolution period, including continued reporting to investors about the dissolution status and maintaining the offering's compliance records for the required retention period (typically at least five years from the date of the last sale in the offering, and longer for tax records).

## Limited Partnership Agreements: Key Differences from LLC Operating Agreements

While the LLC operating agreement is the dominant governing document form for single asset real estate syndications, limited partnership agreements remain common for fund structures, for offerings specifically designed to attract institutional investors who prefer the LP structure, and for transactions with specific tax planning requirements that are better served by the LP form.

Understanding the key structural differences between LP agreements and LLC operating agreements is important for sponsors who use or are considering the LP form.

### **General Partner Versus Manager: Structural Differences**

In a limited partnership, the entity that manages the fund or investment is the general partner, not a manager. The general partner typically has unlimited personal liability for the partnership's obligations, which is the primary reason most real estate LP structures use an LLC as the general partner rather than an individual. A sponsor who serves as individual general partner in a leveraged real estate LP has accepted personal liability exposure that most attorneys would strongly advise against.

The governance framework in an LP agreement mirrors the LLC operating agreement in most substantive respects (major decisions requiring limited partner consent, removal provisions, economic terms, transfer restrictions) but the terminology differs and certain structural rules follow the applicable state LP Act rather than LLC Act. Sponsors who are accustomed to LLC structures should not assume that LP agreement drafting is equivalent. The legal framework has meaningful differences that require specific expertise.

### **LPAC Considerations in the LP Form**

The LPAC mechanism described earlier in this chapter operates in the LP form much as it does in fund structured LLCs, but with terminology and structural references aligned to the LP Act. Limited partner consent rights, the LPAC's authority to approve affiliated transactions and waive specific investment policy provisions, and the LPAC's role as a check on general partner discretion all carry forward. The principal differences relate to how the consent process interacts with the general partner's management authority under the LP Act, and to the specific provisions of the LP agreement that authorize LPAC action on the limited partners' behalf. LP agreement drafting should reflect these structural differences rather than simply renaming LLC concepts with LP terminology.

### **Tax Considerations Specific to the LP Form**

The LP structure carries certain tax advantages and considerations that differ from the LLC structure. Limited partners in an LP are passive investors for tax purposes by definition. Their partnership income and losses are passive income and losses regardless of the limited partner's level of involvement. This passive classification can be advantageous for investors who are seeking passive income to absorb passive losses from other investments, but it also means limited partners cannot claim active trade or business status for LP income under any circumstances.

The general partner in an LP (whether an individual or a GP entity) is allocated all of the self-employment income from the partnership's activities, which may create self-employment tax exposure that does not arise in the LLC context. For fund structures with significant management fee income, the GP entity's tax treatment of that income must be specifically analyzed.

## Pre-Launch Operating Agreement Review Checklist

The following checklist identifies the most common deficiencies in real estate syndication operating agreements. Each item represents a provision that should be specifically addressed and specifically drafted, not left to implication, not incorporated by reference to a statutory default, and not assumed to be standard without confirming it is present.

| Provision Area                  | Key Questions to Confirm                                                                                                                                                                                                                                 |
|---------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Ownership interests and units   | Are interests expressed as percentages or units? Is the total authorized amount specified? Is the pro rata calculation methodology defined?                                                                                                              |
| Capital accounts                | Do capital account mechanics comply with Treasury regulation substantial economic effect requirements? Is the distinction between capital account, book value, and FMV specified for each calculation that uses one of those measures?                   |
| Preferred return: type          | Is the preferred return cumulative or non-cumulative? Is this specifically stated, not left to inference? Does the PPM disclose non-cumulative treatment if that is the structure?                                                                       |
| Preferred return: accrual       | Is the accrual simple or compounding? Is the calculation period (daily, monthly, annual) specified? Is the base (unreturned capital, total commitment) defined?                                                                                          |
| Distribution waterfall          | Is the four tier structure (return of capital, preferred return, catch up, residual split) precisely stated for both operating and liquidating distributions? Are interim distribution interactions addressed?                                           |
| Catch up provisions             | Is the catch up full or partial? Is the catch up rate (typically $\text{promote} \div (1 - \text{promote})$ for an institutional standard calibration) specifically defined? Does it apply to operating distributions or only liquidating distributions? |
| Clawback provisions             | Is the clawback calculation methodology specified (deal by deal vs. fund level)? Is it pre or post-tax? Is security for the obligation (escrow) required?                                                                                                |
| IRR and equity multiple hurdles | If IRR based hurdles are used, is the calculation methodology specified precisely enough for the fund administrator to apply at every distribution event?                                                                                                |
| Manager authority               | Are manager only decisions and major decisions clearly defined with specific thresholds? Is the major decision definition calibrated to this specific deal's risk profile?                                                                               |

| Provision Area                  | Key Questions to Confirm                                                                                                                                                                                   |
|---------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Manager removal                 | Is the for cause definition specific (not just material breach)? Is the vote threshold, cure period, and economic treatment upon removal all specified?                                                    |
| Key person provisions           | If key person provisions are included, are the key persons named? Is the consequence of key person departure clearly defined?                                                                              |
| Fee provisions                  | Are all fees specifically authorized with calculation basis, amount, timing, and recipient identified? Is the management fee offset structure defined: which fee categories offset and at what percentage? |
| Affiliated arrangements         | Are all affiliated service arrangements (property management, construction management) specifically authorized with a market rate representation?                                                          |
| Information rights              | Are quarterly and annual reporting obligations specified with deadlines? Is the K-1 deadline addressed? Is the audit right defined?                                                                        |
| Capital calls (fund)            | Are capital call notice requirements, funding deadline, and defaulting investor provisions specified? Are pro rata rights defined with operational procedures?                                             |
| Fund term and investment period | Are the fund term and investment period specified? Are extension conditions and required approvals defined?                                                                                                |
| Subsequent closings             | Is the equalization mechanism specified: rate, calculation methodology, and whether payment flows to the fund or initial investors?                                                                        |
| LPAC                            | Is the LPAC's composition, authority, and decision making process specifically defined? Is the scope of LPAC consent rights distinct from all member voting rights?                                        |
| Transfer restrictions           | Are Rule 144 holding period (from acquisition date), manager consent, ROFR, transferee eligibility, and ERISA threshold provisions all present?                                                            |
| Lender consent                  | Has the loan agreement transfer restriction been reviewed? Does the operating agreement document the approach to lender consent?                                                                           |
| Voting mechanics                | Are notice, record date, quorum, and tabulation procedures specified? Are thresholds differentiated by decision type?                                                                                      |
| Disposition authority           | Is the manager's exit authority defined with any investor consent conditions? Is the final waterfall precisely stated including all pre waterfall deductions?                                              |
| Dissolution                     | Is the dissolution process specified after final distribution? Is the manager authorized to execute all dissolution steps?                                                                                 |
| ERISA                           | Does the operating agreement include benefit plan investor representations, 25% threshold monitoring provisions, and transfer restrictions protecting the threshold?                                       |
| Consistency with PPM            | Do the operating agreement's economic terms, governance rights, and transfer restrictions match the PPM's descriptions? Has securities counsel compared all three offering documents?                      |



## Practical Takeaways

- The operating agreement is the most important document in a real estate syndication, not the PPM, not the subscription agreement. It governs the investment relationship for the entire hold period and controls every material event that occurs during that time. The quality of the operating agreement determines the quality of the investment structure.
- Investment terms (preferred return, waterfall, promote, catch up) are legal terms that live in the operating agreement. Their meaning, their calculation methodology, and the remedies available when they are not honored are all determined by the specific language of that document. In well drafted governing documents, both parties can calculate the outcome of any distribution event without ambiguity. In poorly drafted documents, they generate the disputes that end up in arbitration.
- The preferred return's economic mechanics require three specific disclosures: cumulative or non-cumulative, simple or compounding accrual, and the base on which accrual is calculated. Silence on any of these points is not a drafting economy. It is a future dispute. An offering that markets an 8% preferred return but implements a non-cumulative structure without disclosure has created a material omission under the antifraud standard.
- The distribution waterfall must be precise enough that the fund administrator can calculate each tier without interpretation. The most common waterfall ambiguities (the interaction between interim operating distributions and the preferred return calculation at exit, the treatment of investors who contributed at different times, the calibration of the catch up rate, and the scope of the catch up) are predictable scenarios. An operating agreement that does not address them specifically is not a well drafted governing document.
- The catch up rate must be specified explicitly in the operating agreement. A catch up rate of  $\text{promote} \div (1 - \text{promote})$  (which equals 25% for a 20% promote, 33% for a 25% promote, and so on) calibrates the catch up so the sponsor reaches exactly the stated promote percentage of total profits. Other catch up rates produce a sponsor effective share different from the promote percentage and must be specifically disclosed in the PPM as a divergence from market standard.
- Clawback provisions require specific treatment of four questions: calculation methodology (deal by deal or fund level), Pre-tax versus post-tax, timing of the obligation, and security for the obligation. Generic clawback language that leaves these questions open creates uncertainty about what the clawback actually requires when it is triggered.
- Present both IRR and equity multiple to investors. Presenting only IRR omits total return information. Presenting only equity multiple omits time information. Both metrics together, alongside the expected hold period, give investors the most complete return

picture. Favoring the metric that makes the specific deal look best is incomplete disclosure.

- Capital call commitments are legal obligations, not statements of intent. The operating agreement's defaulting investor provisions (forfeiture, dilution, forced loan, exclusion from future investments) are the teeth behind the commitment. Whatever the specific provisions, they must be disclosed in the PPM before investors commit.
- Management fee offset structures determine how much of the management fee the sponsor actually retains after accounting for affiliated fees. The offset percentage, the fee categories subject to offset, and the calculation methodology must be specified with precision. A PPM that discloses a management fee without explaining the offset structure has not provided adequate disclosure of the sponsor's net compensation.
- For fund structures, the investment period and fund term define the temporal boundaries of the commitment. The transition from committed capital to invested capital for management fee purposes, the key person suspension of the investment period, and the extension conditions must all be addressed in the operating agreement. Subsequent closing equalization mechanics prevent late investors from free riding on early deployment.
- Major decision provisions must define both what decisions require investor consent and what the consent threshold is. Vague major decision definitions create disputes rather than resolve them. Specificity protects both sponsors and investors.
- Manager removal provisions must be specific: the events constituting cause, the vote threshold, the cure period, the economic treatment of the manager's promote and fees upon removal, and the process for appointing a replacement manager. Removal provisions drafted in general terms will be litigated when investors try to exercise them.
- Transfer restriction provisions must describe the complete restriction framework: Rule 144 holding period from the acquisition date (not subscription date), manager consent requirement, ROFR mechanics, transferee eligibility conditions, ERISA benefit plan investor transfer restrictions, and lender consent requirements. Each element serves a different function and all must be present.
- Lender consent to secondary transfers must be confirmed before any offering describes secondary market access as a feature. A secondary transfer program that systematically breaches the loan agreement's transfer restriction covenants creates loan acceleration risk that is existential for the offering.
- The operating agreement must be consistent with the PPM and the subscription agreement. Economic terms, governance rights, transfer restrictions, and hold period must match across all three documents. Any discrepancy creates a disclosure failure with antifraud implications.

- The single most expensive mistake in real estate syndication is a well designed offering built on a poorly drafted operating agreement. The incremental cost of well drafted governing documents, prepared by securities counsel with specific real estate syndication experience, is modest compared to the cost of resolving disputes that arise because the operating agreement did not provide clear answers to predictable questions.

**CHAPTER EIGHTEEN****What Is a “Busted Exemption”?**

Most sponsors who structure private real estate offerings never face a regulatory enforcement action or an investor rescission claim. But most sponsors who do face one did not expect to, and many could have avoided it with choices that seemed minor at the time. The distance between a well-structured offering and an enforcement problem is not as wide as sponsors tend to imagine, and it shrinks considerably when corners are cut in offering documentation, when general solicitation discipline breaks down, or when the conditions of the chosen exemption are not consistently maintained throughout the offering period.

A busted exemption is one of the most consequential problems that can arise in a private real estate syndication. The term refers to a private securities offering that has lost the benefit of the regulatory exemption it was relying upon. When that happens, the offering is no longer a valid private placement under the Securities Act of 1933. It is an unregistered public offering, a violation of Section 5 of the Securities Act, with all the liability, regulatory exposure, and investor remedies that classification carries.

The consequences are not theoretical, and they are not limited to administrative fines. Section 12(a)(1) of the Securities Act gives every investor in an unregistered offering the right to demand rescission: to get their money back, with interest, regardless of how the underlying investment has performed. In a real estate syndication where investor capital has been deployed into an illiquid property, rescission demands from the full investor population are not merely a legal inconvenience. They are potentially catastrophic. They may require forced liquidation of the underlying asset, may trigger default under the property's debt arrangements, may expose the sponsor's principals to personal liability, and may destroy a business that took years to build.

This chapter covers how Regulation D exemptions are lost, the specific failure patterns that most reliably produce exemption failures, the integration doctrine that can inadvertently combine two separate offerings into one unregistered offering, the consequences of a busted exemption across all dimensions (investor rescission, SEC enforcement, state liability, and criminal exposure), and the limited remediation strategies available when an exemption is already compromised.

**How Exemptions Are Lost**

The Regulation D exemptions (Rule 506(b) and Rule 506(c)) are not self-executing. They are conditional privileges. The exemption is available if the issuer satisfies every applicable

condition, and the exemption fails if any material condition is violated. The conditions are specific, they are not subject to informal negotiation or adjustment, and they do not have a grace period for minor violations.

Understanding the mechanism of exemption loss is important because it operates differently than most sponsors expect. An exemption is not formally revoked by a regulator in real time. The issuer does not receive a notice that the exemption has been lost and must stop raising capital. Rather, the exemption retroactively fails to apply, which means every sale of securities made without a valid exemption was a sale of unregistered securities from the moment it occurred. The violation is complete when the disqualifying event happens, not when it is discovered. The investor remedies, most significantly the Section 12(a)(1) rescission right, attach to every sale in the offering, not just the sales that followed the violation.

This retroactive character is one of the most important features of the securities law framework for sponsors to internalize. A general solicitation that occurred three months into a 506(b) offering, at a point when twenty investors had already subscribed, potentially taints the entire offering, not just future investor communications, but the sales to those twenty investors who subscribed before the solicitation occurred. The exemption that was supposed to cover those earlier sales no longer applies, and each of those investors has rescission rights that may not have existed the day before the general solicitation happened.

The failure modes fall into identifiable categories. Some involve affirmative conduct (doing something the exemption prohibits). Others are omissions (failing to satisfy a required condition). Still others involve third party conduct for which the sponsor bears legal responsibility. Understanding each category is the foundation of a compliance program that specifically addresses all of them.

## Common Exemption Busters

### General Solicitation in a 506(b) Offering

The single most common cause of Regulation D exemption failure in the current era of digital marketing is general solicitation in a 506(b) offering. Rule 506(b) absolutely prohibits any form of general solicitation or general advertising in connection with the offering. The prohibition covers any communication directed at the general public that promotes a specific securities offering: social media posts describing the deal, publicly accessible investment portals, email campaigns to unscreened contact lists, podcast appearances that describe a specific current capital raise, and paid advertising of any kind. There is no de minimis exception, no safe harbor for a single post, and no cure period that allows the sponsor to retroactively walk back a communication that constituted general solicitation.

What makes general solicitation particularly dangerous as an exemption buster is its irreversibility. Once a communication that constitutes general solicitation has been made in connection with a specific 506(b) offering, that offering cannot continue to rely on 506(b). The only path forward, if the sponsor wants to continue the offering, is to convert to 506(c), which requires verified accreditation of every investor. That creates its own problem. Investors who subscribed under 506(b) self-certification now need to be re verified under 506(c)'s stricter documentation standard, a process that is operationally complex and legally uncertain.

The digital marketing context amplifies this risk considerably. A sponsor who has been building a public social media presence with educational content, and who then mentions in a LinkedIn post that they are currently raising capital for a specific acquisition, may have crossed the line even without providing offering terms, links to an investment portal, or an explicit invitation to participate. The SEC's general solicitation analysis focuses on whether the communication conditions the public mind with respect to the offering, and a public announcement of a current capital raise on a platform that reaches thousands of followers is difficult to characterize as anything other than a public offering of securities.

### **⚠ General Solicitation That Has Occurred Cannot Be Undone**

*The most important characteristic of general solicitation as an exemption buster is that it is irreversible. Once a communication that constitutes general solicitation has been made in connection with a 506(b) offering, the exemption may be compromised for the entire offering, not just prospectively, but retroactively for every investor who subscribed before the violation occurred.*

*There is no regulatory cure for general solicitation that has already happened. There is no grace period. There is no correction mechanism short of converting the entire offering to 506(c) and re verifying every prior investor's accreditation through the documentation methods Rule 506(c) requires.*

*The analysis of whether specific marketing activity constitutes general solicitation, and whether the offering will proceed under 506(b) or 506(c), must be completed before any marketing occurs. Sponsors who begin marketing a specific offering and then ask their attorney whether they have engaged in general solicitation are asking the wrong question at the wrong time.*

## **Sales to Non-accredited Investors in a 506(c) Offering**

Rule 506(c) is available only for offerings limited exclusively to accredited investors with verified accreditation. The admission of a single non-accredited investor to a 506(c) offering, regardless

of how sophisticated that investor may be, regardless of how small their investment, regardless of whether the admission was inadvertent, destroys the 506(c) exemption for the entire offering.

Unlike Rule 506(b), which expressly allows up to 35 sophisticated non-accredited investors, Rule 506(c) has no tolerance for non-accredited investor participation. This creates two distinct failure paths: admitting an investor who was genuinely non-accredited, and accepting investment from an investor whose accreditation was not actually verified through the documentation methods Rule 506(c) requires.

The second path is the more common one in practice. Many sponsors who believe they are conducting 506(c) offerings are actually conducting 506(b) offerings with general solicitation, because they are accepting investor self-certification of accreditation rather than the documentation review (or the no action letter equivalent) that 506(c) mandates. Self-certification satisfies 506(b). It does not satisfy 506(c). A 506(c) offering where investors self-certify accreditation through a subscription agreement checkbox is not a 506(c) offering. It is an unregistered public offering: general solicitation without the verification that gives 506(c) its legal foundation.

### **Exceeding the 35 Non-accredited Investor Limit Under 506(b)**

Rule 506(b) permits up to 35 non-accredited but sophisticated investors to participate in a single offering. This limit is aggregate. It applies across the entire offering, across all closings, including secondary transfers of interests to non-accredited investors. Once the 35 investor cap is reached, no additional non-accredited investors may be admitted to any subsequent closing without busting the exemption.

The cap creates administrative complexity that most sponsors underestimate when they first admit non-accredited investors to a 506(b) offering. The count must be tracked across every closing and every secondary transfer for the life of the offering. An investor who sells their interest to a non-accredited buyer in a secondary transfer increases the count even if the original investor was themselves non-accredited, because the transfer creates a new investor relationship with the entity. An operating agreement that does not specifically restrict secondary transfers to accredited investors is an operating agreement that could inadvertently produce a violation through a secondary transfer the sponsor did not review.

This operational burden is one of the primary reasons most sponsors conducting 506(b) offerings limit participation exclusively to accredited investors even though the rule technically permits non-accredited participation. The theoretical flexibility of the 35 investor allowance is rarely worth the administrative tracking obligation it creates across the offering's lifetime.

### **Misrepresentation or Omission in Offering Documents**

A valid exemption with fraudulent disclosure is not a legal offering. It is a fraud. Under the antifraud provisions of the securities laws (Section 17(a) of the Securities Act and Rule 10b-5 under the Securities Exchange Act) a material misstatement or misleading omission in connection with the offer or sale of a security creates fraud liability regardless of whether the underlying exemption is otherwise intact.

The distinction between a busted exemption and a fraud claim matters because the legal consequences differ in important ways. A busted exemption produces Section 12(a)(1) strict liability rescission rights, subject to the one year and three year limitations periods under Section 13 of the Securities Act. A fraudulent misrepresentation produces Section 12(a)(2) liability (for written misrepresentations and oral communications) and Rule 10b-5 claims (for any connection to a securities transaction), with different standards of proof, different causation requirements, and potentially different damages calculations. In the worst cases, both apply simultaneously to the same offering: the exemption failure opens up Section 12(a)(1) strict liability while the misrepresentation opens Rule 10b-5 and Section 12(a)(2) liability.

The categories of materially misleading disclosure that appear most frequently in private real estate syndication PPMs: projections presented as likely outcomes rather than estimates; track record presentations that cherry pick successful exits while omitting underperforming or failed investments; liquidity representations that describe hoped for secondary market access as if it currently exists; fee structures described less completely in marketing materials than in the operating agreement; and conflict of interest disclosures that identify the conflict generically without explaining its specific economic implications.

### **⚠ A Technically Valid Exemption With Fraudulent Disclosure Is Not a Legal Offering**

*The securities laws' private placement exemptions protect sponsors from the registration requirement. They do not protect against the antifraud provisions. A sponsor who structures a technically valid 506(c) offering (accredited investors only, properly verified, Form D filed) but who misrepresents the investment's return history, conceals material conflicts of interest, or provides a PPM with risk factors that are generic boilerplate unrelated to the actual risks of the specific deal, has not achieved compliance.*

*The exemption availability and the antifraud obligations are independent. Satisfying one does not satisfy the other. Both must be met for an offering to be legally sound, and the failure of either exposes the sponsor to investor claims and regulatory enforcement.*

## **Failure to Timely File Form D**



Rule 503 requires that Form D be filed with the SEC within 15 calendar days of the date of first sale of securities in any Regulation D offering. Missing this deadline does not automatically bust the exemption. The SEC's position is that a late or missing Form D filing does not, by itself, disqualify the offering from the exemption. But the consequences of a missed filing are real and compounding.

In most states, the state securities law notice filing is required concurrently with or shortly after the federal Form D. A sponsor who never files the federal Form D has therefore also failed to file state notices, creating state level compliance failures in every state where investors reside. Some states treat state notice filing failures as independent bases for investor rescission claims. The failure that starts as an administrative oversight can cascade into substantive investor remedies at the state level even if the federal exemption remains technically intact.

Beyond the immediate consequences, a history of missing or late Form D filings is visible on EDGAR to anyone who checks: institutional investors, potential co-sponsors, successor buyers in secondary transactions, and SEC examiners. A Form D history that shows systematic non filing, late filing, or inaccurate exemption identification signals a compliance culture that raises broader questions about how the offering was structured and operated.

## Integration of Separate Offerings

Integration is a doctrine under which what appear to be two separate securities offerings are treated as a single offering for exemption purposes. When two offerings are integrated, the conditions of the chosen exemption must be satisfied across the combined offering, which frequently means the combined offering exceeds the limits of the exemption that each individual offering satisfied on its own.

The classic integration scenario in real estate syndication: a sponsor closes a 506(b) offering for one property, then shortly afterward launches a second 506(b) offering for an adjacent acquisition. The two offerings are separate in the sponsor's mind (different SPVs, different investors, different properties). But if the SEC views them as integrated, the two offerings are one offering, and all of the investors in both, including the non-accredited investors admitted to each offering individually, count together against the combined 35 investor limit.

## Integration Doctrine: When Two Offerings Become One

The integration doctrine exists to prevent issuers from avoiding the substantive requirements of a securities exemption by artificially dividing what is functionally one offering into multiple smaller offerings, each of which appears to satisfy the exemption's conditions. If the doctrine did not exist, a sponsor could raise unlimited capital from non-accredited investors by structuring a

series of small offerings, each under the 35 investor cap, which together constitute a massive unregistered public offering.

The original integration framework, developed by the SEC through decades of guidance and no action letters, was replaced in 2020 with a more structured approach codified in Rule 152. The current SEC rules provide both a safe harbor from integration and a general principle for analyzing whether integration applies when the safe harbor is not available.

## The Current Integration Framework

Under Rule 152(a), the general principle is that offerings will not be integrated if each offering either complies with the registration requirements of the Securities Act or relies on an available exemption for which all conditions are independently satisfied. Beyond this general principle, Rule 152(b) provides four non-exclusive safe harbors that protect distinct offering activities from integration regardless of the general analysis.

The 30 day safe harbor under Rule 152(b)(1) is the primary practical tool for preventing integration in serial real estate offerings. Any offering made more than 30 calendar days before the commencement of any other offering, or more than 30 calendar days after the termination or completion of any other offering, will not be integrated with such other offering. If a sponsor completes one offering and waits at least 30 calendar days before commencing the next, the two offerings will not be integrated under the current rule, regardless of any factual similarities between them.

There is one nuance to the 30 day safe harbor that matters specifically in the syndication context. Where an exempt offering that prohibits general solicitation (such as a Rule 506(b) offering) follows by 30 or more calendar days an offering that permits general solicitation (such as a Rule 506(c) offering, Regulation A, or Regulation Crowdfunding), the issuer must have a reasonable belief that, for each purchaser in the later 506(b) offering, the issuer either did not solicit the purchaser through general solicitation in the prior offering or established a substantive relationship with the purchaser before the commencement of the 506(b) offering. This proviso prevents the safe harbor from being used to launder general solicitation contacts into a 506(b) offering.

If neither the 30 day safe harbor nor another Rule 152(b) safe harbor is available because the offerings are closer in time or otherwise not within the safe harbor's conditions, the general principle under Rule 152(a) applies. The SEC has indicated that the prior facts and circumstances analysis (which historically considered factors such as whether the sales were part of a single plan of financing, whether they involved the same class of security, whether they were made at around the same time, whether the same type of consideration was received, and whether the sales were made for the same general purpose) remains relevant context for the

Rule 152(a) analysis, but the safe harbors are the primary practical tool for sponsors who want certainty.

### Other Rule 152(b) Safe Harbors

Three additional safe harbors codified in Rule 152(b) protect specific offering activities from integration.

- Rule 152(b)(2) protects employee compensation offerings under Rule 701, employee benefit plan offerings, and offshore offerings under Regulation S from integration with other concurrent offerings.
- Rule 152(b)(3) protects a registered offering from integration with prior terminated or completed exempt offerings under conditions specified in the rule.
- Rule 152(b)(4) protects an exempt offering permitting general solicitation from integration with a prior terminated or completed exempt offering conducted under an exemption prohibiting general solicitation.

For most real estate sponsors operating under Regulation D, the practical integration safe harbor is the 30 day rule under Rule 152(b)(1). Planning the timing of consecutive offerings with at least 30 days between the completion of one and the commencement of the next provides certainty against integration claims.

### Practical Guidance on Separating Offerings

The integration question most commonly arises in three scenarios for real estate sponsors.

**Consecutive single asset offerings.** A sponsor who closes a 506(b) offering for Property A and immediately begins raising capital for Property B faces integration risk if the two offerings are close in time, involve similar investor populations, and use similar offering terms. The solution is straightforward: wait at least 30 days after the close of the first offering before commencing the second.

**Bridge financing followed by a private placement.** A sponsor who raises a small amount of bridge capital from a handful of investors (friends, family, close associates) before launching a formal offering sometimes creates an integration problem by treating the bridge as an informal arrangement outside the securities laws. Any bridge financing that involves the sale of a security must be analyzed under the exemption framework, and the bridge must either qualify for its own exemption that is separate from the main offering or be structured to fall within a safe harbor from integration.

**Multiple property offerings in a short period.** A sponsor running a platform that launches multiple offerings close in time, whether multiple properties offered simultaneously or in rapid succession, faces the most complex integration analysis. Each offering must be independently

analyzed for integration risk, and where offerings overlap in time, the investor populations, the class of security, and the terms must be sufficiently distinct to support separate exemption treatment.

### **Integration Safe Harbor Timeline: Consecutive 506(b) Offerings**

#### **Offering A**

Launched January 1. First sale January 15. Final close March 31.

#### **Safe Harbor Satisfied**

Begin Offering B on or after April 30 (30 days after the last sale in Offering A, which occurred at the March 31 final close).

#### **Integration Risk**

Begin Offering B before April 30 while Offering A is still open, or within 30 days of its close, particularly if investors overlap or the securities are the same class (for example, equity membership interests in similar SPVs). The 30 day clock runs from the last sale in the prior offering, not from the initial close or the first sale. For ongoing multi closing offerings, the final sale date may be significantly later than the initial closing.

## **Consequences of a Busted Exemption**

The consequences of a busted exemption fall into four distinct categories that can arise simultaneously and compound each other: investor rescission rights under federal law, SEC enforcement exposure, state securities law liability, and criminal exposure for willful violations. Understanding each category separately, and understanding how they interact, is essential for assessing the full risk profile of an exemption failure.

### **Rescission Rights of Investors**

Section 12(a)(1) of the Securities Act provides that any person who offers or sells a security in violation of Section 5 (the provision requiring registration or a valid exemption) is liable to the purchaser for the consideration paid, plus interest at the applicable rate, less any income received, upon tender of the security. This is the rescission right, and it is strict liability. The investor does not need to prove that the sponsor knew about the violation, that the sponsor acted in bad faith, or that the investment performed poorly. They need only show that securities were offered or sold without registration or a valid exemption.

The financial exposure from rescission rights is calculated as capital invested plus interest at the applicable statutory rate (which varies by jurisdiction) less any income received from the investment. For a \$10 million offering outstanding for two years at a 5% annual rate, the

rescission exposure could approach \$11 million even before accounting for legal fees. For a larger offering or a longer period, the numbers scale accordingly. If the invested capital has been fully deployed into an illiquid real estate asset, the sponsor faces a rescission obligation that the operating entity may not be able to satisfy, potentially triggering default under the property's debt arrangements and threatening the viability of the investment for every investor, including those who are not seeking rescission.

The limitations framework for Section 12(a)(1) is set out in Section 13 of the Securities Act (15 U.S.C. § 77m) and is strict. The action must be brought within one year after the violation upon which it is based, and in no event more than three years after the security was bona fide offered to the public. Unlike Section 12(a)(2), Section 12(a)(1) does not include a discovery rule. The one year period runs from the date of the violation itself, not from the date the investor learned of the violation. Courts have consistently rejected attempts to import a discovery component into the 12(a)(1) limitations period. The three year provision is a statute of repose that the Supreme Court has confirmed is not subject to equitable tolling.

Section 12(a)(2) of the Securities Act provides an additional and complementary rescission right for sales made by means of a prospectus or oral communication that includes a material misrepresentation or omission. Section 12(a)(2) has its own limitations rule: one year after the discovery of the untrue statement or omission (or after such discovery should have been made by the exercise of reasonable diligence), with an absolute three year statute of repose. The defendant can avoid liability under Section 12(a)(2) by demonstrating due care (that they did not know, and in the exercise of reasonable care could not have known, of the misrepresentation). This due care defense is not available under Section 12(a)(1), which is strict liability. The two provisions operate in parallel, and a fraudulent offering with a busted exemption may simultaneously produce claims under both.

## SEC Enforcement Exposure

The SEC has civil enforcement authority over securities law violations that allows it to seek injunctive relief, disgorgement of illegal profits, civil money penalties, and bars from future participation in securities offerings. For a busted exemption that resulted from inadvertent noncompliance with a technical condition (a late Form D filing, a general solicitation made without understanding that it constituted solicitation) the SEC's enforcement response is typically proportionate to the violation's severity, the sponsor's compliance posture, and whether investors were actually harmed.

For more serious violations (intentional general solicitation in a 506(b) offering, deliberate admission of non-accredited investors to circumvent disclosure requirements, or sale of securities to investors who were not vetted at all) the SEC's enforcement response can include substantial civil penalties, disgorgement of all compensation received in connection with the

offering, and a bar from participating in future Regulation D offerings. For violations involving fraud, the penalties are substantially higher and can include bars from the securities industry more broadly.

Civil monetary penalties under the federal securities laws are structured in three tiers based on the nature of the violation, are assessed per act or omission, and are adjusted annually for inflation under the Federal Civil Penalties Inflation Adjustment Act Improvements Act of 2015. Tier 1 applies to any violation regardless of intent and reaches the lowest threshold. Tier 2 applies to violations involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and produces materially higher per act penalties. Tier 3 applies to violations that also involve substantial losses to others or substantial gains to the violator and produces the highest per act penalties. The current inflation adjusted penalty amounts under each tier are published annually by the SEC. Because penalties are assessed per act or omission, the total civil penalty exposure in an enforcement action involving a multi investor offering can substantially exceed the per act figures published in any given year.

SEC enforcement can be triggered by investor complaints, routine examination of EDGAR filings, referrals from state securities regulators, tips from former employees or business partners, or the SEC's own monitoring of public marketing activity. For offerings with digital marketing programs (social media posts, websites, email campaigns) the SEC's ability to identify potential violations through publicly accessible materials is significantly greater than in the era of purely private capital raises.

## State Securities Law Liability

State securities regulators retain independent enforcement authority under their blue sky laws regardless of whether the federal exemption is otherwise intact. A state regulator can pursue enforcement actions for fraud and misrepresentation in offerings made within their borders even when the federal exemption is valid. For a busted federal exemption, state enforcement authority adds an additional layer of liability with state specific penalties, disgorgement requirements, and future offering restrictions that operate independently of whatever the SEC may or may not pursue.

Several states are particularly active in private offering enforcement. California's Department of Financial Protection and Innovation has one of the most active state securities enforcement programs in the country. New York's Martin Act is one of the broadest state securities fraud statutes in the United States, and the New York Attorney General's office enforces it aggressively. Texas, Massachusetts, and other states with major investor populations maintain active enforcement postures that can be triggered by investor complaints or SEC referrals.

State regulators also coordinate through NASAA, the North American Securities Administrators Association, which issues model rules, enforcement guidance, and coordinates multi-state investigations. A compliance failure that triggers attention from one state regulator can result in NASAA coordinated inquiries from multiple states simultaneously. For a sponsor conducting a nationally marketed 506(c) offering with investors in dozens of states, a compliance failure can attract concurrent attention from multiple state regulators across the investor base.

State securities law violations can also produce rescission rights under state law, independent of the federal Section 12(a)(1) right. A failure to make a required state notice filing, even if the federal exemption remains intact, can provide investors in that state with a state law rescission right that did not exist before the state filing failure.

### **Criminal Exposure for Willful Violations**

Willful violations of the securities laws (including willful violations of Section 5 and willful securities fraud under Section 17(a)) can result in criminal prosecution by the Department of Justice. Criminal penalties for willful securities violations include prison terms of up to five years for Section 5 violations under Section 24 of the Securities Act, and up to twenty years for securities fraud under 18 U.S.C. § 1348, along with substantial monetary fines. Criminal prosecution is relatively rare compared to civil enforcement, but it occurs with consistency in cases involving intentional fraud, Ponzi like structures, misappropriation of investor funds, and egregious misrepresentations.

The most relevant criminal risk for real estate sponsors is not the inadvertent exemption failure that arises from ignorance or misunderstanding of the exemption's requirements. It is intentional misrepresentation: a PPM that describes the sponsor's track record in a way known to be false, a use of proceeds section that misrepresents how investor capital will be used, financial reporting to investors that misrepresents the property's actual operating performance, or capital raise activity that deliberately conceals the lack of a valid exemption. The criminal standard requires willfulness (knowing, intentional violation) which draws a meaningful distinction between good faith compliance failures and deliberate fraud.

Criminal liability for securities fraud is personal, not just corporate. The corporate entity may be fined, but the individual sponsors and principals who made the decisions that constituted the fraud can be imprisoned. For a real estate syndication sponsor who is simultaneously managing a portfolio of properties and an investor base, the prospect of individual criminal liability for offering conduct is a risk that justifies the investment in proper legal counsel and documented compliance processes at every stage of the offering.



## Remediation Strategies When an Exemption Is Compromised

Discovering that an exemption has been compromised after the offering has launched, and investors have subscribed, is a legal emergency. The instinct is to fix the problem immediately: contact investors, resolve informally, reach out to the SEC proactively. Each of those instincts, acted upon without qualified securities counsel, creates its own problems. Informal investor communications about a potential violation may constitute an unregistered offer of rescission. Voluntary SEC disclosure without counsel may not be structured to take advantage of available cooperation credit. The response framework matters as much as the discovery.

### Step 1: Stop the Violating Activity Immediately

When a compliance failure is discovered (a general solicitation event in a 506(b) offering, an ineligible investor who was admitted, an unregistered person receiving transaction based compensation for introducing investors) stop the activity that caused the failure immediately. Do not continue marketing under a compromised exemption. Do not accept additional subscriptions while the violation is being analyzed. Continuing the violating activity while conducting an internal review does not preserve options. It expands the exposure and may be evidence of intentional ongoing violation rather than inadvertent error.

### Step 2: Engage Qualified Securities Counsel Immediately

The compliance analysis of a potential securities law violation requires securities counsel with experience in SEC enforcement matters and private offering compliance, not general corporate counsel, not the sponsor's real estate attorney, not the sponsor's accountant. Engaging qualified securities counsel before taking any corrective action, before communicating with investors about the potential problem, and before contacting any regulatory authority is not just advisable. It is essential for preserving attorney client privilege and for structuring any subsequent actions appropriately.

Attorney client privilege attaches to communications with counsel about the violation. Communications made before counsel is engaged may not be privileged and may be discoverable in a subsequent regulatory proceeding or investor litigation. Counsel evaluates whether voluntary SEC disclosure is appropriate given the specific facts, whether a formal rescission offer is the right remediation approach, and what communications, if any, should be made to existing investors.

### Step 3: Preserve All Records

Place all records related to the offering on legal hold immediately: offering documents, investor communications, marketing materials, subscription agreements, financial records, and



communications related to the potentially violating activity. Do not delete, alter, or move any records related to the offering. Deletion or alteration of records after a potential violation is identified can constitute obstruction of justice or evidence spoliation, creating independent liability that compounds the original violation. This is a risk that sponsors sometimes create for themselves in the panic of discovering a problem, a risk that is entirely avoidable.

#### **Step 4: Assess Scope and Nature of the Violation**

With counsel engaged, the first priority is a structured assessment of what happened: which investors were affected, when the violation occurred, whether it was a single event or an ongoing pattern, and what legal consequences flow from the specific facts. This assessment determines which remediation options are available and which, if any, have already been foreclosed by the nature of the violation.

The scope of the rescission exposure is particularly important to quantify early. Rescission exposure equals, for each affected investor, the capital they invested plus interest at the applicable rate minus any income they received. For a large offering with many investors, this calculation may produce a number that significantly exceeds the current liquid assets of the offering entity, which affects the remediation strategy and the urgency of the situation.

#### **Step 5: Consider a Formal Rescission Offer**

A formal rescission offer (offering to buy back investor positions at the statutory rescission price) can, under certain circumstances, cut off the limitations period for investor claims. By giving all affected investors the right to rescind at the statutory price, and by providing appropriate disclosure of the violation and its consequences, the sponsor can cap potential rescission exposure rather than leaving it open to future discovery and litigation.

A rescission offer is a formal securities transaction that itself must comply with securities law. It is not simply sending investors a letter offering to buy their interests. The SEC has specific rules governing rescission offers, including timing requirements, disclosure requirements, and the mechanics of acceptance. A poorly structured rescission offer can create new liability rather than curing the original violation. This is counsel's domain, not the sponsor's unilateral action.

Not every violation warrants a formal rescission offer, and not every rescission offer is the best remediation strategy for a specific situation. The analysis depends on the nature and severity of the violation, the likely response rate among investors, the sponsor's ability to fund the rescission obligation, and the regulatory context. These are judgments that require-experienced securities counsel who has managed similar situations. There is no generic template that applies to every busted exemption.

#### **Step 6: Evaluate Voluntary SEC Disclosure**

Whether to voluntarily disclose a compliance failure to the SEC, and how to do so, is one of the most consequential strategic decisions in a remediation process. Voluntary cooperation with the SEC has historically been a factor in the agency's exercise of enforcement discretion, and it can produce meaningfully better outcomes than being the subject of an investigation that discovers the violation through other means. But voluntary disclosure that is poorly structured, that omits relevant facts, or that is not appropriately framed by experienced enforcement counsel can create problems as serious as the original violation.

This decision is counsel's to advise on, not the sponsor's to make unilaterally. The specific facts of the violation, the SEC's current enforcement posture, the severity of the investor harm (if any), and the sponsor's overall compliance history all affect the analysis. The default rule is clear: engage counsel first, and make no voluntary disclosure without counsel's guidance and involvement.

### **⚠ Never Take Corrective Action in Response to a Compliance Failure Without Engaging Qualified Securities Counsel First**

*The instinct when a compliance problem is discovered is to fix it immediately: contact the investor directly, offer to resolve informally, reach out to the SEC proactively without preparation. Each of these instincts, acted upon without counsel, creates its own problems.*

*Informal investor communications about a potential violation may constitute an unregistered offer of rescission, itself a potential securities violation. Voluntary SEC disclosure without counsel may not be structured to take advantage of available cooperation credit and may inadvertently waive protections.*

*Compliance failures are legal emergencies that require the same response as any other legal emergency: engage experienced counsel immediately and do not take action without their guidance.*

## **Compliance Failure Quick Reference**

The following table summarizes the common compliance failures, their legal consequences, and the immediate response steps. This table is a reference tool. The specific analysis for any given failure requires assessment by qualified securities counsel.

| Compliance Failure                        | Legal Consequences                                                                                      | Immediate Response                                                                                 |
|-------------------------------------------|---------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------|
| General solicitation in a 506(b) offering | Exemption potentially busted for all investors, including those who subscribed before the solicitation. | Cease all marketing immediately. Engage securities counsel. Assess whether conversion to 506(c) is |

| Compliance Failure                                                                | Legal Consequences                                                                                                                                                              | Immediate Response                                                                                                                                                                                                                               |
|-----------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                                                   | Section 12(a)(1) rescission rights for all investors. SEC enforcement exposure. State enforcement exposure.                                                                     | possible. Evaluate scope of rescission exposure. Do not accept new subscriptions.                                                                                                                                                                |
| Admission of non-accredited investor in a 506(c) offering                         | Potential exemption impairment for entire offering. Rescission right for the non-accredited investor. Possible rescission exposure for full investor pool if exemption is lost. | Engage securities counsel. Assess whether the investor can be rescinded individually. Evaluate impact on exemption availability for remaining investors. Strengthen verification procedures going forward.                                       |
| Exceeding 35 non-accredited investor limit in 506(b)                              | Exemption potentially busted at the moment the 36th non-accredited investor subscribes. Section 12(a)(1) rescission rights for all investors.                                   | Engage securities counsel. Stop accepting non-accredited investors immediately. Assess whether rescission of the excess investor or investors is possible and whether it would cure the violation.                                               |
| Self-certification accepted in lieu of required verification in a 506(c) offering | Offering may be a 506(b) offering with general solicitation, in other words an unregistered public offering. Section 12(a)(1) rescission rights. SEC enforcement exposure.      | Engage securities counsel. Assess the extent of general solicitation activity. Evaluate whether retroactive verification through documentation review or the March 2025 no action letter approach can cure the failure. Cease new subscriptions. |
| Material misrepresentation or omission in PPM                                     | Section 12(a)(2) rescission rights for all investors. Potential Rule 10b-5 fraud liability. Exemption may remain intact but offering is tainted by fraud exposure.              | Engage securities counsel. Assess materiality and scope of the misstatement. Prepare corrective disclosure. Deliver corrective disclosure to all investors before new subscriptions are accepted.                                                |
| Late or missing Form D filing                                                     | State notice filing failures cascade automatically. State level rescission exposure possible. Not automatically an exemption failure. Due diligence red flag.                   | File late with explanation. Engage securities counsel for state specific consequences. Remediate state notice failures in each investor state.                                                                                                   |
| Transaction based compensation to unregistered broker dealer                      | Broker dealer violation. Investors introduced through the broker have rescission rights independent of exemption status. SEC enforcement exposure.                              | Cease compensation arrangement immediately. Engage securities counsel. Assess rescission exposure for investors introduced through the broker. Evaluate voluntary SEC disclosure.                                                                |
| Integration of separate offerings                                                 | Combined offering may exceed individual exemption conditions.                                                                                                                   | Engage securities counsel. Assess whether the Rule 152(b)(1) 30 day                                                                                                                                                                              |

| Compliance Failure                                             | Legal Consequences                                                                                                                                                                            | Immediate Response                                                                                                                                                                                          |
|----------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                                | Rescission exposure across both offerings if the combined offering lacks a valid exemption.                                                                                                   | safe harbor or another safe harbor applies. Evaluate the facts and circumstances across both offerings. Stop new sales pending assessment.                                                                  |
| Bad actor disqualifying event discovered after offering launch | Potential exemption disqualification under Rule 506(d) from the date the offering began. Section 12(a)(1) rescission rights for all investors. SEC may waive disqualification on application. | Suspend new investor admissions immediately. Engage securities counsel. Apply for SEC waiver under Rule 506(d)(2)(ii). Assess rescission exposure. Do not disclose to investors without counsel's guidance. |

## Building the Compliance Culture That Prevents These Problems

The busted exemption scenarios described in this chapter share a common feature: they are almost all preventable with the processes, documentation, and professional relationships that a well-structured offering program maintains from the outset. The failures that produce rescission exposure and SEC enforcement are rarely failures of intent. They are failures of process, discipline, and the application of experienced professional judgment at the moments when it matters.

The compliance architecture that prevents exemption failures has several components, none of which is expensive relative to the potential consequences of their absence.

- Exemption selection made deliberately before any marketing begins, with a qualified securities attorney's involvement. The decision between 506(b) and 506(c) is not a marketing decision. It is a legal decision with irreversible consequences if the wrong choice is made or if marketing activity precedes the decision.
- A documented general solicitation policy that distinguishes permissible brand building activity from prohibited offering specific communications, implemented consistently across all marketing channels before any offering specific content is published.
- A documented investor qualification process that collects and retains the documentation required by the chosen exemption (verification documentation for 506(c), substantive background information for 506(b) sophistication assessments, entity eligibility analysis for entity investors) for every investor in every offering.

- A Form D filing calendar maintained by counsel or a compliance administrator, with the initial filing date and all annual amendment dates calendared in advance and monitored to ensure timely filing.
- A state blue sky filing calendar that tracks the investor states for each offering, the filing deadlines applicable in each state, and the annual renewal obligations. State filings are offering specific and state specific. They must be tracked separately for each offering.
- A bad actor questionnaire process completed by every covered person before any offering launches, with completed questionnaires retained as part of the offering's compliance record and updated annually and whenever a new covered person is added to the offering's structure.
- An integration analysis conducted before any new offering is launched, specifically addressing the timing and character of prior recent offerings and confirming that the new offering will be treated as separate for exemption purposes.
- A compliance calendar maintained across all active offerings, with all recurring obligations (annual Form D amendments, state renewal filings, bad actor monitoring updates, K-1 deadlines, financial reporting deadlines) tracked with advance reminders.

None of these elements is technically sophisticated. Each requires discipline, organization, and the application of legal judgment at appropriate decision points. The sponsors who face the most serious exemption failures are typically those who treated compliance as an afterthought, completing the PPM because it is obviously required, but not maintaining the ongoing compliance program that keeps the offering legally sound across its entire life.

Securities counsel with specific private real estate offering experience is not optional for any of these elements. The legal judgment about whether specific marketing activity constitutes general solicitation, whether a specific investor qualifies as sophisticated under 506(b), whether two offerings are integrated, and whether a discovered violation requires a rescission offer or voluntary SEC disclosure is not something a template or a checklist can substitute for. These are the judgment calls that determine whether a compliance failure is contained or catastrophic.

## Practical Takeaways

- A busted exemption is a Section 5 violation of the Securities Act, leaving the sponsor with an unregistered public offering. Every investor in the offering has a strict liability rescission right under Section 12(a)(1) (the right to demand return of their invested capital plus interest) regardless of whether the violation was intentional and regardless of how the underlying investment has performed.
- The rescission exposure from a busted exemption is calculated on the full amount invested by all investors in the offering, plus interest, minus any income received. For a

large offering outstanding for several years, this exposure can significantly exceed the current liquid assets of the offering entity, potentially threatening the viability of the investment for every investor, not just those seeking rescission.

- The Section 12(a)(1) limitations period under Section 13 of the Securities Act is one year from the violation itself and three years from when the security was bona fide offered to the public. There is no discovery rule for 12(a)(1) claims. Section 12(a)(2) by contrast has a one year from discovery and three year repose framework. Sponsors should not assume the three year repose period is the only limitations issue. The one year period from the violation can foreclose claims much sooner.
- General solicitation that has already occurred in connection with a 506(b) offering cannot be undone. The violation is complete and irreversible from the moment the communication was made. The exemption selection and the general solicitation analysis must be completed before any marketing activity, not during or after.
- Rule 506(c) requires verified accreditation for every investor, not self-certification through a subscription agreement checkbox. Self-certification satisfies 506(b). It does not satisfy 506(c). A 506(c) offering with self-certified accreditation is an unregistered public offering.
- The 35 investor limit for non-accredited investors in a 506(b) offering is an aggregate cap across the entire offering's lifetime, including secondary transfers. It must be tracked across all closings and all transfers. Once reached, no additional non-accredited investors may be admitted without busting the exemption.
- A technically valid exemption with fraudulent disclosure is not a legal offering. It is fraud. The antifraud provisions of the securities laws apply independently of the exemption analysis. Satisfying the exemption's conditions does not satisfy the antifraud provisions.
- The integration doctrine under Rule 152 can combine two separate offerings into one if they are close enough in time and otherwise satisfy the rule's integration principle. The 30 day safe harbor under Rule 152(b)(1) provides certainty: two offerings are not integrated if they are more than 30 days apart. Planning consecutive offerings with at least 30 days between them eliminates the integration risk in most cases. When a 506(b) follows a 506(c) by 30 days or more, the issuer must additionally have a reasonable belief about the absence of general solicitation contact with the 506(b) purchasers.
- State securities law liability exists independently of federal exemption status. State regulators retain antifraud enforcement authority regardless of whether the federal exemption is valid, and state notice filing failures can produce state law rescission rights independent of the federal analysis. A sponsor who relies on federal preemption to avoid state compliance has misunderstood what federal preemption covers.
- SEC civil monetary penalties are structured in three tiers (any violation, fraud or reckless disregard, and substantial loss or gain) assessed per act or omission, and adjusted

annually for inflation. Because penalties are assessed per act in an enforcement action involving a multi investor offering, the total civil penalty exposure can substantially exceed the per act figures published in any given year.

- Criminal liability for willful securities violations is personal. Individual sponsors and principals can be imprisoned for knowing, intentional violations of the securities laws, including intentional fraud. The criminal risk is most concentrated in cases of deliberate misrepresentation, misappropriation of investor funds, and intentional evasion of registration requirements.
- When a compliance failure is discovered, engage qualified securities counsel immediately and take no corrective action without their guidance. Informal investor communications about the potential violation, unilateral rescission offers, and uncoordinated voluntary SEC disclosure each create their own legal problems that compound the original violation. Compliance failures are legal emergencies that require experienced professional response.
- The compliance architecture that prevents exemption failures (deliberate exemption selection, documented general solicitation policies, rigorous investor qualification, timely Form D and state blue sky filings, bad actor questionnaires, integration analysis, and a maintained compliance calendar) costs a fraction of what a single busted exemption costs to remediate. The investment in prevention is the only rational posture.

## CHAPTER NINETEEN

# Form D and Blue Sky Filings

State securities regulation is, for many sponsors, the most operationally underestimated component of a private offering. Federal exemptions tend to get the attention: selecting 506(b) versus 506(c), managing accreditation verification, understanding the general solicitation rules. State obligations, by contrast, are often treated as an administrative afterthought, a Form D to file, some notice fees to pay, a few checkboxes to complete before moving on.

That characterization is both legally wrong and practically dangerous. State securities regulators, operating under the blue sky laws of their respective jurisdictions, retain meaningful authority over Regulation D offerings even after federal preemption eliminates their ability to impose substantive registration requirements. They can bar non-compliant issuers from future offerings in their state. They can impose fines. They can, in some jurisdictions, pursue criminal penalties for egregious violations. For sponsors running national capital raises (marketing to accredited investors across multiple states through digital channels) the state by state compliance obligation potentially exists in all fifty states simultaneously.

This chapter covers three related topics that every real estate syndication sponsor must understand. First, Form D, the federal notice filing whose timing, content, and annual amendment requirements trip up sponsors more consistently than almost any other compliance obligation. Second, the blue sky framework, what state securities laws require even when federal preemption eliminates substantive registration, and how those requirements differ across states. Third, bad actor disqualification under Rule 506(d), a compliance condition that can destroy the availability of the Regulation D exemption and that must be checked before the offering launches, with a specific process for issuers and their covered persons.

## Form D: What It Is and Why It Matters

Form D is a notice filing submitted through the SEC's EDGAR electronic filing system in connection with securities offerings conducted under Regulation D. Its function is informational. It tells the SEC that an issuer is conducting a private offering and provides basic information about the offering, rather than regulatory in the sense of requiring SEC review or approval. The SEC does not review or approve Form D filings. Filing Form D does not create or confirm the availability of the Regulation D exemption. The exemption's availability depends entirely on whether its substantive conditions were satisfied.

That last point deserves emphasis because sponsors sometimes treat Form D filing as the thing that makes their offering legal. It is not. The offering is legal, or not, based on whether it satisfies



the substantive conditions of the applicable exemption. Form D is the notice that the offering is happening. Filing it late, or incorrectly, does not retroactively invalidate a properly structured offering. But it does create regulatory exposure, it can compound into state level compliance failures, and it is a visible record on EDGAR that institutional investors and their counsel will examine in any due diligence context.

## **SEC Electronic Filing Requirements**

Form D is filed electronically through the SEC's EDGAR system at [sec.gov](https://www.sec.gov). The issuer must have an EDGAR account established before filing. Account setup requires advance registration and is not instantaneous, which means issuers who do not set up their EDGAR account before the offering launches may find themselves unable to meet the 15 day filing deadline. Setting up the EDGAR account is a logistical step that should be completed before the offering documents are finalized, not after the first investor subscribes.

The Form D is a single notice (available on EDGAR at [sec.gov/form/formd](https://www.sec.gov/form/formd)) that is submitted electronically. Once filed, it becomes publicly accessible on EDGAR, where it can be searched by any member of the public, any state securities regulator, or any institutional due diligence team. The information disclosed in Form D, including the names of executive officers and directors, the exemption relied upon, and the total amount raised, is permanent public record. Accuracy matters not just for regulatory compliance but because inaccuracies are visible and persistent.

## **Filing Deadline: 15 Days After First Sale**

The Form D must be filed no later than 15 calendar days after the date of first sale of securities in the offering. The first sale is the date on which the issuer first enters into a binding commitment with an investor to sell securities, typically the date the subscription agreement is accepted by the manager and the investor is formally admitted to the offering.

This is the first timing question that sponsors frequently get wrong. The first sale date is not the date capital is received, not the date the offering documents were finalized, and not the date the first investor expressed interest. It is the date the subscription agreement is accepted, the moment when the investor's admission becomes binding. In multi-step closing processes where subscription, verification, capital receipt, and formal acceptance are separated in time, the first sale date is when formal acceptance occurs.

Identifying this date precisely matters because the 15 day clock is specific and unforgiving. An offering that had its first sale on April 1 has a Form D deadline of April 16 (15 calendar days, not business days). Missing that deadline by even a day is a late filing that creates state compliance cascades, regulatory record exposure, and, in some states, independent investor remedies.

## What Information Form D Requires

Form D requests the following categories of information.

- Issuer name and address. The legal name of the entity conducting the offering and its principal place of business.
- Date of first sale. The date that triggers the 15 day filing deadline.
- Exemption relied upon. The specific Regulation D rule: Rule 504, Rule 506(b), or Rule 506(c). This selection is publicly visible on EDGAR, which is why sponsors conducting 506(b) offerings who used general solicitation (perhaps without realizing it) sometimes face the uncomfortable discovery that their disclosed exemption was wrong.
- Type of securities offered. For a real estate syndication, the relevant category is typically equity or pooled investment fund interests depending on the fund structure. The characterization must be accurate.
- Total offering amount and total amount sold. The total capital the issuer plans to raise and the amount raised as of the date of filing (or the most recent amendment).
- Identities of executive officers, directors, and 20% equity owners. The information the SEC uses to enforce the bad actor disqualification rules, discussed below.
- Use of proceeds. A general description of how the offering proceeds will be used: real estate acquisition, working capital, fees, and so on.
- Whether the offering involved sales to non-accredited investors. A yes or no disclosure relevant for 506(b) offerings that admitted sophisticated non-accredited participants.

Form D is deliberately concise. It does not require the level of disclosure contained in the PPM, does not describe the offering's terms in detail, and does not describe the property. Its function is notification, not disclosure. The SEC uses the aggregated Form D database to monitor private capital markets activity, identify patterns that may warrant examination, and check for bad actor issues, not to review the offering's merits.

## Amending and Updating Form D

Form D is not a one-time filing obligation. For offerings that remain open or continue admitting investors beyond the first anniversary of the initial filing, an annual amendment is required on or before the anniversary of the initial Form D filing. The annual amendment updates the total amount sold and keeps the offering's regulatory record current.

Annual amendments are, without question, the Form D obligation that sponsors most consistently fail to meet. The initial filing gets done, usually under the pressure of the 15 day deadline, and the annual amendment obligation simply falls off the compliance radar. For multi-year offerings, fund structures with extended offering periods, and ongoing multi closing

offerings, the missing annual amendment is a gap that is immediately visible on EDGAR to anyone who looks.

In addition to the mandatory annual amendment, a new Form D amendment should be filed whenever material information changes: the total amount raised has changed significantly, there are changes to the executive officers or directors (which affect the bad actor analysis), or the offering terms have changed in a way that affects the Form D disclosures. Each amendment updates the existing record rather than creating a new filing.

### **⚠ The Annual Form D Amendment Is Not Optional for Multi-year Offerings**

*Form D compliance is a recurring obligation, not a one-time filing. For any offering that remains open or continues to admit investors beyond the first anniversary of the initial Form D filing, an annual amendment is required on or before that anniversary date.*

*For fund structures with investment periods spanning multiple years, multi closing offerings, and ongoing open end structures, annual Form D amendments are required for the life of the offering. Sponsors who build multiple offerings over time need a compliance calendar that tracks the annual amendment dates for each offering alongside other ongoing obligations.*

*Missing an annual amendment is a predictable, preventable failure. A simple calendar reminder set at the time of the initial filing prevents it every time.*

## **What Happens If You Don't File Form D?**

The SEC's position is that failure to file Form D does not automatically disqualify the offering from the Regulation D exemption. The exemption's availability depends on whether its substantive conditions were satisfied, not on whether the notice was filed. But the consequences of missed filings are not trivial, and they compound in ways that can produce outcomes far more serious than the filing failure itself.

### **SEC Consequences and Bad Actor Disqualification Risk**

The SEC has broad discretion in how it responds to Form D filing failures. For issuers who have made a good faith effort to comply with the exemption's substantive conditions and whose Form D failure was isolated or inadvertent, the SEC's response has typically been limited to the filing failure itself. But for sponsors with a pattern of non-filing, with inaccurate Form D disclosures, or with Form D failures in the context of broader compliance problems, the SEC's response can be more consequential.

The SEC has proposed, and some state regulators have implemented, rules that would bar issuers who willfully fail to file Form D from relying on Regulation D for future offerings. The SEC has also indicated that systematic non filing can be evidence of a broader compliance culture problem that warrants examination. While no universal Form D non filing bar has been adopted at the federal level, the trend is toward more serious consequences for repeated failures.

From a bad actor perspective, Form D non filing is not itself a triggering event under Rule 506(d). But an SEC enforcement action arising from Form D non filing could, depending on its form, constitute a triggering event that disqualifies the issuer from future Regulation D offerings. The indirect path from Form D failure to bad actor disqualification is real even if the direct path does not exist.

### **State Consequences and Loss of Federal Preemption Benefits**

The most immediate and consistently significant consequence of a missed Form D filing is what it does to the state level compliance posture. Most states require that their state securities notice filing be made concurrently with or shortly after the federal Form D. A sponsor who never files the federal Form D has therefore also failed to make state notice filings in every state where investors reside, creating state level compliance failures with the specific penalties and enforcement consequences those states impose.

Those state level consequences vary significantly. Some states treat noncompliance with notice filing requirements as a basis for administrative penalties only. Others, including some that are significant capital raising markets, treat state notice filing failures as a basis for investor rescission claims. A missing state notice filing in a state whose securities laws provide investors with a rescission right for filing failures is a problem that the federal Form D relationship makes automatically worse. You cannot have made the state filing if you never filed the federal form that the state filing requires.

Beyond the immediate consequences, a history of missing or late Form D filings is visible on EDGAR. Institutional investors and their counsel routinely check EDGAR as part of due diligence on any private fund sponsor they are considering. A Form D record showing systematic late filing, missing annual amendments, or obvious inaccuracies in the exemption identification communicates a compliance culture that raises broader questions about how the offering was structured and how investor obligations are being managed.

### **Practical Remediation Steps**

When a Form D filing is missed or significantly delayed, the practical remediation steps are straightforward.

- File the late Form D as soon as the failure is discovered, with the accurate first sale date noted. Late filing is better than continued non filing. The filing creates the public record of the offering and triggers the state filing obligations that should have been met earlier.
- File the required state notice filings in every investor state immediately after the federal Form D is filed. Explain the late filing to state regulators as required. Some states require a brief explanation for late filings. Others simply accept the filing without requiring explanation.
- Engage securities counsel to assess whether the specific states where investors reside have imposed any penalty for the late filing, whether any investor rescission rights were triggered under those states' laws, and whether any corrective action or investor disclosure is advisable.
- Implement a compliance calendar going forward that specifically tracks the annual Form D amendment dates alongside the state renewal obligation dates. The remediation process is the right time to build the compliance infrastructure that prevents recurrence.

## State Securities Laws: Blue Sky Overview

Every state has its own securities law (commonly called a blue sky law) that regulates the offer and sale of securities within the state's borders. These laws predate federal securities regulation, vary significantly in their structure and enforcement priorities, and operate in parallel with the federal framework. Understanding the relationship between federal preemption and state authority is the foundation of blue sky compliance for any private real estate offering.

The name blue sky traces to an early twentieth century characterization of fraudulent securities promoters who would sell shares in speculative ventures worth nothing more than so many feet of blue sky. Whatever the etymology, the laws themselves are a serious regulatory framework that imposes independent compliance obligations on securities issuers operating in those states.

### Federal Preemption for Covered Securities Under Rule 506

Federal preemption under the National Securities Markets Improvement Act of 1996 (NSMIA) significantly curtailed state registration authority for certain categories of securities. Section 18 of the Securities Act, as amended by NSMIA, preempts state registration requirements for covered securities, a defined category that includes securities sold in Rule 506 Regulation D offerings. This means a state cannot require a Rule 506 issuer to register its securities at the state level before offering or selling to investors in that state. The state's merit review authority, its ability to examine the offering's terms and economic fairness and refuse to permit offerings it considers unfair, is eliminated for Rule 506 offerings.

Before NSMIA, state blue sky laws could require substantive registration. The state securities regulator could examine the offering's terms, the sponsor's qualifications, and the fairness of the economic structure, and refuse to permit the offering if it did not meet the state's standards. Merit review states took this authority seriously. For sponsors of national Rule 506 offerings, NSMIA's preemption of merit review is a genuine operational benefit. The offering's terms are governed by federal standards and the parties' negotiation, not by each state regulator's view of what constitutes a fair offering.

### **Federal Preemption Versus Notice Filing Requirements: The Key Distinction**

#### **What NSMIA Preempts**

- State registration requirements for Rule 506 offerings
- State merit review of offering terms, economics, and fairness
- State authority to block a Rule 506 offering based on substantive review

#### **What NSMIA Does NOT Preempt**

- State notice filing requirements (copy of Form D plus state specific form or consent to service)
- State filing fees (which vary significantly by state)
- State antifraud enforcement authority (fully preserved)
- State authority to bar non-compliant sponsors from future in state offerings
- State annual renewal filing requirements (in states that impose them)

#### **Practical Implication**

A sponsor who relies on federal preemption to skip state notice filings has misunderstood what preemption covers. Preemption eliminates the registration requirement, not the administrative notice obligation.

### **State Notice Filing Requirements**

Regulation D Rule 506 offerings require notice filings in each state where securities are offered or sold to investors. The general structure of these filings is the same across states. After Form D is filed with the SEC, the issuer submits a state notice to each applicable state that typically includes a copy of the federal Form D, a state specific cover form or consent to service of process, and a filing fee. The specific requirements (the form used, the timing, the fee amount, the additional materials required) vary by state and must be confirmed for each offering. Most states accept state notice filings through NASAA's Electronic Filing Depository (EFD), which streamlines the process across multiple state filings.

Most states impose the notice filing in connection with the first sale to an investor in that state. For sponsors with a single state investor base, the filing obligation is geographically contained.

For sponsors marketing nationally under Rule 506(c) (with publicly accessible marketing through digital channels that reach investors in every state simultaneously) the filing obligation potentially exists in all fifty states as investors subscribe from different jurisdictions. Managing this across the life of a multi closing offering requires organized tracking and a process for making state filings promptly when new investor states appear.

## Filing Fees and Deadlines by State

Filing fees vary from a nominal amount in some states to several thousand dollars in others. Some states calculate the fee as a percentage of the amount raised from investors in that state. Others charge a flat fee regardless of offering size. For a large 506(c) offering raising capital nationally, the aggregate state filing fees across all investor states can be a significant expense, one that belongs in the offering's budget as a predictable compliance cost.

State filing deadlines also vary. Most states require the filing within 15 days of the first sale to an investor in that state, consistent with the federal Form D deadline. Some states require a pre-sale filing, meaning the notice must be submitted before any securities are offered to investors in that state. Certain states impose annual renewal obligations, requiring a new filing and fee each year the offering remains active.

The state by state variation in fees, timing, and form requirements makes managing blue sky compliance a genuine administrative function that benefits from experienced securities counsel or a blue sky filing service. For first time sponsors managing their first multi-state offering, attempting to work through the state specific requirements without assistance is a reliable path to missed deadlines, incorrect filings, and the penalties that follow.

## States That Require Special Attention

While a comprehensive state by state survey is beyond the scope of this chapter, several states warrant specific attention for real estate sponsors planning private offerings with national investor reach.

### States with Merit Review Authority

Although NSMIA preempts state merit review for Rule 506 offerings, a small number of states retain merit review authority over certain offerings that do not qualify for NSMIA preemption. Regulation A+ Tier 1 offerings are not covered by NSMIA preemption and require state by state qualification in every state where they are offered, making Tier 1 impractical for national offerings and driving most sponsors toward Tier 2, which does benefit from preemption.

For any offering that falls outside Rule 506 preemption (including offerings under Rule 504, intrastate exemptions, and any offering where the exemption is later found to have failed) state



merit review authority is reinstated. This is another reason why maintaining the integrity of the chosen federal exemption is so important. Losing a Rule 506 exemption does not just expose the sponsor to federal liability. It eliminates the NSMIA preemption and potentially reinstates state registration requirements for every state where the offering was made.

## States with Aggressive Enforcement Programs

Several states maintain particularly active securities enforcement programs that real estate sponsors conducting national offerings should understand.

**California.** California's Department of Financial Protection and Innovation (DFPI) maintains one of the most active state securities enforcement programs in the country. California requires a state notice filing for all Regulation D Rule 506 offerings with California investors, due within 15 days of the first sale to a California investor. The filing must include a copy of the Form D, a California specific cover form, and the applicable filing fee, which can be substantial for large offerings. Failure to make the required California filing can result in significant penalties and can affect the ability to conduct future offerings in California.

**New York.** New York requires a notice filing for Regulation D Rule 506 offerings. Effective December 2, 2020, the New York Attorney General's Investor Protection Bureau adopted amended rules requiring issuers conducting Rule 506 offerings to file a Form D and pay the applicable filing fee through NASAA's Electronic Filing Depository within 15 days of the first sale to a New York investor. This requirement replaced the pre 2020 Form 99 dealer registration framework and aligned New York's blue sky filing approach with NSMIA and the practice in most other states. In addition to the notice filing requirement, New York retains independent antifraud enforcement authority under the Martin Act, one of the broadest state securities fraud statutes in the United States. The Martin Act does not require proof of intent to defraud. A material misrepresentation or omission in connection with a New York securities offering can establish Martin Act liability on a stricter standard than federal fraud law requires. Sponsors with New York investors should be particularly rigorous in both meeting the notice filing requirement and ensuring offering document accuracy.

**Texas.** Texas requires a Form D filing for Regulation D offerings with Texas investors, with fees and timing requirements that should be confirmed with counsel familiar with Texas securities law. The Texas State Securities Board maintains an active enforcement presence and has historically scrutinized private real estate offerings. Texas investors are a significant component of many national real estate syndication offerings, making Texas filing compliance particularly important.

**Massachusetts.** Massachusetts has historically taken an assertive approach to investor protection in private offerings. The Massachusetts Securities Division has enacted specific



guidance on various private offering topics and maintains an active examination and enforcement program. Sponsors conducting offerings with Massachusetts investors should confirm current filing requirements and ensure their offering documentation meets Massachusetts standards.

**Florida and other large investor population states.** States with large populations of accredited investors (Florida, Illinois, Washington, Colorado, and others) frequently appear in the investor base of nationally marketed offerings. Each has its own notice filing requirements, fees, and timing deadlines that must be satisfied for investors in those states.

The practical message: for a nationally marketed Rule 506(c) offering, blue sky compliance is a fifty state obligation that arises incrementally as investors subscribe from different states. The compliance process must include a mechanism for identifying each new investor's state of residence at subscription and initiating the required state filing within the applicable deadline.

### **NASAA Coordinated Review for Regulation A+ Offerings**

For sponsors conducting Regulation A+ Tier 1 offerings (which are not covered by NSMIA preemption and require state by state qualification) NASAA (the North American Securities Administrators Association) operates a coordinated review program that allows issuers to seek qualification from multiple states simultaneously through a single coordinated filing process. The NASAA coordinated review program assigns a lead state reviewer who coordinates with reviewers in other participating states, reducing the burden of pursuing fifty separate state review processes.

The coordinated review program does not eliminate the substantive review that each participating state performs. It streamlines the process and creates a single point of coordination. For sponsors whose offering strategy requires Tier 1, the NASAA coordinated review program is essential knowledge. For most real estate sponsors conducting Rule 506 offerings, NSMIA preemption means NASAA coordinated review is not relevant, but understanding its existence is useful context for sponsors who may eventually move toward retail investor access through Regulation A+.

NASAA also issues model rules and guidance that influence the enforcement approach of member state securities administrators. NASAA's positions on private offering topics (investor qualification, general solicitation, offering document standards) frequently shape what individual state regulators look for in examination contexts. Sponsors conducting nationally marketed offerings should monitor NASAA publications for regulatory developments that may affect their compliance obligations at the state level.

## **Bad Actor Disqualification Under Rule 506(d)**

Among all the conditions governing a Regulation D Rule 506 offering, bad actor disqualification under Rule 506(d) may be the most overlooked. That is partly because satisfying it requires knowledge of the personal legal and regulatory history of every covered person associated with the offering, which feels intrusive and is sometimes skipped out of misplaced sensitivity. It is partly because the consequences of a violation are severe: the entire Regulation D exemption can be disqualified retroactively from the date the offering began.

Rule 506(d), adopted by the SEC pursuant to Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, became effective September 23, 2013. Understanding what the bad actor rules require, who they cover, and how to implement them correctly before launching an offering is not a best practice. It is a threshold compliance obligation that must be satisfied before any securities are offered.

### What Triggering Events Disqualify

Rule 506(d) disqualifies an offering from relying on Regulation D if any covered person has experienced a specified triggering event within the applicable lookback period. The triggering events include the categories below.

- Criminal convictions. Any conviction, within the previous ten years, of any felony or misdemeanor in connection with the purchase or sale of any security; involving the making of a false filing with the SEC; or arising from the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities.
- Court orders and injunctions. Any court order, judgment, or decree entered within the previous five years that restrains or enjoins the person from engaging in any conduct in connection with the purchase or sale of securities or the making of false filings with the SEC.
- Final orders of certain regulators. Any final order within the previous ten years of state securities regulators, federal banking agencies, or the CFTC that bars the person from associating with a regulated entity or from engaging in securities activities, or that constitutes a final order based on a violation of law prohibiting fraudulent, manipulative, or deceptive conduct.
- SEC disciplinary orders. Any SEC order that bars or suspends the person from association with regulated entities, or any similar FINRA bar or suspension.
- SEC cease and desist orders. Any SEC cease and desist order in connection with violations of scienter based antifraud provisions or Section 5 of the Securities Act, entered within the previous five years.
- SRO expulsion or suspension. Any expulsion or suspension from membership in FINRA, the MSRB, or another registered securities exchange.

- Stop orders. Any SEC stop order or similar state securities regulator order in connection with any registration statement or Regulation A offering, within the previous five years.

## Who Is a Covered Person

The list of covered persons is broader than most sponsors initially assume, which is why the bad actor questionnaire process must be comprehensive.

- The issuer itself, including any predecessor or affiliated issuer that sold securities in the same or related offering in the past three years.
- Any director, executive officer, other officer participating in the offering, general partner, or managing member of the issuer. For a real estate syndication SPV, this includes the manager entity and its principals.
- Any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power.
- Any promoter connected with the issuer in any capacity at the time of the sale. The definition of promoter is broad under the securities laws and can include persons who are not formally officers or directors but who took the initiative in founding and organizing the issuer.
- Any investment manager of the issuer for pooled investment fund issuers.
- Any person who has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with the offering, and their directors, executive officers, general partners, and managing members.

The look through requirement: when a covered person is an entity rather than an individual, the bad actor analysis must look through the entity to its principals. A sponsor structure where the manager is an LLC owned by a holding company owned by the individual principals requires examining bad actor history at every level of the chain. This look through requirement is frequently overlooked in offerings with layered ownership structures.

## The Bad Actor Questionnaire Process

The standard mechanism for satisfying the bad actor disqualification requirement is a written questionnaire distributed to every covered person before the offering launches. The questionnaire asks each covered person to represent whether they have experienced any triggering event within the applicable lookback period, with specific questions tracking each category.

The questionnaire process has several requirements that sponsors sometimes shortcut.

- Completeness. The questionnaire must reach every covered person, not just the principals the sponsor knows well. All 20% equity owners, all officers participating in the

offering, all paid solicitors: the full list must be identified and queried. Missing a covered person is not a harmless omission. It is a failure to complete the required process.

- **Timing.** Questionnaires should be completed before the offering begins, before any securities are offered. A triggering event discovered after the offering has launched and investors have subscribed creates a retroactive disqualification problem that is difficult to resolve without rescission and refund of investor capital.
- **Documentation.** Completed questionnaires should be retained as part of the offering's compliance record. The questionnaire responses are the evidence of the issuer's reasonable care in investigating bad actor status.
- **Update obligations.** If a triggering event occurs after the offering begins (a covered person receives an SEC enforcement order during the offering period) the issuer must assess whether the event disqualifies the offering and take appropriate corrective action, including potential investor disclosure and cessation of new sales.

## The Disclosure-exception for Pre-existing Events

Rule 506(e) provides a limited exception. If a covered person had a triggering event that occurred before September 23, 2013 (the effective date of the bad actor rules), the event does not disqualify the offering, but the issuer must disclose the event to investors a reasonable time before any sale. This disclosure-exception is narrow. It applies only to the specific grandfathered period before the rule's effective date. Any triggering event occurring on or after September 23, 2013, with no applicable waiver, disqualifies the offering entirely if not waived by the SEC.

Sponsors who discover pre-existing triggering events from the grandfathered period must include specific disclosure of those events in the PPM, describing the nature of the event, the covered person involved, and the date and circumstances. This disclosure should be prepared by securities counsel who understands the regulatory history and can characterize it accurately.

### **⚠ A Disqualifying Triggering Event Discovered After Investors Subscribe Cannot Be Easily Cured**

*If the bad actor investigation reveals a triggering event after the offering has begun and investors have committed capital, the issuer faces a potentially disqualified exemption. The offering was conducted without a valid registration exemption, a securities violation.*

*The remediation options are limited: an SEC waiver application under Rule 506(d)(2)(ii) (available in limited circumstances, requires a showing that the violation occurred without the issuer's knowledge and that a waiver is consistent with investor protection), rescission of the offering requiring return of investor capital with interest, or a careful legal analysis of*

*whether any alternative exemption is available for completed sales. None of these outcomes are good.*

*The time to discover a bad actor problem is before the offering begins. The questionnaire process takes modest time and creates minimal disruption. A retroactive disqualification problem costs orders of magnitude more to address.*

## Building a Blue Sky Filing Calendar

The operational complexity of state blue sky compliance for a nationally marketed offering with investors across multiple states, combined with the ongoing Form D amendment obligations and bad actor monitoring requirements, makes a structured compliance calendar essential. Without one, obligations accumulate and expire unnoticed until a missed filing triggers a regulatory inquiry, a state enforcement action, or a due diligence process that reveals a compliance gap.

A complete blue sky filing calendar for a Regulation D real estate offering should track the items below.

- Initial state filings. For states that require a pre-sale filing, the filing must be completed before any securities are offered to investors in that state. The calendar should identify which states impose pre-sale requirements and confirm those filings are complete before marketing begins in those states.
- Post subscription state filings. For each state from which a new investor subscribes, the required notice filing must be made within the applicable deadline (typically 15 days from the first sale to that state's investor). The calendar should capture each new investor state as it arises and track the filing completion against the deadline.
- Federal Form D filing. The initial Form D, due within 15 days of the date of first sale. The calendar entry should note the first sale date (to be updated at closing) and the corresponding deadline.
- Annual Form D amendment. The anniversary of the initial Form D filing, with a reminder set at least 30 days in advance to allow preparation and review before the deadline.
- State annual renewal filings. States that impose annual renewal requirements on Regulation D notice filings must be tracked separately for each offering. The renewal dates and fees should be calendared and monitored.
- Bad actor questionnaire updates. At least annually, and whenever a new covered person is added to the offering's structure, the questionnaire process should be updated for any new or changed covered persons.

For sponsors managing multiple concurrent offerings, the compliance calendar must track all of these obligations for each offering independently. State filings for one offering do not satisfy state obligations for another, and Form D filings are offering specific. A single calendar tracking all active offerings, organized by offering and by deadline type, is the practical tool that prevents the administrative failures that compound into regulatory problems.

| Obligation                                 | Trigger                                  | Deadline                                                                                | Consequence of Failure                                                                                |
|--------------------------------------------|------------------------------------------|-----------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------|
| Federal Form D (initial)                   | Date of first sale                       | 15 calendar days after first sale                                                       | State filing cascade; regulatory record gap; due diligence red flag                                   |
| State notice filings (all investor states) | First sale to investor in each state     | Varies by state: typically 15 days from first sale; some states require pre-sale filing | State penalties; possible investor rescission rights in some states; bar on future offerings in state |
| Annual Form D amendment                    | Anniversary of initial Form D filing     | On or before anniversary date each year the offering continues                          | EDGAR record gap; visible compliance failure; state annual renewal failures cascade                   |
| State annual renewal filings               | Calendar based per state                 | Varies by state: typically anniversary of initial state filing                          | Loss of active filing status; state penalties; possible bar on new investors from that state          |
| Bad actor questionnaire (initial)          | Before offering launches                 | Before first offer of securities                                                        | Potential retroactive exemption disqualification if triggering event exists and is undiscovered       |
| Bad actor questionnaire (updates)          | New covered persons added; annual review | Before new covered person begins participating; annually                                | Same as initial: undiscovered triggering event creates retroactive disqualification risk              |
| SEC waiver application for bad actor event | Discovery of disqualifying event         | As soon as possible: delays expand the violation period                                 | Continued offering without valid exemption; expanding rescission exposure                             |

## Common Blue Sky Mistakes

### Mistake 1: Treating Blue Sky Compliance as a One-time Event

The most common blue sky mistake is treating the initial state filings as the entire obligation. The state filing obligation is continuous. As new investors subscribe from new states, new filings

must be made. Annual renewal obligations must be satisfied. The filing that was made in Year 1 does not satisfy the obligation for Year 2 in states that require annual renewal. A sponsor who files diligently at the initial closing and then treats blue sky compliance as complete has fulfilled only the beginning of a multi-year obligation.

### **Mistake 2: Filing in the Wrong Exemption Category**

Form D's most visible public field is the exemption relied upon: Rule 504, Rule 506(b), or Rule 506(c). Sponsors who used general solicitation (perhaps inadvertently, through digital marketing or a publicly accessible investment portal) but who file Form D under Rule 506(b) have created a public record that is inconsistent with what actually happened. If the general solicitation is later identified, the Form D inaccuracy becomes evidence that the sponsor was either unaware of the general solicitation (which is itself a compliance failure) or aware and chose to misrepresent the offering.

Correcting an exemption identification after filing requires filing an amendment to Form D with the correct exemption, and living with the public record that the initial filing was incorrect. Making the right exemption selection before filing requires the same analysis that should have been done before any marketing began. Both problems trace to the same root: failing to conduct the exemption analysis before marketing starts.

### **Mistake 3: Incomplete Bad Actor Investigation**

The bad actor investigation that is limited to the sponsor's individual principals, without identifying all covered persons in the broader category, is an incomplete investigation. Paid solicitors, 20% equity owners of the issuer entity, and officers participating in the offering are covered persons whose history must be checked. The look through requirement for entity covered persons means that the principals of the manager entity's own parent or affiliated entities may also require-examination. A bad actor questionnaire that asks only the named principals of the sponsor LLC has not completed the required inquiry.

### **Mistake 4: Missing State Filings for Online Marketing Reach**

A 506(c) offering with publicly accessible digital marketing (a website, social media posts, email campaigns) is theoretically marketed to potential investors in all fifty states simultaneously. While state filing obligations typically attach to actual investor subscriptions rather than the marketing reach, the first investor in a new state creates an immediate filing obligation. Sponsors who do not have a process for identifying each new investor's state of residence at subscription and initiating the required filing within the applicable deadline will routinely miss state filing deadlines as their investor base expands.

### **Mistake 5: Ignoring States with No Investor Initially**



Sponsors who make state filings in the states where their first investors reside sometimes assume that those filings are the complete obligation. When a subsequent closing or referral produces an investor from a state where no prior filing was made, the new investor state requires a filing within the applicable deadline from the date of that state's first sale. A sponsor with investors in twenty states may have made filings in five. The fifteen unfilled states are outstanding obligations, not states where compliance is simply optional because no filing was made yet.

## The Complete Post-closing Compliance Obligation Framework

Blue sky and Form D obligations sit within a broader post-closing compliance framework that extends throughout the life of the offering. The following table summarizes the full set of ongoing compliance obligations that a Regulation D real estate syndication sponsor should track from closing through final disposition.

| Obligation                                                                  | Timing                                                         | Legal Source                              |
|-----------------------------------------------------------------------------|----------------------------------------------------------------|-------------------------------------------|
| Annual Form D amendment                                                     | On or before anniversary of initial Form D filing              | Rule 503(a)(3) of Regulation D            |
| State notice filings (per investor state)                                   | Within applicable state deadline from first sale to that state | State blue sky laws (vary by state)       |
| State annual renewal filings (where required)                               | Per state specific renewal schedule                            | State blue sky laws                       |
| Bad actor monitoring (annual update)                                        | At least annually; upon any new covered person                 | Rule 506(d) of Regulation D               |
| Quarterly financial reports to investors                                    | Within 30 to 45 days of quarter end                            | Operating agreement information rights    |
| Annual financial statements to investors                                    | Within 90 to 120 days of fiscal year end                       | Operating agreement information rights    |
| Schedule K-1 to each investor                                               | By March 15 (September 15 with extension)                      | IRC §6031; operating agreement            |
| Distribution notices (each distribution)                                    | At or before time of distribution                              | Operating agreement                       |
| Material event notices                                                      | Promptly upon occurrence                                       | Operating agreement; antifraud provisions |
| Investor accreditation reverification (506(c) subsequent closings or calls) | Before each subsequent closing or capital call                 | Rule 506(c) verification requirement      |



| Obligation                                       | Timing                                       | Legal Source                             |
|--------------------------------------------------|----------------------------------------------|------------------------------------------|
| ERISA benefit plan investor threshold monitoring | At each new investor admission; ongoing      | ERISA §3(42); DOL plan asset regulations |
| Form 1-K annual report (Reg A+ Tier 2 only)      | Within 120 days of fiscal year end           | SEC Regulation A                         |
| Form 1-SA semiannual report (Reg A+ Tier 2 only) | Within 90 days of first fiscal half year end | SEC Regulation A                         |
| Form 1-U current report (Reg A+ Tier 2 only)     | Within 4 business days of material event     | SEC Regulation A                         |

## Practical Takeaways

- Federal preemption under NSMIA eliminates state registration requirements for Regulation D Rule 506 offerings. States cannot require merit review of the offering's terms or block the offering. But states retain the authority to require notice filings and fees, and they retain full antifraud enforcement authority regardless of preemption. Preemption does not make state compliance optional.
- Form D must be filed with EDGAR within 15 calendar days of the date of first sale, which is the date the subscription agreement is accepted by the manager, not the date capital is received. Annual amendments are required for every year the offering continues and are the Form D obligation that sponsors most consistently fail to meet for multi-year offerings.
- Missing Form D does not automatically bust the federal exemption, but it cascades immediately into state notice filing failures in every state where investors reside. Some states provide independent investor rescission rights for state notice filing failures. The federal Form D failure is rarely isolated. Its consequences are felt at the state level.
- State notice filings are offering specific, state specific, and individually timed. A 506(c) offering marketed broadly nationally triggers state filing obligations incrementally as investors subscribe from different states. Each new investor state creates a filing obligation with its own deadline. The filing calendar must track these obligations continuously, not just at the initial closing. Most state filings now flow through NASAA's Electronic Filing Depository, which simplifies the mechanics across multiple states.
- Bad actor disqualification under Rule 506(d), adopted pursuant to Section 926 of the Dodd-Frank Act and effective September 23, 2013, is a threshold condition for the entire Regulation D exemption. A disqualifying event affecting any covered person potentially voids the exemption retroactively from the offering's start. Written questionnaires must be completed by every covered person before any securities are offered, and the process must be updated when new covered persons are added. The look through

requirement for entity covered persons extends the investigation beyond the named principals of the manager LLC.

- Covered persons for Rule 506(d) include the issuer, directors, executive officers, 20% equity owners, promoters, and paid solicitors, and their respective principals where covered persons are entities. The category is broader than sponsors typically assume, and the investigation must be comprehensive.
- States with particularly active enforcement programs (California, New York, Texas, Massachusetts) require specific attention. California imposes substantial filing fees and significant penalties for missed filings. New York, since December 2, 2020, requires a Form D notice filing through NASAA's Electronic Filing Depository within 15 days of the first sale to a New York investor, and the Martin Act imposes fraud liability on a strict standard without requiring proof of intent. Texas and Massachusetts maintain active enforcement programs that regularly examine private offering compliance.
- A structured compliance calendar maintained across all active offerings (tracking initial state filings, ongoing state filings as new investor states appear, annual Form D amendments, state renewal filings, bad actor monitoring updates, and investor reporting obligations) is the operational infrastructure that prevents administrative failures from becoming substantive compliance problems.

## CHAPTER TWENTY

# Investment Advisers Act and Investment Company Act Considerations

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Two federal regulatory frameworks sit in the background of every real estate fund and syndication structure, rarely discussed in early deal planning conversations but capable of creating compliance obligations that reshape the sponsor's entire operating model if they apply. The Investment Advisers Act of 1940 regulates persons who are in the business of advising others about securities investments for compensation. The Investment Company Act of 1940 regulates entities that are in the business of investing in securities. Both statutes have breadth of application that surprises sponsors who have not specifically analyzed them, and both carry consequences for non-compliance that are as serious as any discussed elsewhere in this handbook.

For real estate fund sponsors, the central question under each statute is whether the sponsor's activities or the fund's investment portfolio brings them within the statute's coverage, and if so, whether an exemption is available. Getting these answers wrong in either direction creates problems. Registering when registration is not required adds cost and obligation without benefit. Failing to register when registration is required creates regulatory exposure with consequences that include enforcement actions, disgorgement, and bars from the securities industry.

This chapter covers the Investment Advisers Act registration analysis for real estate fund managers, when registration is required, which exemptions are available, and what registration means in practice. It then addresses the Investment Company Act analysis in depth, including the 40% test that determines whether a fund is an investment company, the Section 3(c)(1) and 3(c)(7) exemptions that most private funds rely on, and the Section 3(c)(5) exemption that is specifically available to sponsors of real estate mortgage and loan portfolios, a provision that is genuinely important and consistently underused in the real estate fund context.

## When Real Estate Fund Managers Must Register as Investment Advisers

The Investment Advisers Act of 1940 defines an investment adviser as any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, about the value of securities or as to the advisability of investing in, purchasing, or selling securities. This definition is broad, deliberately so, and its application to real estate fund managers is more far reaching than most sponsors appreciate. The instinctive reaction of many real estate sponsors is that they are operators, not advisers, and that a statute

designed for investment managers should not capture what they do. That reaction is understandable and almost universally wrong.

## **The Definition of Investment Adviser Under the Advisers Act**

Three elements define an investment adviser under the Advisers Act: advice about securities, for compensation, and in the business of providing such advice. Each element must be present, and each requires careful analysis in the real estate fund context. The most consequential and most commonly misunderstood element is the first, advice about securities, because it turns on a question that has nothing to do with whether the sponsor thinks of themselves as an investment adviser.

## **The Threshold Question: Are the Fund's Real Estate Investments Securities?**

The key to understanding why most real estate fund sponsors are investment advisers lies in the correct application of the Howey investment contract test, not to the limited partnership or LLC interests that investors hold (those are clearly securities, as discussed throughout this handbook), but to the fund's own real estate investments. The operative question is whether the fund itself is a passive investor in its real estate assets, relying on the efforts of a third party to generate profits, or an active investor capable of generating those profits through its own direct efforts.

Most private real estate funds are structured with an operating platform (one or more companies containing the employees, systems, and expertise that evaluate, acquire, and operate real estate assets on behalf of the fund) and one or more special purpose entities that act as the general partner or manager of the fund. The GP entity of the fund typically does not independently have the capability to identify, underwrite, acquire, and operate real estate assets. Instead, it delegates those functions to the affiliated operating platform, which acts as the investment adviser or manager to the fund and often provides ancillary services such as property management, leasing, construction management, and development oversight.

Applying the Howey test to this structure: the fund is relying on the efforts of the operating platform, a third party relative to the fund's limited partners, to realize profits from its real estate investments. Under Howey, this makes the fund a passive investor in those real estate assets, which means the assets are investment contracts and therefore securities for purposes of the Advisers Act. The fund's portfolio will constitute a securities portfolio if at least 50% of its total value consists of securities, or if the fund is a private fund (which it is if it relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act). In either case, the operating platform managing that portfolio is engaging in the business of advising others (the fund) as to the advisability of investing in, purchasing, or selling securities.

This is the analysis that most real estate sponsors miss. They focus on whether the LP interests their investors hold are securities (they obviously are) and incorrectly conclude that the advice about securities element requires them to be advising investors about whether to buy or sell those LP interests. It does not. The advice about securities that triggers the Advisers Act definition is the advice the operating platform provides to the fund about whether to acquire, hold, or dispose of the real estate assets, assets that are themselves securities because the fund is a passive investor in them.

### **The Correct Howey Analysis: Why the Fund's Real Estate Holdings Are Securities**

#### **Step 1: Apply Howey to the Fund's Real Estate Investments (Not to the LP Interests)**

Question: Is the fund a passive investor in its real estate, relying on a third party operating platform to generate profits?

If YES (typical externally managed fund structure): The real estate investments are investment contracts (securities) for Advisers Act purposes.

If NO (the fund's GP can independently manage all real estate functions without relying on a separate affiliated operating platform): The real estate investments are not securities, and the Advisers Act may not apply.

#### **Step 2: Is the Fund's Portfolio a Securities Portfolio?**

Yes, either because greater than 50% of the fund's value consists of securities, or because the fund is a private fund (relies on 3(c)(1) or 3(c)(7)).

All assets of a private fund are treated as a securities portfolio by definition.

#### **Step 3: Is the Operating Platform Advising the Fund About Those Securities?**

Yes, it provides continuous and regular supervisory or management services regarding the fund's securities portfolio (its real estate investments).

The operating platform is therefore an investment adviser.

#### **Counterexample**

An internally managed REIT whose board and executives directly manage all real estate operations, with no external operating platform, is NOT relying on a third party. The REIT's real estate assets are not investment contracts, and the REIT is not subject to the Advisers Act. (The REIT's publicly offered shares are still subject to the Securities Act and Exchange Act.)

The practical implication of this analysis is direct and uncomfortable for many sponsors. Virtually every real estate fund managed by an external operating platform is a securities portfolio, and virtually every external operating platform that provides continuous and regular management services to that fund for compensation is an investment adviser. The question is not whether the

Advisers Act applies (for most sponsors it does) but which exemption from registration is available given the fund's structure and the adviser's assets under management.

## For Compensation

Compensation under the Advisers Act is construed broadly and includes any economic benefit received in connection with the advisory services, direct or indirect. Management fees, asset management fees, acquisition fees, and the promoted interest (carried interest) the sponsor earns from fund performance all qualify. Even if the only compensation were the carried interest (with no management fee) that economic benefit contingent on fund performance constitutes compensation for investment advisory services. A sponsor who structured fees entirely as promote rather than management fee would still satisfy the compensation element.

## In the Business of Providing Advice

The business requirement distinguishes persons who regularly provide investment advisory services from those who do so only occasionally or incidentally. A real estate developer who raises equity from investors for a single development project through a one-time fund, manages the project to completion, distributes proceeds, and returns to development without further fund activity occupies a different position from a sponsor who manages a multi fund platform across multiple investment cycles, maintains a dedicated investor relations program, and charges ongoing management fees for investment advisory services.

The more the sponsor's activities resemble those of a professional investment manager (recurring fund formation, multi asset portfolio management, ongoing investor communications, continuous management fee structures) the more clearly they are in the business of providing investment advice. Most sponsors building a real estate fund platform, as opposed to executing a single project, satisfy this element without question.

The conclusion that most experienced practitioners reach after working through the Howey analysis: real estate fund sponsors are investment advisers. Both the plain text of the Advisers Act and the policy underlying the securities laws support this conclusion. Adopting a reading that exempts real estate fund managers from the Advisers Act would leave the entire-externally managed real estate fund sector (which manages trillions of dollars of investor capital) completely unregulated, contrary to the integrated regulatory framework the SEC enforces. The question for most sponsors is therefore not whether they are investment advisers, but whether an exemption from registration is available and, if not, what registration requires.

## The Private Fund Adviser Exemption

The most commonly applicable exemption for real estate fund managers is the private fund adviser exemption under Section 203(m) of the Advisers Act. This exemption is available to

investment advisers that act solely as advisers to private funds (a defined category that includes funds relying on the Section 3(c)(1) or Section 3(c)(7) Investment Company Act exemptions) and that have assets under management (AUM) attributable to private fund clients of less than \$150 million in the United States.

An investment adviser relying on the private fund adviser exemption is not required to register with the SEC under the Advisers Act. However, as discussed below, a fund manager who qualifies for the private fund adviser exemption is typically required to file as an Exempt Reporting Adviser, which requires filing a partial Form ADV with the SEC and maintaining certain recordkeeping and reporting obligations, even without full registration.

The \$150 million AUM threshold for the private fund adviser exemption is calculated based on the regulatory AUM of the adviser's private fund clients, the gross value of assets managed for those clients, including leverage. For a real estate fund manager with multiple funds, all of the private fund AUM is aggregated for purposes of the threshold. A manager whose aggregate private fund AUM reaches \$150 million loses the private fund adviser exemption and must either register under the Advisers Act or qualify for a different exemption.

### **The Venture Capital Fund Exemption**

The venture capital fund adviser exemption under Section 203(l) of the Advisers Act is available to investment advisers that act solely as advisers to one or more venture capital funds. A venture capital fund is specifically defined by SEC rule and generally requires: representing to investors that the fund pursues a venture capital strategy, investing primarily in qualifying portfolio companies (which are private operating companies), not being a registered investment company or a business development company, not borrowing at the fund level in excess of 15% of aggregate capital commitments, not offering investors redemption rights in the ordinary course, and not using leverage at the portfolio company level solely to provide capital to the fund.

Real estate funds do not qualify as venture capital funds under this definition. The venture capital fund exemption is not available to real estate fund managers regardless of the fund's structure or strategy. It is mentioned here to clarify that sponsors who have heard of the venture capital fund exemption should not assume it applies to their fund structures.

### **When Registration Is Required**

A real estate fund manager must register as an investment adviser with the SEC (or with state regulators, depending on AUM) when none of the available exemptions apply. The most common path to required registration for a real estate fund manager is growing the platform above the \$100 million AUM threshold that triggers mandatory SEC registration, or above the

\$150 million threshold that ends the private fund adviser exemption, at which point SEC registration is required unless another exemption is available.

Registration is also required when the fund manager advises clients other than private funds. A fund manager who also advises separately managed accounts (individual investor accounts managed on a discretionary basis alongside the fund) may be providing advisory services that fall outside the private fund adviser exemption's scope, which is limited to advice to private fund clients.

Failure to register when registration is required is not merely a compliance oversight. It is a violation of the Advisers Act that exposes the investment adviser to SEC enforcement, disgorgement of fees received while unregistered, and potentially a bar from the securities industry. Investment advisory activities conducted without registration when registration is required are conducted without the regulatory framework that protects investors in registered advisory relationships.

## State Versus SEC Registration: The \$150 Million Threshold

Registration as an investment adviser occurs at either the federal (SEC) or state level, depending on the amount of assets under management. The threshold structure has three tiers based on AUM.

An investment adviser with regulatory AUM below \$25 million must register with the state securities regulator in the state where it has its principal place of business, unless an exemption from state registration is available. SEC registration is generally not available to advisers with AUM below this level. Most states have their own investment adviser registration requirements and their own exemption frameworks. Smaller real estate fund managers (those managing a first or second fund with limited total AUM) typically fall into this state registration tier.

An investment adviser with regulatory AUM between \$25 million and \$100 million is classified as a mid-sized adviser. Mid-sized advisers are generally required to register with the state securities authority in their principal office and place of business and are generally prohibited from registering with the SEC. There are two principal exceptions to this rule. First, a mid-sized adviser whose home state does not subject the adviser to state examination (currently only New York) must register with the SEC rather than the state. Second, certain categories of advisers (including advisers required to register in fifteen or more states, pension consultants, and a few others) may elect SEC registration regardless of AUM. Outside of these specific exceptions, mid-sized advisers cannot voluntarily switch from state to SEC registration.

An investment adviser with regulatory AUM above \$100 million must register with the SEC, unless an exemption from SEC registration is available. The actual mandatory SEC registration



threshold under Rule 203A-1 is \$110 million, with a buffer down to \$90 million before mandatory withdrawal, in order to avoid frequent switching between state and SEC registration as AUM fluctuates near the threshold. SEC registration brings the adviser into the full Advisers Act compliance framework: Form ADV filing and public disclosure, fiduciary duty obligations, compliance program requirements, examination by SEC staff, and the marketing rule obligations described below.

Regulatory AUM for purposes of these thresholds is calculated based on the value of the securities portfolios for which the investment adviser provides continuous and regular supervisory or management services. An account is a securities portfolio if at least 50% of its total value consists of securities. All assets of a private fund (including uncalled capital commitments) are treated as a securities portfolio regardless of the nature of those assets. For a real estate fund manager, all committed capital in each fund counts toward AUM from the time commitments are made, not just from the time capital is deployed.

For real estate fund managers whose aggregate regulatory AUM is below \$150 million and who advise only private funds, the private fund adviser exemption under Section 203(m) typically provides relief from SEC registration, though state registration requirements must still be analyzed separately for each state where the adviser operates or has investors. The private fund adviser exemption does not eliminate all regulatory obligations. ERA filing requirements typically apply regardless of exemption status.

### **⚠ AUM Thresholds Must Be Recalculated Regularly, Including Uncalled Commitments**

*Regulatory AUM includes all assets of a private fund including uncalled capital commitments, not just deployed capital. A real estate fund with \$80 million in committed capital counts at \$80 million for AUM purposes even if only \$40 million has been deployed. Sponsors who track only deployed capital may be significantly underestimating their regulatory AUM and misjudging which registration threshold applies.*

*A fund manager who qualifies for state only regulation or for the private fund adviser exemption when a fund launches may cross the \$100 million SEC threshold or the \$150 million private fund adviser exemption threshold as the platform grows across multiple funds. The calculation must be performed at least annually. An adviser who crosses the applicable threshold must register within 90 days.*

*Continuing to operate as an unregistered adviser after crossing the applicable threshold is a violation of the Advisers Act, a violation that carries disgorgement, enforcement, and potential industry bar consequences. Sponsors building multi fund platforms should build this monitoring obligation into their compliance calendar from the beginning.*

## Exempt Reporting Advisers

An investment adviser that qualifies for either the private fund adviser exemption or the venture capital fund exemption, and is therefore not required to register with the SEC, is nonetheless typically required to file as an Exempt Reporting Adviser (ERA). ERA status involves filing a partial Form ADV with the SEC through IARD (the Investment Adviser Registration Depository) and updating that filing annually, but does not require full registration and does not subject the adviser to all of the compliance obligations that apply to registered investment advisers.

### ERA Filing Obligations

An ERA must file the following portions of Form ADV: Part 1A (Schedule A on ownership and control, Schedule B on indirect owners, Schedule D on private fund reporting for each qualifying fund), and must respond to specific items in Part 1A addressing the adviser's business, disciplinary history, and the private funds it manages. ERA filings are publicly accessible through the SEC's Investment Adviser Public Disclosure (IAPD) database, meaning institutional investors, co investors, and regulatory counterparties can review the fund manager's ERA filing history.

ERA status does not require filing the narrative Part 2 of Form ADV (the brochure that registered advisers must deliver to clients) but it does require annual updating of the Part 1A items that apply. It does not create a relationship with the SEC as a regulated investment adviser in the same way that full registration does. An ERA is not subject to routine SEC examination as a registered investment adviser would be.

The annual updating obligation for ERAs is frequently overlooked by fund managers who treat the initial ERA filing as a one-time task. An ERA whose annual update is not filed on time is in violation of the SEC's ERA reporting requirements, a regulatory failure that is visible in the IAPD database and that creates the same due diligence red flag as a late Form D.

### State ERA Requirements

Many states have their own ERA equivalent requirements that apply to investment advisers who rely on the private fund adviser exemption or other exemptions from full state registration. The specific requirements vary significantly by state. Some states require a state level registration filing even when the adviser is exempt from full registration. Others recognize the federal private fund adviser exemption and impose no independent state filing obligation. Still others impose notice filing requirements similar to the blue sky notice filing requirements discussed in Chapter 19.

A real estate fund manager in Texas, California, New York, or any other major state should confirm the specific state requirements applicable to exempt advisers in that state before relying

solely on the federal private fund adviser exemption. State securities regulators coordinate through NASAA, but state ERA and exempt adviser requirements are not uniform and must be confirmed state by state.

## **Key Compliance Obligations for Registered Investment Advisers**

A real estate fund manager that crosses the registration threshold, or that chooses to register voluntarily through one of the limited categories that permits voluntary SEC registration, enters a comprehensive regulatory framework that imposes ongoing compliance obligations that go well beyond the Regulation D offering compliance described in the preceding chapters.

Understanding what registration requires is essential for sponsors who are approaching the registration threshold and for sponsors who are evaluating whether the benefits of their growing platform justify the compliance infrastructure that registration demands.

### **Form ADV and Public Disclosure**

Form ADV is the registration document and disclosure document for registered investment advisers. It has two parts. Part 1A and Part 1B are detailed questionnaires that collect information about the adviser's business, ownership, key personnel, disciplinary history, and the private funds it manages. Part 2A (the brochure) and Part 2B (the brochure supplement) are narrative disclosure documents that describe the adviser's services, fee structures, investment strategies, conflicts of interest, and disciplinary history in plain English.

Form ADV is filed electronically through IARD and is publicly accessible through the SEC's IAPD database. The brochure (Part 2A) must be delivered to each advisory client at the commencement of the advisory relationship and must be updated and re delivered whenever there are material changes to the information it contains. For a registered investment adviser managing multiple private funds, the brochure is the primary disclosure document that investors receive as a condition of their investment relationship, and its accuracy and completeness are governed by the same antifraud standards that apply to offering documents.

Form ADV must be updated annually within 90 days of the adviser's fiscal year end, and promptly whenever any information becomes materially inaccurate. An adviser whose Form ADV contains inaccurate information, even information that was accurate when filed but has since changed, is in violation of the Advisers Act's requirement that the adviser maintain accurate records.

### **Fiduciary Duty and Conflicts of Interest**

Registered investment advisers are fiduciaries. They owe a comprehensive duty of care and loyalty to their advisory clients. For a registered investment adviser managing a real estate fund, this means the adviser owes a fiduciary duty to the fund's investors that goes beyond the contractual obligations in the operating agreement and the disclosure obligations in the PPM.

The duty of care requires the adviser to provide investment advice that is in the client's best interest, based on a reasonable understanding of the client's financial situation, investment objectives, and risk tolerance. For a fund manager, this means making investment decisions (property acquisitions, hold versus sell determinations, capital structure choices) that are in the best interest of the fund's investors, not merely in the interest of maximizing the adviser's own compensation.

The duty of loyalty requires the adviser to eliminate conflicts of interest where possible, and to disclose all material conflicts that cannot be eliminated so that investors can make informed decisions about whether to accept those conflicts. For a real estate fund manager, common conflicts of interest include affiliated property management arrangements where the adviser earns fees from the fund for services it controls, cross deal conflicts between multiple concurrent funds competing for the same deals, and fee structures that create compensation independent of investment performance.

The Advisers Act's fiduciary duty framework is more demanding than the general legal standard that applies to unregistered fund managers. Registered investment advisers cannot resolve conflicts in their own favor even with disclosure. They must act in the client's best interest, which means placing the client's interests above their own when they conflict.

## Marketing Rule Compliance

The SEC's marketing rule (Rule 206(4)-1 under the Advisers Act, adopted by the SEC on December 22, 2020, effective May 4, 2021, with a compliance date of November 4, 2022 following an 18 month transition period) governs how SEC registered investment advisers can market their services and present their performance records. The marketing rule replaced the prior advertising rule and cash solicitation rule and is one of the most technically demanding compliance obligations for registered real estate fund managers. Its application to real estate investment performance records requires careful attention. The marketing rule applies only to SEC registered investment advisers. Exempt Reporting Advisers are not subject to the marketing rule, though they remain subject to general antifraud requirements that prohibit false or misleading communications.

The marketing rule defines an advertisement broadly to include any communication, distributed to more than one person, that offers the adviser's investment advisory services or solicits investments in an investment company managed by the adviser. For a registered real estate

fund manager, this encompasses website content, PPMs (which may be treated as offering related communications subject to the rule), investor presentations, track record summaries, and any other communication that describes the adviser's services or performance.

Key requirements of the marketing rule relevant to real estate fund managers include the categories below.

- **Performance presentations.** Performance records must be presented fairly and not misleadingly. Net performance (after fees and expenses) must be presented alongside gross performance. Related performance (performance of prior funds managed by the same team) and extracted performance (performance of a subset of a fund's investments) are subject to specific requirements designed to prevent selective presentation of favorable records.
- **Hypothetical performance.** Projected returns and model portfolio performance are hypothetical performance under the marketing rule and are subject to specific conditions, including policies and procedures governing the presentation of hypothetical performance and disclosure of its limitations. Financial projections in PPMs may implicate this requirement.
- **Testimonials and endorsements.** The marketing rule permits the use of testimonials and endorsements (including social media ratings and reviews) subject to specific disclosure requirements, including identifying them as testimonials or endorsements, disclosing whether compensation was paid for the testimonial, and disclosing conflicts of interest.
- **Third party ratings.** The use of third party ratings in marketing materials is subject to requirements including disclosure of the date and time period covered, the identity of the third party providing the rating, and the criteria used in the rating.

## Compliance Program Requirements

A registered investment adviser must adopt and implement a written compliance program reasonably designed to prevent violations of the Advisers Act and the rules thereunder. Under Rule 206(4)-7, the compliance program must be reviewed for adequacy and effectiveness at least annually, and the results of that review must be documented. The adviser must designate a Chief Compliance Officer (CCO) responsible for administering the compliance program.

For a real estate fund manager who registers as an investment adviser, building an adequate compliance program involves written policies and procedures covering all areas of material Advisers Act risk (conflicts of interest, personal trading, portfolio management, valuation, marketing, recordkeeping), annual review of those policies and procedures, training of supervised persons, maintenance of required records, and response protocols for compliance breaches when they are identified.

The CCO does not need to be a full time employee dedicated exclusively to compliance. Many smaller registered investment advisers appoint a principal of the firm as CCO and supplement that designation with compliance consulting services. But the CCO role must be substantive. An SEC examination that reveals a CCO who has not actually administered the compliance program, reviewed policies, or responded to identified breaches will produce deficiency findings that can escalate to enforcement.

## **The Investment Company Act: Why Most Real Estate Funds Must Avoid Coverage**

The Investment Company Act of 1940 is the statute that regulates investment companies, entities whose primary business is investing in securities. Registration as an investment company under the Act imposes a regulatory framework so burdensome that virtually no private real estate fund would voluntarily register: limits on the use of leverage, restrictions on affiliated transactions, SEC approval requirements for management compensation, governance requirements that include independent directors, mandatory registration of publicly offered securities, and ongoing reporting obligations equivalent to those of a public company.

No private real estate fund manager wants to be an investment company. The practical question, therefore, is whether the fund's activities and investment portfolio trigger the Investment Company Act's definition of investment company, and if they do, which exemption is available to avoid registration. This analysis is not optional. It must be conducted before the fund is structured, and the structure must be designed to either avoid investment company status or to satisfy the conditions of an available exemption.

### **The 40% Test and Its Implications**

The foundational definition of an investment company under Section 3(a)(1)(C) of the Investment Company Act covers any issuer that is engaged or proposes to engage primarily in the business of investing, reinvesting, or trading in securities, OR that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40% of the value of the issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

The second prong (the 40% test) is the one that most frequently catches real estate funds. An entity whose investment securities (broadly defined) exceed 40% of its total assets is presumptively an investment company unless it falls within an exclusion or exemption. For a real estate fund that holds its property assets directly in wholly owned SPVs, the equity interests

in those SPVs are securities. If the fund's total assets are primarily those equity interests, the 40% threshold may be exceeded, bringing the fund within investment company status.

This analysis explains a structural feature of many real estate funds that might otherwise seem unnecessarily complex. The fund holds properties through wholly owned or majority controlled subsidiaries rather than through minority interests in other entities because the treatment of those subsidiary interests under the Investment Company Act differs from the treatment of minority equity interests. A fund that controls its property holding entities through managing member or general partner interests may be able to treat those interests as non-securities for purposes of the 40% test under certain interpretive positions, reducing the measured investment securities percentage. This is a technical analysis that requires securities counsel familiar with Investment Company Act positions.

### Section 3(c)(1) and Section 3(c)(7) Exemptions

The two exemptions from investment company status that most private real estate funds rely on are Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act. Each provides a different path to exemption based on the fund's investor population.

**Section 3(c)(1).** A fund is excluded from the Investment Company Act definition if it is not making and does not presently propose to make a public offering of its securities, and has not more than 100 beneficial owners of its outstanding securities. The 100 beneficial owner limit is a hard cap. A fund with 101 investors loses the 3(c)(1) exemption regardless of investor sophistication. The 100 investor count uses look through rules that require counting the investors of certain entity owners (in particular, entities that own 10% or more of the fund's voting securities and that are themselves investment companies or that would be investment companies but for 3(c)(1) or 3(c)(7), and entities formed for the purpose of investing in the fund) which can complicate the count for funds with family offices and investment clubs as investors.

**Section 3(c)(7).** A fund is excluded from the Investment Company Act definition if it is not making and does not presently propose to make a public offering of its securities, and the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers. A qualified purchaser is an individual with at least \$5 million in investments, a company with at least \$25 million in investments, or certain trusts managed by qualified purchasers. The qualified purchaser standard is significantly more demanding than the accredited investor standard. Not every accredited investor is a qualified purchaser. The advantage of 3(c)(7) is that it has no cap on investor count, making it appropriate for large funds with many investors who all meet the higher threshold.

Most real estate syndications and smaller funds (those with fewer than 100 investors and no need for more) rely on the Section 3(c)(1) exemption. Institutional real estate funds with large



investor bases and all institutional investor populations may rely on 3(c)(7). The choice between them is a structural decision that must be made before the fund is formed and before any investors are admitted.

### **⚠ Losing the 3(c)(1) Exemption by Exceeding 100 Investors Has No Cure**

*If a fund that relies on Section 3(c)(1) admits a 101st beneficial owner, it has lost the 3(c)(1) exemption and become an unregistered investment company, a violation of the Investment Company Act.*

*This is not a violation that can be cured after the fact by having the 101st investor exit the fund. The fund was an investment company from the moment the 101st investor was admitted, and any securities transactions during the period of non-compliance are potentially tainted.*

*Fund structures that anticipate growth beyond 100 investors must plan for 3(c)(7) from the outset. They cannot migrate from 3(c)(1) to 3(c)(7) retroactively after exceeding the investor limit. And 3(c)(7) requires that every existing investor, not just new investors, meet the qualified purchaser standard.*

## **Section 3(c)(5): The Real Estate Equity and Ownership Exemption**

Section 3(c)(5)(C) of the Investment Company Act provides an exclusion from investment company status that is specifically and uniquely tailored to entities primarily engaged in owning, acquiring, and managing real estate. It is the most important and most underutilized exemption available to private real estate equity fund sponsors. Understanding its scope correctly opens structural possibilities that the 3(c)(1) and 3(c)(7) exemptions cannot provide.

Section 3(c)(5)(C) excludes from investment company status any issuer primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Despite the statutory language's emphasis on mortgages, decades of SEC staff no action guidance have substantially expanded the exclusion's reach, most importantly by treating direct fee ownership of real property as a qualifying interest. This means 3(c)(5)(C) is not primarily a mortgage fund exemption. It is an equity real estate fund exemption whose asset composition rules are workable for any fund whose portfolio consists primarily of directly owned properties.

Unlike Section 3(c)(1) and Section 3(c)(7), which are defined by the fund's investor count or investor sophistication, Section 3(c)(5)(C) is defined entirely by the nature of the fund's asset



portfolio. A fund that qualifies faces no limit on the number of investors it may admit and does not need to restrict its investors to qualified purchasers. It can raise capital from any number of accredited investors, which is a structural advantage that can double or triple the capital capacity of a direct real estate equity fund compared to what 3(c)(1) permits.

### **The Asset Composition Test: The 55/80/20 Framework**

Qualifying for Section 3(c)(5)(C) requires satisfying a specific asset composition test developed by the SEC staff through decades of no action guidance. The statutory text requires only that the fund be primarily engaged in purchasing mortgages and interests in real estate, but the staff's interpretation imposes numeric thresholds that the market treats as effectively binding.

- At least 55% of the fund's total assets must consist of qualifying interests, the higher quality category of assets that directly represent real property ownership or effective real property control.
- At least 80% of the fund's total assets must consist of qualifying interests plus real estate related interests, a broader category of assets with real estate exposure but without the direct ownership or control that qualifying interests represent.
- No more than 20% of the fund's total assets may consist of miscellaneous assets, assets that are neither qualifying interests nor real estate related interests.

The 55%/80%/20% composition test is the framework within which every 3(c)(5)(C) fund must operate. Understanding precisely which assets fall into which category, and why, is the analytical core of the exemption. The most consequential distinction for a direct real estate equity fund is between fee ownership (a qualifying interest) and minority equity ownership through LP or LLC interests (a real estate related interest, not a qualifying interest). Getting that distinction right determines whether the 55% qualifying interest threshold is achievable.

### **Fee Ownership of Real Property: The Central Qualifying Interest**

The most important qualifying interest category for a typical real estate equity fund sponsor is direct fee ownership of real property. The SEC staff has consistently held, through a series of no action letters, that fee interests in real property qualify as interests in real estate within the meaning of Section 3(c)(5)(C), even though they are technically not mortgages or liens. This is the interpretive position that makes 3(c)(5)(C) genuinely useful for equity sponsors rather than exclusively for lenders.

Fee ownership means outright ownership of the land and improvements, the property held in the fund's name or in a wholly owned or controlled subsidiary. When a real estate fund acquires an apartment building, an office property, or a retail center in a structure where the fund or its wholly owned SPV holds fee title to the property, that asset is a qualifying interest for 3(c)(5)(C) purposes. The staff's reasoning is that fee ownership is the highest form of an interest in real

estate. It represents direct, complete ownership of the real property, which is more substantive than a lien on the property.

This classification has significant structural implications. A fund that acquires properties directly, taking fee title to each asset through controlled SPVs, and whose portfolio consists primarily of those directly owned properties will satisfy the 55% qualifying interest threshold naturally, because each property is a qualifying interest. The fund is doing exactly what real estate equity funds do: buying, owning, and operating real property. The 3(c)(5)(C) exemption is designed to accommodate precisely this business model.

Long term net leases (triple net leases and similar arrangements through which the fund holds the economic equivalent of fee ownership) are also treated as qualifying interests. When a fund holds a long term ground lease on a property, or a long term net lease in which it bears the responsibilities and receives the economic benefits of ownership, the staff has treated that interest as a qualifying interest consistent with the fee ownership classification.

### **The Critical Distinction: Minority LP and LLC Interests Are NOT Qualifying Interests**

The most important limitation in the 3(c)(5)(C) qualifying interest analysis, and the one most consequential for fund structure decisions, is that minority equity interests in real estate owning limited partnerships and LLCs are not qualifying interests. They are real estate related interests, which count toward the 80% threshold but not the 55% threshold.

The distinction is based on the presence or absence of ownership or effective control over the underlying real estate. When a fund owns a minority LP interest in a real estate partnership (a 30% limited partner interest, for example, in a joint venture that owns a specific property) the fund does not own the real estate. It owns an equity interest in an entity that owns the real estate. That equity interest does not represent direct ownership or effective control of the real property itself. It represents a contractual relationship with the partnership, governance rights typically inferior to those of the general partner, and economic rights that flow from the partnership's ownership of the property.

The SEC staff has drawn this line consistently in its no action guidance: direct ownership equals qualifying interest; minority ownership through an entity equals real estate related interest. The rationale is that the statutory language refers to interests in real estate, not interests in entities that own real estate. A minority LP interest is an interest in a partnership, not an interest in the underlying real property the partnership owns.

### ⚠ The Qualifying Interest / Real Estate Related Interest Distinction Drives Fund Structure

*A fund that primarily invests through minority LP or LLC interests in other real estate entities (as a passive LP in other operators' deals, for example) will have difficulty satisfying the 55% qualifying interest threshold, because those minority positions are real estate related interests, not qualifying interests.*

*A fund that acquires properties directly through wholly owned or controlled SPVs (taking fee title to each asset) will satisfy the 55% threshold naturally, because each fee ownership position is a qualifying interest.*

*This distinction creates a clear structural rule for 3(c)(5)(C) funds: the fund must be the owner of record (or through a controlled subsidiary), not a passive minority investor in someone else's deal. The exemption is available to operators who directly control their real estate, not to fund of funds structures or passive co investors in other sponsors' vehicles.*

## What Counts as a Real Estate Related Interest

Real estate related interests (the assets that count toward the 80% threshold but not the 55% threshold) represent the second tier of the 3(c)(5)(C) composition test. For a direct equity fund that is primarily a fee owner, the real estate related interest category matters primarily because it provides flexibility for assets held during transitional periods, for cash equivalents temporarily held between property acquisitions, and for ancillary portfolio positions. Common real estate related interests include the items below.

**Minority equity interests in real estate LLCs and limited partnerships.** As discussed above, minority LP and LLC interests in real estate owning entities are real estate related interests. For a fund that sometimes co invests as a minority partner in deals led by other sponsors, those positions fall here. They count toward the 80% threshold, which means they are not fatal to the exemption, but they erode capacity for qualifying interests at the 55% level. A fund with significant minority passive positions may find the 55% threshold difficult to maintain if those positions grow relative to directly owned properties.

**REIT shares.** Shares in publicly traded or privately held real estate investment trusts count as real estate related interests. A fund that holds REIT shares as a portfolio management tool, a liquidity reserve, or as part of a broader real estate strategy includes those positions in the 80% category.

**Agency and non-agency mortgage backed securities.** CMBS certificates and residential MBS (instruments that provide exposure to pools of real estate mortgages rather than to specific identified properties or loans) are real estate related interests. The staff has consistently

distinguished between holding an individual mortgage on a specific property (qualifying) and holding a certificate backed by a pool of mortgages (real estate related).

**Mortgage loans and real property liens.** First and second mortgage loans, deeds of trust, and other real property liens are qualifying interests when they represent direct lending secured by specific identified real property. For an equity fund that occasionally makes purchase money loans or seller financing arrangements in connection with property acquisitions or dispositions, those mortgage positions can count at the qualifying interest tier, though they are not the primary qualifying asset in a direct equity fund context.

**B notes and preferred equity in real estate entities.** Subordinated debt and preferred equity positions in real estate entities that provide economic exposure but do not represent direct ownership or control are real estate related interests. These positions are increasingly common in complex real estate capital stacks and are specifically contemplated in the real estate related interest category.

### The Practical Structure of a 3(c)(5)(C) Direct Equity Fund

For a real estate equity fund sponsor (a manager who acquires, owns, and operates properties rather than primarily lending against them) the 3(c)(5)(C) structure looks very similar to how a well-structured equity fund already operates. The key structural requirement is that the fund must hold its properties through directly controlled subsidiaries (SPVs), not as minority investors in other entities' deals.

The typical 3(c)(5)(C) equity fund structure: the fund entity (LP or LLC) raises capital from accredited investors, deploys that capital to acquire properties through wholly owned or majority controlled SPVs, manages those properties through the manager's operating platform, and distributes returns to investors over the hold period. Each property held through a wholly owned SPV is a qualifying interest. Each property held through a controlled SPV in which the fund holds a majority interest and effective control over the real estate may also qualify, depending on the degree of control and the nature of the SPV structure.

The composition test discipline requires the fund to avoid building a portfolio in which minority passive positions (co-investments as LP in other sponsors' funds, minority equity positions in joint ventures where the fund is not the operating partner) become a substantial portion of total assets. Those positions erode the qualifying interest percentage and can push the fund below the 55% threshold if they grow too large relative to directly owned properties.

#### **Section 3(c)(5)(C) Asset Composition: Direct Equity Fund Application** **Qualifying Interests (At Least 55% of Total Assets Required)**

- Fee ownership of real property held directly or through wholly owned or controlled SPVs
- Long term net leases providing the economic equivalent of fee ownership
- Ground lease interests where the fund holds the lessee position equivalent to ownership
- Mortgage loans and deeds of trust on specific identified real property (when held)
- Qualifying mezzanine loans with effective real estate control upon default (when held)

#### **Real Estate Related Interests (Qualifying + Real Estate Related At Least 80% of Total Assets Required)**

- Minority LP or LLC equity interests in real estate owning entities (co-investments where the fund is a passive minority investor, not the operator)
- REIT shares (publicly or privately held)
- CMBS certificates and agency or non-agency MBS
- B notes and preferred equity in real estate entities
- Other assets closely connected to real estate investment

#### **Miscellaneous Assets (Maximum 20% of Total Assets)**

- Cash and working capital equivalents above operating needs
- Unrelated investment securities
- Any asset that is neither a qualifying interest nor a real estate related interest

#### **Key Structural Rule**

Direct fee ownership through controlled SPVs = qualifying interest. Minority passive LP or LLC interest in another entity's property = real estate related interest only.

#### **Result**

No investor count limit. Any number of accredited investors permitted. No qualified purchaser requirement (unlike 3(c)(7)).

## **Why 3(c)(5)(C) Is Available to Equity Sponsors, and Why It Matters**

The misconception that Section 3(c)(5)(C) applies only to mortgage funds and lenders has caused most real estate equity fund sponsors to default to 3(c)(1) or 3(c)(7) without considering whether their portfolio would qualify for the more favorable exemption. The reality, properly understood, is that any fund whose portfolio consists primarily of directly owned real estate (as most equity funds do) can potentially qualify for 3(c)(5)(C) if its structure is designed around controlled property ownership rather than passive minority co-investment.

The practical consequences of qualifying for 3(c)(5)(C) versus defaulting to 3(c)(1) are economically significant. A direct equity fund relying on 3(c)(1) is capped at 100 beneficial owners. The same fund relying on 3(c)(5)(C) can admit an unlimited number of accredited investors. At a minimum investment of \$100,000 per investor, the difference between 100

investors and 300 investors is \$20 million in additional equity capacity. At a \$250,000 minimum, it is \$50 million. For a sponsor building a scalable retail accredited investor platform (one designed to raise capital from high net worth individuals who do not meet the qualified purchaser threshold) the 3(c)(5)(C) exemption is transformative.

Qualifying for 3(c)(5)(C) also removes the requirement, inherent in 3(c)(7) structures, that all investors be qualified purchasers (\$5 million in investments for individuals). The accredited investor population is substantially larger than the qualified purchaser population. Many investors who meet the \$1 million net worth or \$200,000 income thresholds for accredited investor status do not have \$5 million in investments. By relying on 3(c)(5)(C), a fund can access the entire accredited investor market, not just its most financially substantial segment.

Sponsors who are evaluating whether their current or planned portfolio qualifies for 3(c)(5)(C) should engage counsel with specific Investment Company Act expertise to conduct the asset classification analysis, design the fund's investment guidelines around the composition requirements, and review the portfolio management practices that will keep the fund within the qualifying interest thresholds throughout its life. The analysis is fact specific, it requires knowledge of the SEC staff's no action positions, and it must be done prospectively, before the fund structure is set, not retroactively after the portfolio composition creates a compliance problem.

### **Why Fund Structure and Investment Guidelines Matter**

Whether a fund qualifies for Section 3(c)(1), 3(c)(7), or 3(c)(5)(C) is determined at the time the fund is structured and must be maintained throughout the fund's life. The Investment Company Act exemption analysis is not a one-time check at formation. It is an ongoing compliance condition that the fund's portfolio composition and investor count must continuously satisfy.

For a 3(c)(5)(C) fund, the investment guidelines in the operating agreement or LP agreement must specify the required asset composition thresholds, require the manager to manage toward those thresholds, and authorize the manager to decline investments (including co-investment opportunities as a minority LP) that would push the fund below the 55% qualifying interest threshold. A fund whose investment guidelines permit unrestricted minority co-investment in other sponsors' deals is a fund that can inadvertently erode its qualifying interest percentage and lose the 3(c)(5)(C) exemption.

The fund administrator must track the qualifying interest percentage, the real estate related interest percentage, and the miscellaneous asset percentage at each reporting date, with the investment guidelines establishing the required thresholds and the remediation procedures for any temporary breach. This is not a burdensome obligation for a fund that primarily owns

properties directly. The qualifying interest percentage for a portfolio of wholly owned properties will almost always be above 55% without active management.

A fund that inadvertently loses the 3(c)(5)(C) exemption, because minority co-investment positions grew above the limits, or because a portfolio management decision changed the asset composition, has become an unregistered investment company, which is a violation of the Investment Company Act with severe consequences. The investment guidelines and ongoing monitoring are the mechanisms that prevent this outcome.

## Investment Company Act Exemption Comparison

The following table summarizes the three primary Investment Company Act exemptions available to real estate funds and their key conditions.

| Exemption          | Investor Count                                                                                 | Investor Qualification                                                                            | Asset Requirement                                                                                                                                                                                                                                                                               | Best Suited For                                                                                                                                                                       |
|--------------------|------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Section 3(c)(1)    | Maximum 100 beneficial owners; hard cap; secondary transfers to non-accredited investors count | Any accredited investor (or sophisticated non-accredited under 506(b))                            | None: portfolio composition not restricted                                                                                                                                                                                                                                                      | Smaller equity syndications; single asset deals; funds with small, defined investor groups                                                                                            |
| Section 3(c)(7)    | No limit on investor count                                                                     | All investors must be qualified purchasers (\$5M investments for individuals; \$25M for entities) | None: portfolio composition not restricted                                                                                                                                                                                                                                                      | Large institutional funds; family offices; investors with significant existing investment portfolios                                                                                  |
| Section 3(c)(5)(C) | No limit on investor count                                                                     | Any accredited investor (no qualified purchaser requirement)                                      | At least 55% qualifying interests (fee ownership of real property through controlled SPVs is primary; also mortgages and direct liens); at least 80% qualifying plus real estate related interests; max 20% miscellaneous. Minority LP and LLC interests = real estate related, not qualifying. | Direct equity real estate funds that own properties through controlled SPVs; any fund whose portfolio is primarily directly owned real estate, not passive minority co-investments in |



| Exemption | Investor Count | Investor Qualification | Asset Requirement | Best Suited For       |
|-----------|----------------|------------------------|-------------------|-----------------------|
|           |                |                        |                   | other sponsors' deals |

## Practical Takeaways

- Real estate fund sponsors are investment advisers, despite the widespread belief among real estate operators that the Advisers Act does not apply to them. The analysis turns on applying the Howey investment contract test to the fund's own real estate investments, not to the LP or membership interests that investors hold. When the fund is an externally managed entity relying on an affiliated operating platform to identify, acquire, and manage real estate assets, the fund is a passive investor in those assets, those assets are investment contracts (securities), the fund's portfolio is a securities portfolio, and the operating platform managing that portfolio is an investment adviser.
- The only structure that may avoid Advisers Act coverage is a fund whose general partner or manager can independently manage all real estate functions (acquisition, operation, disposition) without relying on a separate affiliated operating platform. Most private real estate funds do not have this structure. Publicly listed REITs that are internally managed by their own boards and executives are the clearest example of a structure that may avoid Advisers Act coverage, but even then, the LP or member interests offered to the public are fully subject to the Securities Act and Exchange Act.
- Regulatory AUM includes uncalled capital commitments, not just deployed capital. A fund manager with \$80 million in committed capital but only \$40 million deployed is at \$80 million for AUM threshold purposes. Below \$25 million in AUM, state only regulation typically applies. Between \$25 million and \$100 million, advisers are classified as mid-sized advisers and are generally required to register with the state rather than the SEC, with limited exceptions (most notably advisers based in New York, where state examination is not available, and certain specifically defined categories such as multi-state advisers required to register in fifteen or more states). Above \$100 million (with an actual mandatory SEC registration threshold of \$110 million and a buffer down to \$90 million before mandatory withdrawal), SEC registration is required unless an exemption is available. The private fund adviser exemption provides relief from SEC registration for advisers with private fund AUM below \$150 million who advise only private funds.
- State registration requirements for investment advisers are independent of the federal framework. A fund manager exempt from SEC registration may still be required to register or file with state securities regulators in states where the fund has investors. State requirements must be confirmed separately for each relevant state.



- Registered investment advisers are fiduciaries with duties of care and loyalty to their advisory clients. For real estate fund managers, this means making investment decisions in investors' best interests and disclosing all material conflicts, a standard more demanding than mere contract compliance or general duty of good faith.
- The SEC marketing rule (Rule 206(4)-1, adopted December 22, 2020, compliance date November 4, 2022) applies only to SEC registered investment advisers. Exempt Reporting Advisers remain subject to general antifraud requirements but not to the specific marketing rule requirements. For registered real estate fund managers, the marketing rule imposes specific obligations around performance presentations, hypothetical performance, testimonials, endorsements, and third party ratings that require careful integration with PPM disclosure and ongoing investor communications.
- The Investment Company Act's investment company definition is triggered when a fund's investment securities exceed 40% of total assets. The analysis must be conducted before the fund is structured, and the structure must be designed either to avoid the definition or to satisfy a specific exemption's conditions.
- Section 3(c)(1) limits the fund to 100 beneficial owners and imposes no investor qualification requirement beyond accreditation. It is the standard exemption for most private real estate equity syndications but caps investor count in ways that limit fund scale.
- Section 3(c)(7) removes the investor count limit but requires all investors to be qualified purchasers, a significantly higher financial threshold than accredited investor status. It is appropriate for institutional quality funds with sophisticated investor bases.
- Section 3(c)(5)(C) is not limited to mortgage funds and lenders, despite the statutory language's emphasis on mortgages. The SEC staff has consistently held that direct fee ownership of real property is a qualifying interest, making 3(c)(5)(C) available to any direct real estate equity fund whose portfolio consists primarily of properties owned through controlled SPVs. This is the most significant and most underappreciated feature of the exemption.
- The central structural distinction in the 3(c)(5)(C) qualifying interest analysis: fee ownership of real property through a wholly owned or controlled subsidiary is a qualifying interest; a minority LP or LLC interest in a real estate owning entity is a real estate related interest, not a qualifying interest. A fund that primarily acquires and controls its properties directly satisfies the 55% threshold naturally. A fund that primarily invests as a passive minority LP in other sponsors' deals will have difficulty meeting the 55% threshold regardless of how real estate focused the portfolio appears.
- The economic consequence of qualifying for 3(c)(5)(C) versus defaulting to 3(c)(1) is material and scalable: no investor count limit versus a hard 100 investor cap. A fund with a \$250,000 minimum investment that can admit 300 accredited investors instead of 100

raises \$50 million more equity. For sponsors building retail accredited investor platforms, this is not a technical footnote. It is a fundamental business capacity decision.

- Qualifying for 3(c)(5)(C) also removes the qualified purchaser requirement of 3(c)(7). The accredited investor population is substantially larger than the qualified purchaser population. By relying on 3(c)(5)(C), a direct equity fund can access the full accredited investor market, not just the subset that happens to have \$5 million in investments.
- Fund investment guidelines must be drafted to implement the 3(c)(5)(C) composition requirements: at least 55% qualifying interests, at least 80% qualifying plus real estate related interests, no more than 20% miscellaneous. For a direct equity fund whose portfolio consists primarily of owned properties, maintaining the 55% threshold is not operationally burdensome. What can erode it is growing minority co-investment positions in other sponsors' deals, a portfolio management decision that the investment guidelines should constrain.
- The Investment Advisers Act and Investment Company Act analyses are specialized fields within securities law that require counsel with specific expertise in these statutes. A real estate securities attorney who understands Regulation D offerings may not have the Investment Company Act interpretive knowledge needed to conduct the asset classification analysis for 3(c)(5)(C) or to handle the investment adviser registration question for a growing platform.

## CHAPTER TWENTY ONE

# Who Can Legally Raise Capital for a Real Estate Syndication or Fund?

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If you were to identify the single compliance failure that most consistently brings otherwise well intentioned real estate sponsors into regulatory jeopardy, it would not be a missed Form D or an improperly drafted operating agreement. It would be a compensation arrangement with someone who helped raise money (a colleague who made introductions, a marketing professional who promoted the offering online, a platform that connected investors to the deal) where that person or entity received payment tied to the amount raised and nobody asked whether that payment structure required broker dealer registration.

The broker dealer problem is not new. It has existed in real estate syndications for decades, surfacing in enforcement actions year after year against sponsors who genuinely did not understand that they were doing something unlawful. The instinct makes sense. If someone helps you find investors and the investment performs well, paying them a share of what they helped raise seems fair. The problem is that effecting transactions in securities for compensation (which is what that arrangement describes) is a federally regulated activity that requires registration under the Securities Exchange Act of 1934.

This chapter works through the capital raising framework as it applies to real estate syndications and funds: who can legally raise capital and under what conditions, what the issuer exemption covers and what it does not, what finders can and cannot do and why the space is so consistently misunderstood, how registered placement agents fit into the picture, how online platforms and funding portals are analyzed under the existing regulatory framework, and what the criminal and civil consequences are when these rules are ignored. The goal is not to make capital raising sound more complicated than it is. It is to give sponsors the framework to structure their arrangements correctly from the start, so that none of the consequences described in this chapter ever become relevant.

## The Broker Dealer Requirement

Section 15(a) of the Securities Exchange Act of 1934 makes it unlawful for any broker or dealer to use the mails or any facility of interstate commerce to effect transactions in securities unless registered with the SEC. Section 3(a)(4) of the Exchange Act defines a broker as any person engaged in the business of effecting transactions in securities for the account of others. Section 3(a)(5) defines a dealer as any person engaged in the business of buying and selling securities for that person's own account.

These definitions are deceptively simple. Their application to the range of activities involved in raising capital for a private real estate offering is considerably more nuanced. The SEC has interpreted the broker definition through decades of enforcement actions, no action letters, and interpretive guidance, identifying specific conduct patterns that indicate a person is operating as a broker regardless of how the arrangement is labeled in a contract or how the parties describe it to each other.

## Who Is a Broker Dealer Under the Exchange Act

A broker dealer is any person or firm engaged in the business of effecting securities transactions. The critical phrase is effecting transactions, which the SEC and courts have interpreted to include a wide range of activities that go beyond simply executing a trade. Soliciting investors, receiving transaction based compensation, handling investor funds, providing investment advice or recommendations, and participating regularly in securities related transactions are all activities that, in combination, indicate broker dealer status.

Registration as a broker dealer is not a formality. It requires membership in FINRA (the Financial Industry Regulatory Authority), compliance with capital requirements, adherence to conduct rules and supervisory obligations, ongoing examination by FINRA and the SEC, and the full suite of regulatory obligations that the broker dealer framework imposes. These requirements exist because broker dealers occupy a position of trust and authority in securities transactions, and the regulatory framework reflects that responsibility.

The significance of the registration requirement for real estate sponsors is direct: anyone who receives transaction based compensation for selling the sponsor's securities, or for facilitating investors' purchases of those securities, needs to be a registered broker dealer unless a specific exemption applies. That is not a rule with many exceptions. Its application is broad, and the consequences of non-compliance are significant.

## The Five Factors the SEC Examines

When evaluating whether an individual or entity is operating as an unregistered broker, the SEC and courts examine whether the person did the things below.

- Solicited investors actively, meaning reached out to potential investors to interest them in a specific securities offering, as opposed to making a purely passive introduction with no pitch, analysis, or persuasion involved.
- Received transaction based compensation, meaning payment was contingent on the success of the securities transaction rather than a fixed fee for services rendered regardless of outcome. A commission, a percentage of capital raised, or any payment that increases when more investors invest is transaction based compensation.

- Handled investor funds or securities, meaning received, transmitted, or held money or securities belonging to investors in connection with the offering.
- Provided investment advice or recommendations, meaning offered analysis of the investment's merits, recommended that specific persons invest, or compared the offering favorably to other investment alternatives, beyond merely conveying factual information about the opportunity.
- Participated regularly in the securities business, meaning the person's involvement was part of an ongoing practice of facilitating securities transactions rather than a single isolated event unconnected to any pattern of similar activity.

No single factor is dispositive. The analysis is holistic, and different combinations of factors can produce broker status under different fact patterns. But in practice, two factors together are reliably predictive: active solicitation combined with transaction based compensation. A sponsor who pays someone a commission or percentage of capital raised while that person is out talking to investors has almost certainly created an unregistered broker dealer arrangement, regardless of what the contract calls it and regardless of how the parties understood the relationship at the time.

## Why Raising Capital for Others Triggers Registration

The broker dealer registration requirement is most clearly implicated when a person raises capital for someone else's offering, an arrangement that is common in real estate syndication, where sponsors frequently bring in outside assistance with investor development. But even in the context of a sponsor's own offering, the issuer exemption described below has limits, and activities that exceed those limits push the sponsor's own personnel into broker territory.

The policy rationale for the broker dealer registration requirement is straightforward. Persons who hold themselves out as facilitators of securities transactions are in a position of significant influence over investors' decisions. Registration ensures that those persons are subject to conduct rules, supervisory oversight, examination, and financial responsibility requirements that protect the investors they serve. When someone operates in that role without registration, investors lose those protections, and the law gives them remedies designed to address that loss.

## The Issuer Exemption

Rule 3a4-1 under the Securities Exchange Act provides a safe harbor (commonly called the issuer exemption) that allows certain persons associated with the issuer of a security to participate in selling the issuer's own securities without registering as broker dealers. This rule is the primary mechanism through which a sponsor who is an officer or employee of the issuing

entity can talk to investors, conduct investor meetings, respond to questions about the offering, and otherwise participate in the capital raising process without triggering registration requirements.

The rule's conditions are specific, and sponsors consistently underestimate how demanding they are in practice.

### **What the Issuer Exemption Covers**

To qualify for the issuer exemption, the person engaging in capital raising activities must satisfy all of the following conditions simultaneously.

- They must be an associated person of the issuer, specifically an officer, director, or employee of the entity issuing the securities. Not a contractor engaged through a separate LLC. Not a consultant who is paid separately for capital raising services. Not a partner who receives a share of profits. The person must have an employment or officer relationship with the issuer itself.
- Their compensation must not be transaction based. The rule specifically prohibits compensation that is paid directly or indirectly as remuneration for securities sales activities. A salary or flat retainer that does not vary based on capital raised satisfies this condition. A bonus that increases as more investors participate does not.
- They must not be associated with a registered broker dealer. If the person who wants to use the issuer exemption has a current FINRA registration or a formal affiliation with a registered broker dealer, the issuer exemption is unavailable to them regardless of their employment relationship with the issuer.
- Their activities must be limited to those specifically authorized by the rule: preparing or sending written communications about the offering, responding to investor inquiries that investors initiated, and performing ministerial or clerical functions in connection with the offering. Cold outreach, mass solicitation campaigns, and organized sales presentations directed at recruiting new capital all fall outside the rule's authorization.

For a practical real estate syndication, the import is this. The sponsor who is an officer of the manager entity can answer calls from investors who reach out, discuss the offering with people already in their network, appear on podcasts or at conferences to describe their investment strategy in general terms, and distribute written offering materials to persons with whom they have a pre-existing relationship, all without registering as a broker dealer. What the sponsor cannot do is pay anyone else a commission for making introductions, or hire a sales team compensated on a per investment basis, without running directly into the registration requirement.

### **What the Issuer Exemption Does Not Cover**

The issuer exemption is frequently misunderstood in two related ways. The first is treating it as covering persons who are not actually employees or officers of the issuer. Contractors, consultants, and affiliated entities hired to assist with capital raising do not qualify for the exemption regardless of how the arrangement is structured or what the agreement calls them. The exemption belongs to the issuer's own employees and officers, not to outside parties engaged to perform capital raising functions.

The second misunderstanding is treating the exemption as covering the compensation paid to outsiders for introductions. It does not. A sponsor who relies on the issuer exemption for their own activities can still violate the broker dealer rules by paying someone outside the issuer's employee structure a commission or percentage of capital raised. The issuer exemption applies to the sponsor's own conduct. It does not create permission to pay others for theirs.

### The Multi Offering Platform Problem

A complication arises for sponsors building platforms designed to conduct multiple offerings over time. The issuer exemption was designed to accommodate occasional, deal specific participation by a company's own officers, not to cover a systematic, ongoing capital raising operation across multiple investment vehicles. Once a person's securities activities rise to the level of a regular, ongoing business (raising capital across multiple offerings, building a marketing infrastructure, developing a professional investor development function) the question of whether the issuer exemption still applies to each individual transaction becomes more complex.

Sponsors who are building genuine real estate investment platforms (with a pipeline of deals, multiple concurrent offerings, and a professional capital raising function) should analyze with securities counsel at the outset whether their anticipated activity level is better served by the issuer exemption or by working with a registered placement agent from the beginning. Getting that analysis right before the platform is built costs significantly less than correcting an unregistered broker problem after it has been embedded in multiple completed offerings.

#### **⚠ The Issuer Exemption Covers Sponsors Talking to Investors, Not Paying Others to Do So**

*The single most common broker dealer compliance failure in real estate syndications is paying an unregistered third party a commission, a percentage of capital raised, or any transaction based compensation for introducing investors to the offering. The issuer exemption applies to officers and employees of the issuer who are compensated on a fixed basis for their employment. It does not extend to outside referral sources, marketing professionals, or any person paid based on the results of their capital raising efforts.*

*Calling a commission arrangement a referral fee, a marketing expense, a business development payment, or a finder's fee does not change what it is. The characterization of the payment has no bearing on the legal analysis. The legal analysis turns on whether the payment is contingent on the success of a securities transaction. If it is, the exemption does not apply.*

## Finders: What They Can and Cannot Do

The finder concept (a person who introduces investors to an offering and receives compensation for doing so) has been a persistent source of compliance failures in private securities offerings for as long as those offerings have existed. The concept sounds reasonable: someone makes an introduction, gets paid if the introduction leads to an investment. The problem is that receiving transaction based compensation for introducing investors to a securities offering is, under the SEC's analysis, acting as a broker. And brokers must be registered.

The label finder does not create an exemption from the broker dealer registration requirement. Courts have consistently declined to recognize a standalone finder exception to Section 15. No action letters from the SEC have never established a bright line category of permissible unregistered finder activity. The SEC's enforcement history in this area makes clear that the characterization of an arrangement as a finder fee is not legally meaningful. What matters is the economic reality of what the person did and how they were compensated.

### The Legal Gray Zone of the Finder

The SEC has acknowledged, in guidance and through the no action letter process, that truly limited finder activity (where a person does no more than provide a single introduction between a specific issuer and a specific investor, without making any sales effort, providing investment analysis, or receiving compensation tied to whether the investor actually invests) may occupy a gray zone that stops short of requiring broker registration. But the practical conditions for operating within that gray zone are demanding enough that most real world finder arrangements fall well outside it.

For finder activity to avoid broker status, the SEC's analysis requires the person to be making a single, isolated introduction rather than operating as part of a recurring business of connecting issuers with investors; providing no analysis, recommendation, or endorsement of the investment's merits to the potential investor; receiving compensation that is not contingent on the investor's actual participation (a flat fee for the introduction itself, regardless of whether it



leads to a subscription); and having no involvement in handling investor funds, subscription documents, or other aspects of the transaction.

The person a sponsor typically wants to engage as a finder is someone who has investor relationships, knows how to present an investment opportunity effectively, and will be more motivated to make introductions if they receive a share of the capital raised. That profile (motivated, engaged in the pitch, compensated on results) describes a broker, not a finder. The practical message is that if the arrangement looks economically like a commission structure, it should be analyzed as one.

## What Activities Require Registration

Any of the following activities, when combined with transaction based compensation, reliably indicate that a person is operating as an unregistered broker.

- Actively soliciting investors, reaching out to potential investors to describe the offering, its terms, or its projected returns, whether by phone, email, in person meeting, or digital communication.
- Presenting investment opportunities, hosting calls or meetings where the offering is pitched to potential investors, or sending materials that describe the offering in terms designed to encourage investment.
- Qualifying or screening investors, gathering information from potential investors about their financial situation, investment experience, or accreditation status in connection with the offering.
- Following up on investor interest, contacting potential investors after an initial introduction to advance the capital raising process.
- Participating in multiple offerings, operating as a capital raising intermediary across multiple issuers or offerings, which demonstrates that the activity is part of a business rather than a single isolated event.

Each of these activities, standing alone, does not necessarily constitute broker activity. Context and compensation matter. But each of them, combined with transaction based compensation, produces broker status under the SEC's analysis. The sponsor who pays anyone to do any of these things on a commission basis has an unregistered broker problem.

## The M&A Broker Exemption

In December 2022, Congress enacted a statutory exemption from broker dealer registration for M&A brokers (persons who facilitate mergers, acquisitions, business sales, and similar transactions involving privately held companies). The exemption was added through Section 501 of the Consolidated Appropriations Act of 2023, which amended Section 15(b) of the

Exchange Act to add new subsection 15(b)(13). The exemption was signed into law on December 29, 2022, and became effective March 29, 2023. The new statutory exemption codifies in rule form what had previously been addressed through the SEC's 2014 no action letter to Faith Colish, providing an exemption for persons facilitating certain business transfers without needing to register as broker dealers.

The M&A broker exemption is relevant in the real estate syndication context primarily for what it does not cover. The exemption applies to persons facilitating the sale or transfer of an eligible privately held company as a business, not to persons facilitating the sale of securities in a fund or investment offering. A sponsor who raises capital from investors for a real estate fund by paying an intermediary a commission based on capital raised is not in M&A broker territory. The intermediary is selling fund interests, not facilitating a business acquisition. The M&A broker exemption does not provide any relief for standard finder or capital raising arrangements in a real estate syndication or fund context.

The exemption is noted here because sponsors who have heard of it sometimes mistakenly believe it provides broader relief than it does. For capital raising arrangements in private real estate funds and syndications, the M&A broker exemption is not available. The analysis returns to the five factor broker test and the issuer exemption as the only available frameworks.

## **Registered Broker Dealers and Placement Agents**

For sponsors who want to use third party capital raising assistance and compensate those parties based on results, the compliant path is a FINRA registered placement agent, a registered broker dealer that specializes in connecting private securities offerings with investors. A registered placement agent can do everything an unregistered finder cannot: actively solicit investors, present investment opportunities, receive commissions, and participate fully in the capital raising process. Registration is what authorizes those activities.

### **When to Hire a Placement Agent**

The decision to engage a placement agent is driven by a combination of legal necessity and practical strategy. The legal necessity arises when the sponsor wants to compensate a third party on a transaction based basis for capital raising activities. That arrangement requires the third party to be registered. The practical strategy consideration is whether the placement agent provides market access that the sponsor's own network cannot.

Placement agents are most valuable to sponsors in three circumstances: when the sponsor is targeting institutional investors, family offices, or RIA platforms whose gatekeepers typically require intermediary engagement; when the sponsor is raising capital at a scale that exceeds what their personal network can support without professional distribution; and when the sponsor

wants access to investor relationships in markets or investor categories outside their current network. A well regarded placement agent with established relationships among family offices and registered investment advisers can introduce a private real estate offering to a credentialed investor population that the sponsor's own network might never reach.

For smaller offerings (those relying entirely on the sponsor's existing investor relationships, where the sponsor's own officers are doing all investor outreach and no third parties are receiving transaction based compensation) a placement agent is not legally required. The issuer exemption covers the sponsor's own activities, and the capital raising can proceed without engaging a registered intermediary. The obligation to use a registered placement agent arises when the sponsor wants someone outside the issuer's own employee or officer structure to receive transaction based compensation for capital raising activities.

### Typical Placement Agent Fee Structures

Placement agent compensation is structured as a percentage of gross proceeds raised through the agent's efforts, typically ranging from 5% to 8% for real estate private placements. The specific rate reflects the size of the offering, the placement difficulty, the agent's market access and reputation, and market conditions at the time of engagement. Some placement agents also negotiate for warrants or co-investment rights alongside the cash commission, which aligns the agent's longer term economic interest with the offering's performance.

For fund structures with multiple closings, the placement agent agreement should specify whether the commission applies to all investors introduced by the agent (regardless of which closing they participate in) or only to investors who fund in the first closing. The distinction matters when subsequent closings attract investors who may have been initially introduced by the agent but funded later. The agreement should also address the tail period, the period after the engagement ends during which the agent is entitled to commission for investors they introduced who subsequently invest, and the definition of which investors count as the agent's introductions for commission calculation purposes.

Placement agent fees reduce the net proceeds available for investment and must be disclosed in the PPM's use of proceeds section as a cost of the offering. A \$10 million offering that pays 6% in placement agent commissions has \$9.4 million available for real estate investment. Investors are entitled to know this, and the PPM must reflect it accurately. Burying placement agent compensation in vague offering expense categories, or failing to disclose it entirely, creates the same material omission problem as any other material disclosure failure.

### Supervision and Due Diligence Obligations

A registered placement agent does not simply lend its regulatory status to a sponsor's offering. It takes on independent obligations that matter to the offering's integrity. FINRA rules require

placement agents to conduct reasonable due diligence on any offering they agree to represent: reviewing the offering documents, evaluating the sponsor's track record and qualifications, assessing the investment's risk profile, and confirming that the offering's terms are consistent with the representations being made to investors.

A placement agent who markets an offering without conducting reasonable due diligence has exposure under FINRA rules and under the securities laws' antifraud provisions, which is why reputable placement agents are selective about the offerings they agree to represent. This selectivity is valuable to sponsors as a signal of quality. The willingness of a well regarded placement agent to represent an offering is evidence that the offering passed a credentialed professional's due diligence review, which carries weight with institutional investors who conduct their own diligence.

The sponsor, in turn, must cooperate fully with the placement agent's due diligence process, providing accurate and complete information, making key personnel available for interview, and disclosing all material facts about the offering, the sponsor's background, and the underlying investment. A sponsor who withholds material information from a placement agent's due diligence process has not just undermined the placement agent's ability to perform its regulatory obligations. It has created its own antifraud exposure from a transaction in which investors relied on representations that were made without full information.

### **⚠ Placement Agent Compensation Must Be Disclosed in the PPM**

*A placement agent relationship that is not fully disclosed in the PPM creates a material omission in the offering documents. The disclosure must identify the placement agent, describe the nature of the relationship and the services being provided, disclose the compensation rate and structure, and reflect the placement agent's fees as a line item in the use of proceeds section.*

*Investors have a right to know that a portion of their capital is being paid to a third party for introducing them to the offering, and that the person who encouraged them to invest received compensation for doing so. Concealing or minimizing that disclosure is not a minor formatting issue. It is a material omission under the antifraud standards that apply to all offering documents.*

## **Online Platforms and Funding Portals**

The growth of online platforms that facilitate private securities offerings (real estate crowdfunding sites, investor portal providers, deal aggregation platforms) has created a

category of market participant whose regulatory status requires careful analysis. These platforms sit at the intersection of technology services and securities regulation, and whether any specific platform needs to register as a broker dealer depends on what it actually does and how it gets compensated, not on whether it describes itself as a technology company rather than a financial intermediary.

The SEC's analysis of online platforms applies the same five factor broker test described earlier in this chapter. Technology based delivery does not create a new regulatory category and does not exempt platforms from the analysis. A platform that solicits investors, curates or recommends investment opportunities, facilitates investor onboarding in ways that go beyond ministerial processing, and receives compensation calculated as a percentage of capital raised is operating as a broker regardless of whether it describes its service as software, infrastructure, or marketplace technology.

### The SEC's Framework for Evaluating Online Platforms

The most reliable indicator of broker status in the online platform context, as in the finder context, is compensation structure. A platform that charges the same fee whether investors invest or not (a flat technology fee, a monthly subscription, a per transaction processing charge) has a much cleaner broker dealer analysis than a platform whose economics improve the more capital its users invest. Sponsors evaluating platforms should pay close attention to how the platform is compensated, because that single fact is the most predictive indicator of the broker dealer analysis outcome.

Beyond compensation, the SEC examines whether the platform selects or curates offerings for presentation to its user base (indicating judgment about investment merit), whether it provides materials or analysis that function as investment recommendations, whether it assists with investor qualification in ways that go beyond ministerial credential collection, and whether it participates in the mechanics of the transaction in ways that reflect an ongoing role in securities activity rather than a one-time technological service.

### Three Categories of Platforms and Their Regulatory Status

**Pure technology platforms (generally not broker dealers).** A platform that provides offering document hosting, investor portal software, and compliance infrastructure (but takes no role in investor solicitation, investment analysis, or capital raise success metrics) is most likely not a broker dealer. Its role is analogous to the printing company that prints the PPM: necessary infrastructure for the offering, not a participant in the securities transaction itself. Even within this category, the platform must exercise care about compensation structure. A platform that charges a percentage of offering proceeds crosses from technology vendor to potential broker,

and a platform with any role in reviewing investor eligibility beyond ministerial credential processing should assess whether that role constitutes providing investment related analysis.

**Marketplace platforms (potentially broker dealers).** A platform that aggregates multiple offerings from different sponsors, presents those offerings to its user base, facilitates investor onboarding across multiple offerings, and receives compensation from issuers calculated as a percentage of capital raised is almost certainly operating as a broker and must be registered or affiliated with a registered broker dealer. This category includes many of the well known real estate crowdfunding platforms. Sponsors using marketplace platforms should confirm the platform's regulatory status before listing an offering. If the platform is operating as an unregistered broker, using it creates the Section 29(b) rescission exposure described below. If the platform is registered or affiliated with a registered broker dealer, the relationship must be disclosed in the PPM as a placement agent relationship.

**Regulation CF funding portals (specifically authorized).** Regulation Crowdfunding, adopted under Title III of the JOBS Act, created a specific category of regulated intermediary called a funding portal for offerings conducted under Regulation CF. A registered funding portal can facilitate Regulation CF offerings without registering as a full broker dealer, but it is subject to a specific regulatory framework administered jointly by FINRA and the SEC. Funding portals are limited to Regulation CF offerings. They cannot facilitate Regulation D offerings. They represent the specific statutory authorization Congress created for online capital raising intermediaries in the crowdfunding context. Real estate sponsors using Regulation CF must use either a registered funding portal or a registered broker dealer as the intermediary for the offering.

**Regulation A+ platforms.** Regulation A+ Tier 2 offerings that involve broad public marketing through online platforms require that any platform participating in the capital raising process on a commission or transaction based basis be a registered broker dealer. Registered broker dealers who specialize in Regulation A+ distribution have emerged as a distinct market segment, and sponsors conducting Regulation A+ offerings should confirm that their digital distribution channels have appropriate broker dealer registration before those channels are engaged on a fee basis.

## Criminal and Civil Liability for Unregistered Securities Activity

The consequences of operating as an unregistered broker dealer, or of knowingly engaging an unregistered broker, are not merely technical regulatory violations. They are severe, they extend to the issuer as well as the person acting as the broker, and they create financial exposure that is asymmetric in the worst possible way for sponsors. Understanding the full scope of liability is

the most effective argument for structuring capital raising arrangements correctly from the outset.

### **Civil Liability Under Section 29(b) of the Exchange Act**

Section 29(b) of the Securities Exchange Act of 1934 provides that any contract made in violation of the Act is void as to the persons whose performance constitutes the violation. In the broker dealer context, this provision has a direct and financially devastating application: any subscription agreement entered into in connection with an unregistered broker's capital raising activities may be voidable at the option of the investor.

This means investors who were introduced to the offering through an unregistered broker have the right to demand return of their invested capital, with interest, even if the investment has performed well and the investor has received distributions. The broker violation infects the investor's subscription agreement, giving them a rescission right that exists independent of the investment's actual performance.

The asymmetry of this exposure is brutal. The investors who want out when the investment underperforms will demand rescission. The investors who are satisfied with their returns will not. The sponsor bears the full downside of the investor pool's disappointed expectations without any offsetting benefit from the pool's contented members. For a \$15 million offering where \$8 million was raised through an unregistered broker's introductions, the sponsor could face \$8 million in rescission demands plus interest, at a moment when that capital is fully deployed into an illiquid real estate asset.

The sponsor does not escape this consequence by pointing to the unregistered broker as the responsible party. The sponsor chose to use the broker, structured the compensation arrangement, and benefited from the capital the broker raised. The Section 29(b) right runs against the issuer, not just the broker, because the issuer is the party whose contract (the subscription agreement) was made in violation of the Act.

### **SEC Civil Enforcement**

The SEC's Division of Enforcement pursues civil enforcement actions against unregistered broker dealers and against issuers who knowingly engage them. In a civil enforcement action, the SEC can seek the remedies listed below.

- Disgorgement of all profits derived from the unregistered broker dealer activity, which typically includes the compensation paid to the unregistered broker, and may include a portion of the profits the issuer earned from capital raised through the broker's efforts.



- Civil monetary penalties, which are calculated on a per violation basis and can be substantial. Each investor introduced by an unregistered broker may constitute a separate violation, meaning the penalties scale with the number of investors.
- Injunctions prohibiting future violations and future participation in certain securities related activities.
- Officer and director bars, orders preventing the principals of the issuer from serving as officers or directors of public companies or from participating as issuers, underwriters, or promoters in future securities offerings.

The SEC's enforcement posture toward unregistered broker dealer activity in private securities offerings has been consistently active, and real estate syndications have been a consistent enforcement area. Sponsors who have built multi offering platforms using commission based intermediaries and who have not analyzed the broker dealer implications of those arrangements are operating under a level of enforcement risk that their capital raising economics do not justify.

### **Criminal Liability Under Section 32 of the Exchange Act**

Willful violations of the Securities Exchange Act, including willful operation as an unregistered broker dealer, are federal crimes under Section 32 of the Exchange Act (15 U.S.C. § 78ff). A person who knowingly engages in unregistered broker dealer activity (meaning they understood that their conduct constituted effecting securities transactions for others and chose to proceed without registration) can face criminal fines of up to \$5 million per violation for individuals, imprisonment of up to twenty years per violation, and, for entities, criminal fines of up to \$25 million.

Criminal prosecution for unregistered broker dealer activity is more common than many sponsors assume. The Department of Justice has pursued criminal cases based on unregistered broker activity in real estate syndications, in Ponzi adjacent fund structures where unregistered brokers were the primary distribution channel, and in digital securities offerings where platform operators facilitated the sale of securities without registration. The willfulness standard in criminal cases requires proof that the defendant knew their conduct was unlawful, but in a regulatory environment where the broker dealer rules are publicly available and the SEC has published extensive guidance, demonstrating willfulness is not as difficult as sponsors sometimes imagine.

### **Liability for the Issuer When an Unregistered Broker Is Used**

Sponsors should understand clearly that the unregistered broker problem does not belong solely to the unregistered broker. The issuer who engaged, compensated, and benefited from an unregistered broker's activities has its own exposure across multiple dimensions.



- Section 29(b) rescission rights run against the issuer. Investors introduced by the unregistered broker can demand return of capital from the issuer, not just from the broker.
- SEC enforcement exposure for causing or facilitating a violation of Section 15. The issuer who knowingly engaged an unregistered broker can be pursued as an aider and abettor of the broker's violation.
- Impact on the offering's Regulation D exemption. Depending on the circumstances, unregistered broker activity in connection with an offering can impair the exemption itself, leaving the offering as an unregistered public offering with all of the busted exemption consequences described in Chapter 18.
- Investor fraud claims beyond Section 29(b). Investors who were solicited by an unregistered broker may bring fraud based claims on the theory that they would not have invested but for the broker's unlawful solicitation, potentially producing damages broader than the straight rescission right.

| Arrangement                                                                                                            | Legal Analysis                                                                                                                                                                                            | Risk Level                     |
|------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------|
| Sponsor officer or employee of manager entity; fixed salary; speaks to investors; no transaction based compensation    | Issuer exemption available under Rule 3a4-1. Permissible without broker registration.                                                                                                                     | Low                            |
| Friend or associate who introduces a specific investor in exchange for a fixed fee unrelated to investment amount      | Requires careful analysis. If truly no transaction based element, no active solicitation, and this is an isolated event, may not constitute brokering. Confirm with securities counsel before proceeding. | Moderate: confirm with counsel |
| Person paid a commission or percentage of capital raised from investors they introduce; actively promotes the offering | Almost certainly an unregistered broker. Section 29(b) exposure for issuer. Investor rescission rights attach. Calling this a finder fee or referral fee does not change the analysis.                    | High                           |
| Online marketplace platform; receives percentage of capital raised from issuers; presents offerings to user base       | Strong broker dealer indicators. Must be registered or affiliated with registered broker dealer, or compensation structure must change to flat technology fees. Due diligence required before engagement. | High if unregistered           |
| Online platform; flat technology or SaaS fee only; no role in investor solicitation or analysis                        | Broker dealer analysis more favorable. Confirm compensation structure and scope of activities with securities counsel.                                                                                    | Low to Moderate                |
| Social media influencer paid per investor who subscribes                                                               | Unregistered broker activity. Securities Act antifraud provisions also implicated by undisclosed paid promotion. Avoid entirely.                                                                          | High                           |

| Arrangement                                                                                                           | Legal Analysis                                                                                                                                                        | Risk Level                 |
|-----------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------|
| FINRA registered placement agent; compensated on commission from capital raised                                       | Permissible. Registration satisfies Section 15. Must be disclosed in PPM. No Section 29(b) rescission exposure from broker registration status.                       | Low: disclose properly     |
| Registered investment adviser who introduces advisory clients; receives no transaction based compensation from issuer | Generally permissible. IA acts in advisory capacity to clients. Confirm IA compliance with its own fiduciary obligations to clients before relying on this structure. | Low: confirm with counsel  |
| Regulation CF funding portal; registered with FINRA; facilitating Regulation CF offering                              | Permissible for Regulation CF offerings only. Cannot facilitate Regulation D offerings. Must be properly registered.                                                  | Low if properly registered |

## Practical Takeaways

- The broker dealer registration requirement under Section 15 of the Exchange Act applies to anyone who effects transactions in securities for the account of others in the course of a business. There is no real estate exception, no private placement exception, and no threshold below which the requirement disappears. The rules apply fully to private fund and syndication capital raises.
- The issuer exemption under Rule 3a4-1 allows officers, directors, and employees of the issuer to participate in capital raising activities without broker registration, provided their compensation is not transaction based, they are not affiliated with a registered broker dealer, and their activities are limited to responding to investor inquiries and preparing written communications. The exemption applies to the sponsor's own personnel. It does not extend to anyone outside the issuer's employee or officer structure.
- Paying any person outside the issuer's officer and employee structure a commission, percentage of capital raised, or any other transaction based compensation for introducing investors or facilitating subscriptions creates an unregistered broker dealer problem. The label applied to the arrangement (finder's fee, referral fee, marketing expense, business development payment) has no bearing on the legal analysis. What matters is whether the compensation is tied to the success of a securities transaction.
- The M&A broker exemption codified in December 2022 by Section 501 of the Consolidated Appropriations Act of 2023 (adding Section 15(b)(13) to the Exchange Act, effective March 29, 2023) does not apply to capital raising in real estate funds or syndications. It covers persons facilitating the acquisition or transfer of an eligible privately held business, not persons facilitating the sale of fund interests to investors.
- Online platforms that facilitate investment in real estate offerings must be analyzed under the same five factor broker test as any other capital raising intermediary.

Compensation structure is the most reliable indicator: a platform paid as a percentage of capital raised is operating as a broker. Sponsors must conduct pre-launch diligence on the regulatory status of every platform in their offering's capital raising infrastructure.

- Section 29(b) of the Exchange Act gives investors introduced through an unregistered broker the right to void their subscription agreements and demand return of capital regardless of investment performance. This exposure is asymmetric. Investors who are disappointed will exercise it. Investors who are satisfied will not. The sponsor bears the downside of the entire arrangement.
- For sponsors who need third party capital raising assistance on a commission basis, the compliant path is a FINRA registered placement agent. The placement agent relationship must be disclosed in the PPM, with identification of the agent, description of services, and compensation structure disclosed in the use of proceeds section. Failure to disclose creates a material omission with the same antifraud consequences as any other undisclosed material fact.
- Criminal liability for willful unregistered broker dealer activity under Section 32 of the Exchange Act (15 U.S.C. § 78ff) reaches both the person acting as the broker and, in appropriate circumstances, the issuer who knowingly engaged them. The penalties (up to \$5 million per violation and twenty years imprisonment for individuals, up to \$25 million for entities) are not theoretical. The DOJ has prosecuted real estate syndication participants for unregistered broker activity, and the enforcement record demonstrates that the criminal standard of willfulness is achievable in circumstances that sponsors sometimes assume are too gray to prosecute.

## CHAPTER TWENTY TWO

# Marketing Your Offering

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There is a persistent and dangerous misconception among real estate sponsors that marketing a private offering is somehow different from, or freer than, marketing other types of securities. The misconception has understandable roots. Real estate feels different from stocks and bonds. The investors are often people the sponsor knows personally. The transactions are private. The vocabulary of real estate marketing (deals, opportunities, projects, partnerships) does not carry the same regulatory connotations as the vocabulary of Wall Street finance.

The federal securities laws do not share those intuitions. The antifraud provisions of Section 17(a) of the Securities Act and Rule 10b-5 under the Exchange Act apply to every material representation made in connection with the offer or sale of a security, regardless of whether the security is publicly registered, regardless of the sophistication of the investors, and regardless of whether the communication was made in a formal disclosure document or a casual email, a one pager, or a social media post. The general solicitation rules of Regulation D apply with the same force to a 506(b) offering marketed through a real estate podcast as they apply to a 506(b) offering marketed through a national newspaper advertisement.

The digital marketing environment that most real estate sponsors now use (websites, social media, email campaigns, podcasts, educational content) creates more ways to violate those rules accidentally, more evidentiary permanence when violations occur, and more surface area for regulatory scrutiny than the one on one conversations and private dinners that characterized real estate capital raising a generation ago. A sponsor who discusses offering terms on a publicly accessible podcast has created a permanent record of potential general solicitation that requires no subpoena to access.

This chapter works through the marketing framework for real estate syndications and funds: the threshold question of which exemption governs and what that choice permits; the specific requirements and best practices for 506(b) and 506(c) marketing programs; the Regulation A+ pathway for reaching retail investors; the construction of effective and compliant pitch materials; the digital marketing channels available to sponsors and the compliance discipline each requires; and the antifraud framework that applies across every communication channel a sponsor uses.

## The Compliance Foundation of All Marketing

Before any marketing channel is activated, any pitch deck is sent, or any investor conversation is initiated, the exemption governing the offering must be selected and confirmed with securities

counsel. That choice determines the entire permissible marketing architecture. Every subsequent decision (what channels are available, what content is permitted, what documentation is required) flows directly from the exemption. There is no sensible marketing design that does not start with this step.

## Antifraud Rules Apply to All Communications

The securities antifraud provisions apply to every material statement made in connection with the offer or sale of a security, in any medium, through any channel, by any person authorized to speak on behalf of the issuer. This is not a rule with exemptions for informal communications, marketing materials, or preliminary conversations. The pitch deck sent to a prospective investor is a securities communication subject to the antifraud standard. The sponsor's website is a securities communication. The investor newsletter sent monthly to an existing database is a securities communication. The podcast appearance in which a sponsor describes their current offering is a securities communication.

Under Section 17(a)(1) of the Securities Act, the government must show scienter (the defendant knew the statement was false or was recklessly indifferent to its accuracy). Under Section 17(a)(2) and (3), the standard is negligence. Even good faith mistakes that produce materially misleading communications create liability. This means the antifraud analysis is not limited to intentional deception. A sponsor who genuinely believes their financial projections are accurate but presents them without disclosing the assumptions on which they depend, without identifying the scenarios under which they will not be achieved, and without any downside analysis has potentially made materially misleading statements under a negligence standard.

The practical implication is that every investor facing communication (every document, every presentation, every email, every social media post that describes the offering or the sponsor's track record) should be reviewed against the antifraud standard before it is sent or published. Not because sponsors are presumed to be dishonest, but because the antifraud standard is demanding enough that good intentions do not ensure compliance.

## Material Misstatements and Omissions in Marketing Materials

A statement is material if a reasonable investor would consider it important in deciding whether to invest. In real estate offering marketing, the categories of material misstatement that appear most reliably are described below.

**Return projections without adequate disclosure of assumptions and risks.** Projected returns (IRRs, equity multiples, cash on cash yields, annualized preferred returns) are among the most common sources of antifraud liability in private real estate marketing. The problem is not the projection itself. Sophisticated investors expect financial projections. The problem is projections that omit the assumptions on which they depend, that present only optimistic

scenarios without meaningful downside analysis, or that use methodologies designed to produce the most attractive number rather than the most realistic one. A sponsor who advertises a 12% preferred return without disclosing that the preferred return is not guaranteed, depends on property performance, and will not be paid if operating cash flow is insufficient has made a potentially material misrepresentation, even if the PPM includes all of those qualifications.

**Track record misrepresentations.** How a sponsor presents their prior investment performance is one of the most scrutinized areas in offering document review. Presenting only successful exits while omitting underperforming or failed deals, presenting returns on a gross basis without disclosing fees and expenses, using cherry picked time periods that capture periods of favorable performance, and attributing to the sponsor's own management the returns of deals managed by a prior employer or a different team are all forms of track record misrepresentation that appear consistently in enforcement actions.

**Liquidity misrepresentations.** Private real estate interests are illiquid investments, and any communication that suggests meaningful secondary market liquidity without accurate disclosure of the restrictions, the absence of a functioning secondary market, or the redemption limitations of the specific investment is a material misrepresentation about a feature that directly influences investor decision making.

**Conflict of interest omissions.** Affiliated fees, related party arrangements, sponsor co-investment structures, and any other arrangement in which the sponsor has an economic interest that differs from investors' interests must be fully disclosed. Presenting the offering as though the sponsor's interests are perfectly aligned with investors while concealing compensation structures that diverge from that alignment is a material omission.

### **⚠ Your Offering's Marketing Materials Are Securities Communications, Not Promotional Collateral**

*Every representation made in connection with the offer or sale of a security is subject to the antifraud provisions of Section 17(a) of the Securities Act and Rule 10b-5 under the Exchange Act. That includes the pitch deck emailed to a prospective investor, the executive summary posted on the investor portal, the social media post describing the investment opportunity, and the podcast appearance in which the sponsor discusses their current offering.*

*The formal offering documents (the PPM, subscription agreement, and operating agreement) are the primary disclosure instruments. But they are not the only communications subject to antifraud scrutiny. A material misstatement in the pitch deck that contradicts or supplements the PPM is a problem that the PPM's existence does not*

*cure. The antifraud analysis looks at all communications that shaped investor expectations, not just the formal documents they signed.*

## Rule 506(b) Marketing: The Pre-existing Relationship Requirement

Rule 506(b) prohibits general solicitation and general advertising in connection with the offering. This rule was designed for a world in which private offerings were conducted through personal relationships and professional networks. Applying it to the current environment (where sponsors build public social media followings, publish investment focused websites, and reach thousands of people through digital channels) requires understanding both what the rule prohibits and what it permits.

### What General Solicitation Means in Practice

General solicitation refers to broadly advertising or promoting a securities offering to members of the public rather than to a defined group of investors with whom the sponsor has established relationships. The SEC's interpretation of what constitutes general solicitation is broad and applies clearly to digital channels.

- A publicly accessible website that describes a specific investment opportunity, mentions investment terms, identifies projected returns, or invites visitors to inquire about investing constitutes general solicitation, even if the website does not explicitly say securities offering.
- Social media posts describing a specific deal, mentioning projected returns, or inviting followers to contact the sponsor about an investment constitute general solicitation, even when framed as updates, market commentary, or progress reports on a specific property or fund.
- Email campaigns sent to lists of recipients who do not have a pre-existing substantive relationship with the sponsor constitute general solicitation, even if the emails describe the offering as private or exclusive or are sent only to persons who have expressed general interest in real estate investing.
- Podcast appearances, webinar recordings, and YouTube videos in which specific offering terms are discussed constitute general solicitation if those communications are publicly accessible.

- Investor events or conferences at which the specific offering is presented to attendees who were not selected based on a documented pre-existing relationship with the sponsor constitute general solicitation.

A single act of general solicitation in connection with a 506(b) offering can destroy the exemption for the entire offering, retroactively. As discussed in Chapter 18, this is one of the most consequential and least reversible compliance failures in private offering practice. The general solicitation analysis must be completed before any marketing activity begins, not after a communication has already been sent.

## **Building Investor Relationships Before an Offering**

The critical qualifier for 506(b) marketing is the pre-existing substantive relationship. A communication directed to a person with whom the sponsor has a pre-existing, substantive relationship established before the offering was contemplated does not constitute general solicitation. It is a private communication to a known, qualified contact. The relationship must be both pre-existing (not created in response to the specific offering) and substantive, meaning the sponsor has enough knowledge of the person to assess whether they are a financially appropriate candidate for this type of investment.

For a 506(b) offering, this means the investor database that will support the offering must be built before the specific offering exists. The time to cultivate investor relationships is between offerings, maintaining contact with prior investors, developing relationships with new prospective investors through normal professional activity, and documenting those relationships in a CRM or investor management system that creates a record of when the relationship was established and what interaction has occurred.

The documentation of pre-existing relationships is not merely a best practice. It is evidence that will matter if the relationship is ever challenged. A sponsor who cannot demonstrate that a relationship was established before the offering was contemplated, through documented prior contact, has no factual basis on which to claim the relationship qualifies as pre-existing for 506(b) purposes. The CRM record, the prior email correspondence, the prior meeting notes are the evidence that transforms an asserted pre-existing relationship into a documented one.

## **Content Marketing and Relationship Development**

The most sustainable approach to building the investor database that supports a 506(b) program is educational content marketing, creating and distributing content that demonstrates the sponsor's expertise, builds credibility with prospective investors, and generates organic investor interest before any specific offering is in view. A sponsor who publishes thoughtful analysis of real estate markets, educational content about private real estate investing mechanics, and genuine commentary on the investment environment can build a following of



engaged, financially qualified prospective investors over time, without those communications constituting general solicitation for a specific offering.

The key discipline in educational content marketing for a 506(b) sponsor is maintaining a clean separation between the educational content program and the marketing of any specific offering. Educational content that discusses real estate investing generally, describes the types of deals the sponsor pursues as a general strategy, and builds the sponsor's credibility as an operator does not constitute general solicitation. Educational content that describes a current or forthcoming specific offering (its terms, its projections, its property) does. That line must be maintained consistently, with securities counsel's guidance about where it sits.

## Investor Events and Private Dinners

In person engagement (investor dinners, exclusive educational events, property tours) remains one of the most effective relationship building tools for 506(b) sponsors because it is inherently private, allows the sponsor to vet attendees before the invitation is extended, and produces the kind of substantive interaction that satisfies the pre-existing relationship standard.

For an investor event to support 506(b) marketing without constituting general solicitation, attendees should be selected based on a documented prior relationship with the sponsor, not recruited through open social media promotion, purchased lists, or general invitation. A private dinner for ten investors from the sponsor's existing network, at which a forthcoming offering is discussed, is a permissible 506(b) marketing activity. A real estate investment seminar advertised to the general public, at which an offering is described, is general solicitation.

### **⚠ Pre-existing Relationships Must Pre-exist the Offering, Not the Closing**

*One of the most common mistakes in 506(b) marketing is attempting to establish pre-existing relationships after a specific offering has already been conceived. Reaching out to prospective investors through social media, investor conference platforms, or professional networking events after the offering is in planning, but before it formally launches, does not create a pre-existing relationship for that offering.*

*The SEC treats outreach made in connection with a contemplated offering as general solicitation, even when the specific offering details have not yet been disclosed. The investor database that will support a 506(b) offering must reflect genuine relationships developed between offerings, not a contact list assembled in anticipation of the current deal.*

*The practical implication: investor relationship development is a platform level, ongoing activity, not a pre-launch checklist item for each specific deal.*

## Rule 506(c) Marketing: Public Solicitation Done Right

Rule 506(c) traces to Title II of the JOBS Act, signed into law on April 5, 2012. The SEC adopted Rule 506(c) on July 10, 2013, effective September 23, 2013. The rule changed the landscape for private securities marketing permanently. It allows issuers to engage in general solicitation (to publicly advertise their offerings, use social media, maintain investor facing websites, and market to the general investing public) in exchange for a specific obligation: all investors must be accredited investors, and the issuer must take reasonable steps to verify that status through one of the verification methods the SEC has recognized.

For real estate sponsors who want to use the full toolkit of digital marketing, 506(c) is the natural choice. The sponsor website describing the offering, the social media presence, the podcast appearances, the paid advertising are all permissible under 506(c). But the exemption's marketing freedom comes with compliance obligations that sponsors consistently underestimate, and those obligations are not merely administrative.

### Permitted Advertising Channels: Digital, Social, Email, Events

Under Rule 506(c), the following marketing activities are permissible, provided all content is accurate, not misleading, and consistent with the formal offering documents.

- A publicly accessible website describing the offering, the investment structure, the sponsor's track record, and the projected economics of the investment.
- Social media posts on the sponsor's official accounts describing the offering, the investment strategy, and the opportunity available to qualified investors.
- Podcast appearances and webinars in which the sponsor discusses the specific offering opportunity and invites accredited investors to learn more.
- Paid digital advertising targeted at investment audiences, directing potential investors to the offering materials.
- Email campaigns to both existing investors and new prospect lists, describing the offering and inviting inquiry from qualified investors.
- Educational content (videos, articles, blog posts) that discusses the investment strategy and the specific offering structure, published without restriction on access.
- Investor events, conferences, and networking presentations open to the broader investing public, at which the offering is described.

The critical word in all of these permissions is provided. Every 506(c) marketing communication must satisfy the antifraud standard: accurate, balanced, consistent with the PPM, not misleading in any material respect. The permission to publicly market does not create permission to make material misrepresentations in a more visible forum.

## Accreditation Verification Obligations

The fundamental trade in Rule 506(c) (public marketing in exchange for mandatory verified accreditation) creates a compliance obligation that sponsors frequently handle incorrectly. A bare self-certification in the subscription agreement is not sufficient. The investor's representation that they are accredited, standing alone, does not satisfy 506(c)'s verification requirement. The SEC has identified several methods that, when properly implemented, constitute reasonable steps to verify accredited investor status.

The most common verification methods are documentation review (examining tax returns, W-2s, or bank and brokerage statements evidencing accreditation based on income or net worth) and reliance on a written confirmation from a qualifying third party verifier (a licensed attorney, CPA, registered investment adviser, or licensed broker dealer who has reviewed appropriate documentation). Verification platforms and services have emerged to facilitate this process for sponsors who do not want to handle investor financial documents directly.

On March 12, 2025, the SEC Division of Corporation Finance issued a no action letter (the Latham & Watkins letter) clarifying that an issuer can rely on a high minimum investment amount, combined with written representations from the purchaser, as a separate path to satisfying Rule 506(c)'s verification requirement. Under the no action letter, an issuer can reasonably conclude that it has taken reasonable steps to verify accredited investor status if the offering requires a minimum investment of at least \$200,000 for natural persons or \$1,000,000 for legal entities, the purchaser provides written representations that they are accredited and that the minimum investment is not financed by a third party for the purpose of making the particular investment, and the issuer has no actual knowledge of any contrary facts. For entities accredited solely because all of their equity owners are accredited, the entity must require a minimum investment of at least \$1,000,000 or at least \$200,000 per equity owner (where there are fewer than five equity owners). Sponsors structuring 506(c) offerings with these minimum investment amounts now have a verification path that does not require documentation review or third party verifier letters.

Whatever method is used, the verification must be completed before the investor is admitted to the offering, not after subscription and not after capital is received. A sponsor who accepts a subscription from an investor who has not yet been verified, with the intention of verifying before the offering closes, has accepted an unverified subscription in a 506(c) offering. If that investor is not in fact accredited, the 506(c) exemption is potentially impaired. The verification obligation runs from the date of subscription, and the subscription should not be accepted until verification is complete.

Verification records must be maintained for every investor and must be available for examination. This is not a file and forget obligation. It is a record keeping requirement with legal

consequences if records are missing or inadequate in an examination. The specific documentation reviewed for each investor (or, for offerings relying on the March 2025 no action letter, the written representations and the minimum investment compliance), the identity of any third party verifier, and the date of verification should all be captured in the investor file.

## Best Practices for 506(c) Marketing Programs

A well designed 506(c) marketing program combines the permissible breadth of public solicitation with the compliance discipline that ensures the offering's exemption remains intact.

- Establish verification before the investor portal delivers offering materials. Build the investor journey so that accreditation verification is completed (and the investor is confirmed as accredited) before they receive access to the subscription documents and before the sponsor begins counting them as a likely investor.
- Maintain consistency between marketing materials and offering documents. Every claim made in advertising, on the website, or in social media content must be consistent with the PPM. Where the PPM has qualifications or risk disclosures that limit a claim made in marketing materials, those limitations should appear in the marketing materials as well, not just in the formal documents.
- Review all marketing materials with securities counsel before publication. This review should be a standing protocol, not a one-time event. Every new piece of marketing content (new website copy, a new email campaign, a new social media series) should clear legal review before it reaches investors or prospective investors.
- Manage influencer and third party promotion arrangements carefully. Anyone compensated to promote the offering must disclose that compensation prominently, must not make materially misleading statements about the offering, and must be analyzed under the broker dealer framework described in Chapter 21. The issuer bears responsibility for promotional content made by compensated promoters.

## Regulation A+ Marketing: Reaching Retail Investors

Regulation A+ (sometimes called a mini IPO) provides a pathway for sponsors to market real estate offerings publicly to both accredited and non-accredited (retail) investors. Under Tier 2 of Regulation A+, an issuer can raise up to \$75 million in any rolling 12 month period from any investor, regardless of accreditation status, using an offering circular reviewed and qualified by the SEC. The \$75 million Tier 2 limit was set by SEC amendments in November 2020 (raised from the prior \$50 million limit). Tier 1 Regulation A+ offerings remain capped at \$20 million per 12 month period and require state by state qualification, which makes Tier 1 impractical for nationally marketed offerings. The Tier 2 exemption permits general solicitation, does not

require investor by investor accreditation verification, and preempts state registration requirements.

For real estate sponsors with genuine retail market ambitions (building a platform that reaches the broad investing public rather than the accredited investor universe) Regulation A+ Tier 2 represents the only currently available pathway that allows public marketing without accreditation restrictions. But the marketing freedom of Regulation A+ comes with meaningful upfront and ongoing costs that sponsors should assess carefully before selecting this path.

## Testing the Waters Communications

Regulation A+ permits testing the waters communications before the offering circular is filed with the SEC, soliciting expressions of interest from potential investors to gauge demand before committing to the full qualification process. Testing the waters is a genuinely valuable tool for sponsors considering Regulation A+ who want to assess investor appetite before investing in the qualification process, which can take three to six months and requires audit quality financial statements.

Testing the waters communications must include specific required legends, disclosing that no money is being solicited and that no subscriptions will be accepted until the offering circular is qualified. The communications cannot accept funds or binding commitments. But they can describe the offering in general terms, identify the target investment amount and projected returns, and invite prospective investors to register interest. A sponsor who runs a testing the waters campaign and receives meaningful expressions of interest from retail investors has valuable information for evaluating whether to proceed with the full Regulation A+ qualification process.

## Offering Circular and Marketing Materials

The Regulation A+ offering circular is a substantial disclosure document, similar in scope to a public company's registration statement, covering the business, the property or portfolio, the offering terms, audited financial statements, and risk factors. Unlike a Regulation D PPM, the offering circular is reviewed by the SEC's Division of Corporation Finance staff, who may issue comment letters requiring revisions before the offering can be qualified. The review and qualification process typically takes three to six months.

After qualification, all marketing materials used in connection with a Regulation A+ offering must be consistent with the offering circular and must comply with the antifraud standard. For a real estate sponsor, the practical marketing program after qualification can be genuinely broad: paid advertising in mainstream media, social media campaigns directed at retail investors, educational content for a general audience, and investor events open to the public. The marketing freedom is real. But every material representation must be consistent with the offering

circular, and any material change to the information in the offering circular requires an amendment.

The ongoing reporting obligations of Regulation A+ Tier 2 (annual Form 1-K, semiannual Form 1-SA, and current reports on Form 1-U for material events) are the regulatory cost of maintaining the public marketing permission. These are SEC filings, not internal reports, and they must be accurate and timely. For sponsors who have not previously operated in a public reporting environment, the operational requirements of these obligations should be carefully assessed before committing to the Regulation A+ path.

## Your Investor Pitch Deck and Executive Summary

The investor pitch deck and executive summary are typically the first substantive materials a prospective investor encounters, before they read the PPM, before they speak with the sponsor, before they evaluate whether to proceed. These documents form the first impression, and that impression is a securities communication subject to the full antifraud standard. Sponsors who treat the pitch deck as a sales tool with different rules than the offering documents have fundamentally misunderstood their legal obligations.

### What Sophisticated Investors Expect to See

Institutional investors, family offices, and experienced accredited investors have reviewed enough private real estate offerings to recognize immediately whether a pitch deck reflects genuine investment discipline or is structured to present the most favorable picture possible. Materials that project only optimistic outcomes, present a track record selectively, minimize risk disclosure, and describe every aspect of the investment in superlatives do not build confidence. They raise skepticism.

Sophisticated investors expect to see, in a professional pitch deck or executive summary, the elements described below.

- The investment thesis stated clearly and honestly. What the sponsor believes the opportunity is, why it exists, and what specific factors will drive returns. Generic investment theses (we buy value add multifamily in growing markets) without specific support do not satisfy this expectation.
- The sponsor's track record presented accurately and completely. Prior investments with actual exit results (not just the successful ones), the dates of acquisition and disposition, the capital invested and returned, and a comparison to the projected returns at the time of investment. Institutional investors often request detailed investment by investment track records and cross reference them against public records.

- The property or portfolio described specifically. Location, physical characteristics, current occupancy and rent levels, competitive market context, and the specific business plan for the investment period. Vague descriptions that could apply to any property in any market do not convey the investment specific analysis that sophisticated investors expect.
- Financial projections with disclosed assumptions. The rent growth rate assumed, the exit cap rate assumed, the renovation budget and its basis, the projected debt service coverage, and the scenarios under which the projected returns will and will not be achieved.
- Risk factors specific to the investment. Not the generic list that appears in every syndication PPM, but the risks specific to this property, this market, this business plan, and this sponsor. Investors who have been through a real estate cycle expect honesty about what can go wrong.
- A clear description of the terms. The preferred return, the waterfall, the promote, the fees, the hold period, and the minimum investment. Terms buried in footnotes or presented in ways that obscure their significance raise red flags about whether the sponsor wants investors to understand what they are agreeing to.

## Common Mistakes in Pitch Materials

The mistakes that most often appear in real estate syndication pitch materials, and that most often create both investor relations problems and legal exposure, fall into identifiable patterns.

**Projections without disclosed assumptions.** A projected IRR of 18% means nothing without knowing what rent growth, exit cap rate, leverage ratio, and operating expense assumptions produced it. Projections presented without disclosed assumptions cannot be evaluated, which is often the point, but it is also a material omission under the antifraud standard.

**Incomplete track records.** A track record section showing only completed exits with positive returns, while omitting deals that are still being held at below projected performance or deals that experienced losses, is misleading. Sophisticated investors will ask for the complete record. The pitch deck should provide it proactively.

**Liquidity misrepresentations.** Describing the investment as liquid or easily transferable based on a theoretical ability to sell limited partnership interests, without disclosing the Rule 144 holding period, the absence of a functioning secondary market, or the practical difficulty of finding a buyer for an LP interest, is a material misrepresentation.

**Guaranteed return language.** Describing the preferred return as a guaranteed return, or implying through language like you will receive 8% that the preferred return is certain rather than



contingent, creates false expectations that the offering documents may not cure. The preferred return is a priority in the distribution waterfall, not a guarantee of performance.

**Inconsistency with the PPM.** Projections, fee disclosures, and structural descriptions in the pitch deck that differ from what the PPM actually says create a material inconsistency that is itself an antifraud problem. When investors receive materials that tell different stories, and the more favorable version is what induced their investment, the sponsor faces the consequences of the inconsistency.

## Digital Marketing for Real Estate Syndications

Digital marketing has fundamentally changed how real estate sponsors reach prospective investors. Podcasts, social media platforms, educational websites, and email newsletters allow sponsors to communicate with larger audiences than were reachable through purely personal networks, to establish credibility and expertise across a broader investment community, and to build investor pipelines in advance of specific offerings. The opportunity is real, and the sponsors who use it effectively have a genuine competitive advantage in capital formation.

The compliance discipline required to use these channels correctly is equally real. The antifraud rules apply to every digital marketing channel. The general solicitation restrictions of 506(b) apply to digital channels with the same force they apply to print advertising. The investment adviser marketing rules apply to registered advisers' digital communications. Every digital channel that reaches prospective investors is a regulatory touchpoint that must be managed deliberately.

### Sponsor Website Best Practices

The sponsor's website is the most visible and most permanent marketing channel the sponsor operates, and it is a securities communication subject to the antifraud standard for any sponsor conducting securities offerings. Building a compliant website requires the same discipline applied to formal offering documents.

- **Consistency with offering documents.** Every claim on the website about the investment structure, the economic terms, the sponsor's track record, and the offering must be accurate and consistent with the PPM. Discrepancies between the website and the PPM are material misrepresentations that regulators can identify by comparing the two documents, which is exactly what they do.
- **Risk disclosure.** The website should include prominent, offer specific risk disclosures, not just a generic past performance is not indicative of future results footer, but meaningful disclosure of the risks material to the specific investment and the specific investor population.



- Exemption disclosure and eligibility gating. For 506(b) and 506(c) offerings, the website should clearly state that securities are offered pursuant to a registration exemption and that the offering is available only to eligible investors. For 506(b) offerings specifically, investor portal access should be gated behind a documented pre-existing relationship, not freely accessible to anyone who creates an account.
- Legal review before launch. The complete website content (every page, every financial claim, every track record presentation) should be reviewed by securities counsel before the site is made publicly accessible. Not a general structural review, but a page by page analysis of every material representation.

## **Social Media Strategy: What to Say and What to Avoid**

Social media is where the compliance gap between 506(b) and 506(c) sponsors is most consequential. For 506(b) sponsors, a public social media presence that describes specific offering details is almost always general solicitation. For 506(c) sponsors, a public social media presence that describes the offering is permitted, but must satisfy the antifraud standard for every post.

A written social media policy is not a formality. It is a compliance necessity for any sponsor conducting securities offerings while maintaining a public social media presence. The policy should address the items below.

- What constitutes official issuer communication: which accounts are official company accounts (governed by full compliance review) versus personal accounts of team members (governed by different rules, but with limitations on what they can say about active offerings).
- Pre-approval requirements for material statements: financial projections, descriptions of investment terms, claims about secondary market access, and updates to offering status should require review before posting.
- Response protocols for investor inquiries in public comment sections: how the company responds to questions about the offering in public comment threads can itself constitute solicitation or create representations that generate antifraud liability.
- Archive requirements: all official social media communications related to active offerings should be preserved, because the antifraud analysis examines the full history of communications that shaped investor expectations.

The specific content disciplines are equally important. Projecting specific returns in a social media post without accompanying risk disclosure is the same antifraud problem it would be in a formal document. Describing the investment as low risk or secure without disclosure of the actual risk profile creates false impressions regardless of the platform. Posting information about a specific offering to a general audience account, without the access controls that

distinguish a private 506(b) communication from a public solicitation, may bust a 506(b) exemption in a single post.

### **Email Marketing and Investor Newsletters**

Email marketing occupies different compliance territory for 506(b) and 506(c) sponsors. For 506(b) sponsors, email campaigns must be limited to persons with documented pre-existing substantive relationships. For 506(c) sponsors, email campaigns can reach new contacts, but the content of every email remains subject to the antifraud standard and must satisfy the accuracy and disclosure requirements that apply to all marketing communications.

Investor newsletters (regular email communications to an existing investor and prospective investor database) are an effective relationship maintenance tool for 506(b) sponsors because they allow consistent communication with the established network between offerings without soliciting for a specific current deal. A monthly or quarterly newsletter discussing market conditions, completed investment updates, and general real estate investing themes keeps the sponsor present in prospective investors' thinking without triggering general solicitation concerns for 506(b) purposes, provided the newsletter does not describe or solicit for a specific active offering.

For 506(c) sponsors whose newsletters describe active offerings, the newsletter becomes a marketing document for that offering, subject to the same accuracy, disclosure, and consistency standards as any other marketing material. The fact that it is delivered via email rather than posted publicly does not reduce the antifraud obligations that apply to its content.

### **Podcasts, Webinars, and Educational Content**

Podcasts and webinars have become among the most effective investor development tools for real estate sponsors, particularly for building relationships with prospective investors who do not yet know the sponsor. Educational content (discussions of real estate market conditions, explanations of investment strategies, commentary on deal structures) builds credibility and expertise recognition over time without necessarily constituting general solicitation for a specific offering.

The compliance discipline for podcast and webinar content turns on the specific offering question. A podcast episode discussing real estate market conditions generally, the economics of value add investing, or the mechanics of the preferred return and waterfall structure is educational content that does not constitute general solicitation for any specific offering. A podcast episode describing a specific current offering (its property, its projected returns, its investment terms, and how to participate) is marketing that offering to the podcast's general audience, which for a 506(b) sponsor is general solicitation.

For 506(c) sponsors who use podcasts and public webinars to describe specific offerings, the content of those appearances is a securities communication subject to the antifraud standard. Statements made on a podcast about projected returns, investment risk, or the offering's liquidity features are representations in connection with the offer of a security. The fact that they were made conversationally, without a written script, does not reduce their legal significance.

## Antifraud Compliance Review of All Marketing Materials

A compliance review of marketing materials is not the same as having a lawyer look at the PPM. It is a systematic review of every investor facing communication (every document, every webpage, every presentation, every email template, every social media content series) against the antifraud standard. This review should occur before any material is published or sent, should be conducted by securities counsel with private offering experience, and should be documented in a way that creates a record of what was reviewed and approved.

The specific review should cover the items below.

- Accuracy of all factual claims. Sponsor track record presentations, property descriptions, market characterizations, and any other factual statement that could be verified or falsified.
- Financial projections. Are all assumptions disclosed, are all projections labeled as projections (not guarantees or expectations), and is there meaningful downside scenario analysis alongside the base case?
- Consistency with the PPM. Do all marketing materials accurately reflect the offering terms described in the PPM? Where the PPM has qualifications, limitations, or risk disclosures that bear on claims made in marketing materials, do those limitations appear in the marketing materials themselves?
- Risk disclosure adequacy. Are the material risks of the investment disclosed in the marketing materials themselves, or are they buried in a footnote reference to the PPM that most investors will not read?
- Liquidity and return representations. Is every claim about potential returns accurately qualified as a projection with disclosed assumptions? Is every claim about liquidity or secondary market access accurate and consistent with the actual current state of secondary market infrastructure?
- General solicitation analysis for 506(b) offerings. Has every marketing channel been analyzed for compliance with the no general solicitation requirement, and are all access controls functioning correctly?

Marketing materials should be reviewed before they are published, not after. A sponsor who discovers after the fact that their pitch deck made materially misleading claims, or that their

website described a 506(b) offering to an uncontrolled public audience, has a problem that is difficult and expensive to resolve. The review is a preventive measure that costs a small fraction of what a disclosure failure costs to remediate.

| Marketing Activity                                      | 506(b) Analysis                                                                                                                           | 506(c) Analysis                                                                                                                               | Reg A+ Analysis                                                                                  |
|---------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------|
| Public website describing specific offering and terms   | General solicitation: not permitted. Investor portal must require documented pre-existing relationship before access to offering details. | Permitted. Must be accurate, balanced, consistent with PPM. Risk disclosure required. Legal review before launch.                             | Permitted after offering circular qualification. Must be consistent with offering circular.      |
| Official social media posts about specific offering     | Likely general solicitation: consult counsel before any posts describing specific offering terms or inviting participation.               | Permitted subject to antifraud accuracy standard. Written social media policy required. Pre-approval for material claims.                     | Permitted after qualification. Must be consistent with offering circular.                        |
| Email campaign to existing documented investor database | Generally permissible: contacts must have documented pre-existing substantive relationship with sponsor.                                  | Permissible. Can also include new contacts since general solicitation is permitted.                                                           | Permitted after qualification. Investment limits for non-accredited investors must be disclosed. |
| Paid digital advertising (search, display, social)      | General solicitation: not permitted.                                                                                                      | Permitted. Content must satisfy antifraud standard. Accreditation verification required for all subscribers.                                  | Permitted after qualification.                                                                   |
| Podcast appearances discussing specific offering        | Likely general solicitation if publicly accessible. Educational content not describing specific offering is generally permissible.        | Permitted. Treat all content as subject to antifraud standard: statements made conversationally carry same legal weight as written materials. | Permitted after qualification.                                                                   |
| Investor events and private dinners                     | Permissible if attendees selected based on documented pre-existing relationships, not recruited through open promotion.                   | Permissible. Can include new attendees since general solicitation is permitted. All presentations must satisfy antifraud standard.            | Permitted after qualification.                                                                   |

| Marketing Activity                                    | 506(b) Analysis                                                                                                                                                      | 506(c) Analysis                                                                                                        | Reg A+ Analysis                                                                                            |
|-------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------|
| Educational content (no specific offering referenced) | Generally permissible: does not constitute general solicitation for a specific offering as long as no specific current offering is described or implicitly promoted. | Permissible. Same distinction between educational content and offering specific marketing applies.                     | Permissible including before qualification (testing the waters content must follow specific requirements). |
| Compensated influencer promotion                      | General solicitation: not permitted. Also raises broker dealer concerns.                                                                                             | Permissible if influencer discloses compensation prominently and content is accurate. Broker dealer analysis required. | Permissible after qualification with compensation disclosure. Broker dealer analysis required.             |
| Testing the waters communications                     | Not applicable: 506(b) does not use testing the waters.                                                                                                              | Not applicable: 506(c) does not use testing the waters.                                                                | Permitted before qualification. Must include required legends. Cannot accept subscriptions or funds.       |

## Practical Takeaways

- Exemption selection must precede all marketing activity. The chosen exemption (506(b), 506(c), or Regulation A+) determines the entire permissible marketing architecture. There is no compliant marketing program that does not begin with this analysis.
- The antifraud provisions apply to every investor facing communication in every channel: the pitch deck, the website, the social media post, the email newsletter, the podcast appearance. Marketing materials are securities communications subject to the same legal standard as formal offering documents. Good intentions do not cure material misrepresentations made in marketing materials.
- Rule 506(b) prohibits general solicitation, and that prohibition applies directly to digital channels. A publicly accessible website describing the offering, a social media post about the deal, and an email to an unverified list are all general solicitation that can destroy a 506(b) exemption retroactively. The investor database supporting a 506(b) offering must consist of persons with documented pre-existing substantive relationships established before the offering was contemplated.
- Rule 506(c), adopted by the SEC on July 10, 2013 and effective September 23, 2013 pursuant to Title II of the JOBS Act, permits general solicitation (the public website, social media, paid advertising) in exchange for mandatory verified accreditation for every investor who subscribes. The available verification methods include documentation

review, written confirmation from a qualifying third party verifier, and (under the SEC's March 12, 2025 no action letter to Latham & Watkins) reliance on a minimum investment amount of at least \$200,000 for natural persons or \$1,000,000 for legal entities combined with written representations. Verification must be completed through one of these methods before the subscription is accepted, and verification records must be maintained and available for examination.

- Regulation A+ Tier 2 allows public marketing to retail investors, accredited and non-accredited, up to \$75 million in any rolling 12 month period (the limit raised from \$50 million by SEC amendments effective in November 2020). It requires SEC qualification of an offering circular (typically three to six months with audit quality financial statements) and ongoing public reporting through the life of the offering. Testing the waters before qualification is permitted and is a genuinely useful tool for assessing retail investor appetite before committing to the qualification process.
- Financial projections in marketing materials must disclose the assumptions on which they depend, must present meaningful downside scenarios alongside the base case, and must be labeled clearly as projections rather than guarantees or expectations. A projection without disclosed assumptions is a material misstatement under the antifraud standard.
- Track records must be presented accurately and completely, including underperforming investments and investments that have not yet been exited. Selective track record presentation that highlights successes while omitting failures is a material omission with enforcement consequences.
- Social media requires a written compliance policy governing official accounts, specifying what constitutes official issuer communication, establishing pre-approval requirements for material statements, setting protocols for responding to investor inquiries in public comment sections, and requiring archiving of all communications related to active offerings.
- Every piece of marketing material should be reviewed by securities counsel before it is published or sent, not generally approved at the strategy level, but reviewed at the content level for accuracy, consistency with the PPM, adequacy of risk disclosure, and compliance with the antifraud standard. Pre-publication review costs a small fraction of what a disclosure failure costs to remediate.
- Educational content (discussions of real estate investing generally, market commentary, explanations of investment structures) is generally permissible for 506(b) sponsors as long as it does not describe or implicitly solicit for a specific current or forthcoming offering. The line between educational content and general solicitation must be managed deliberately, with legal guidance, not assumed.

## CHAPTER TWENTY THREE

# Understanding Your Investors

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Every experienced real estate sponsor knows that understanding your investors is not a soft skill. It is a capital markets competency. The sponsor who understands what their investors value, what they worry about, what they need to hear before committing capital, and what they need to see during the hold period to remain confident partners has a structural advantage that no amount of underwriting sophistication can replace. The best deal in the market cannot close if the sponsor does not understand who will fund it and how those people make decisions.

Private real estate offerings attract a remarkably diverse investor population: from the high net worth physician making their first syndication investment to the multi-generational family office that has been allocating to private real estate for decades, from the registered investment adviser channeling client capital to the self-directed IRA custodian working through its own set of compliance requirements, from the domestic accredited investor who has watched the sponsor's prior deals to the international investor for whom an entry into U.S. real estate is itself the primary investment thesis. Each of these investors brings different motivations, different concerns, different due diligence standards, and different expectations about communication and reporting.

Treating these investors as interchangeable (giving every investor the same pitch deck, the same level of disclosure detail, the same frequency of communication) is not just a marketing inefficiency. It is a compliance risk. Investors who did not receive the information they needed to make an informed decision, in a format they could actually evaluate, have a basis for claiming inadequate disclosure regardless of whether the PPM technically contained the required information. Understanding each investor category is how a sponsor builds both better investor relationships and stronger legal protection.

This chapter works through the investor categories that most commonly appear in private real estate syndications and funds: high net worth individuals, family offices, registered investment advisers and wealth managers, institutional investors, self-directed IRA and 401(k) investors, and international investors. For each, it addresses investment motivations, due diligence expectations, communication preferences, and the compliance dimensions specific to that investor type. The chapter closes with a framework for managing investor expectations across the hold period, one of the most consistently underinvested areas in real estate sponsor practice.

## High Net Worth Individual Investors

The majority of investors in Regulation D private real estate offerings are individual accredited investors who meet the income or net worth thresholds of Rule 501 of Regulation D: a net worth exceeding \$1 million (excluding primary residence), or annual income exceeding \$200,000 individually (\$300,000 jointly with a spouse or partner) in each of the two most recent years with a reasonable expectation of the same in the current year. The SEC expanded the definition in August 2020 (effective December 8, 2020) to include individuals holding certain professional certifications: the General Securities Representative license (Series 7), the Investment Adviser Representative license (Series 65), and the Private Securities Offerings Representative license (Series 82), regardless of income or net worth. The 2020 amendments also added knowledgeable employees of private funds (for investments in their employer's fund) and certain family clients of family offices.

Within the broad high net worth category, private real estate offerings tend to attract two distinct subgroups. The first is the established real estate investor: someone who has participated in prior syndications, understands the asset class, and evaluates new opportunities primarily on sponsor track record, deal specific underwriting, and fee structure. This investor brings real estate literacy to the table and tends to ask pointed questions about exit assumptions, debt structure, and the sponsor's carried interest economics. The second is the professionally successful accredited investor who is newer to private real estate (a physician, attorney, executive, or business owner attracted to the asset class for its passive income, tax efficiency, or non-correlation with public markets) but who may need education on how private real estate investment structures work before evaluating whether a specific opportunity fits their portfolio.

Both subgroups require the sponsor's attention but need different communication approaches. Sponsors who pitch the investment thesis to investors who still don't understand the PPM's distribution waterfall, or who can't distinguish between the preferred return and the promote, have the communication sequence reversed. Address the structure before the opportunity.

### Investment Motivations: Passive Income, Tax Efficiency, and Diversification

Understanding what brings a high net worth individual to private real estate, and what their primary objective is, shapes every subsequent communication.

**Passive income.** Many HNW investors are high earners who have limited time and want their capital to generate cash flow without requiring active management. For this investor, the preferred return, the distribution frequency, and the reliability of distributions during the hold period are the primary evaluation criteria. The equity upside at exit is secondary to steady



income. Communication should emphasize operating performance, distribution history, and the property's cash flow stability relative to the underwriting.

**Tax efficiency.** Real estate's depreciation benefits, and particularly accelerated depreciation through cost segregation, are among the most compelling features for high income accredited investors who are generating substantial taxable income. A physician in the top marginal rate bracket who receives a K-1 showing passive losses from a real estate investment can offset those losses against passive income from other sources, sometimes meaningfully reducing their tax liability. The tax efficiency story requires the sponsor to understand the investor's overall tax situation at a general level and to ensure that the offering's tax benefits are accurately disclosed in the PPM rather than promised in marketing materials.

**Diversification.** Professionally successful accredited investors whose net worth is concentrated in a single business, a stock portfolio, or real estate they own directly often seek private real estate syndications for asset class diversification. For this investor, the non-correlation with public markets, the tangibility of the underlying asset, and the professional management of an operator with a specific expertise are the primary appeal. Communication should emphasize the investment's independence from public market conditions and the sponsor's specific value add expertise.

## Risk Tolerance and Return Expectations

High net worth individual investors come with a wide range of risk tolerance profiles, and sponsors who assume a uniform risk appetite across their investor base will miscommunicate with a meaningful portion of it. The physician investing for the first time in a ground up development deal has different risk tolerance than the experienced real estate investor who has been through a full market cycle and understands what development risk actually means in a downturn.

Return expectations in the HNW individual market have been shaped by the performance of prior cycles, the marketing materials of prior sponsors, and increasingly the return projections circulating in online real estate investing communities. Setting realistic return expectations with this investor category requires honesty about what the current investment environment supports, specificity about the assumptions underlying the projected returns, and a clear explanation of the range of outcomes that are plausible, not just the base case that makes the offering look most attractive.

The HNW investor who receives a pitch showing an 18% IRR and invests on that basis, then discovers over a three year hold that the actual performance trajectory suggests an 11% outcome, is not merely a disappointed investor. They are a potential claims risk. The consistency between what the marketing materials projected and what the investment delivered,

and whether the PPM's risk factors specifically identified the underperformance scenarios that materialized, are the first things their attorney will examine.

## Communication Preferences and Reporting Expectations

HNW individual investors generally expect quarterly financial reporting, annual K-1s delivered by the September 15 extended deadline, and prompt notice of material events affecting the investment. What distinguishes the sponsors who maintain strong HNW investor relationships from those who struggle to retain capital for subsequent offerings is the quality of communication during the hold period, particularly during periods when performance is tracking below projections.

The temptation to minimize difficult quarterly updates (to present unfavorable metrics selectively, to characterize a developing problem as a minor concern, to delay communicating bad news in hopes that the situation will improve before the next report) is understandable and counterproductive. Investors who discover a problem on their own, or who receive inadequate updates followed by a sudden adverse disclosure, become far more difficult investors than those who receive honest, contextual reporting throughout the hold period. Transparency during challenges preserves relationships. Evasiveness destroys them.

## Family Offices

Family offices (professional investment organizations managing the assets of a single wealthy family or a small group of related families) represent one of the most valuable investor relationships a real estate sponsor can develop. A single family office relationship can commit capital across multiple offerings over multiple fund cycles, provide introductions to other family offices in its network, offer the level of continuity and institutional memory that individual investor relationships rarely provide, and represent a meaningful anchor position in a capital raise that helps attract other investors.

## Structure and Decision Making Dynamics

Family offices vary significantly in their investment sophistication, staffing, and decision making structures. A large single family office managing \$500 million or more may have a dedicated investment team with real estate expertise, a formal investment committee, a defined allocation policy for private real estate, and a due diligence process that rivals what an institutional investor applies. A smaller family office managing \$50 million may be staffed by a single investment officer who relies heavily on outside advisers and whose investment decisions are made by one or two family principals.

Understanding which type of family office you are dealing with determines how the sponsor should structure the engagement. For the larger, institutionally operated family office, the

sponsor should expect a formal due diligence process, requests for audited financial statements or review level financials, legal document review by the family office's own counsel, and an investment committee presentation. The process can take months and should be managed accordingly. For the smaller family office, the decision maker may be accessible directly and may make decisions on a shorter timeline, but the quality of the disclosure materials and the credibility of the sponsor's track record are equally important.

In either case, the sponsor should understand who within the family office has investment authority, who is the initial point of contact for due diligence, and what the family office's prior real estate investment experience is. A family office that has never invested in a private real estate syndication before has different education needs than one that has been doing so for twenty years.

## Diligence Expectations

Family offices consistently conduct more rigorous due diligence than individual accredited investors, and sponsors who have built the legal and compliance infrastructure described in this handbook are well positioned to satisfy it. Typical family office diligence requests include the items below.

- The full legal document set, not just the PPM, but the operating agreement, subscription agreement, and any side letters from other investors. Family office counsel will read the operating agreement carefully, including the economic waterfall, the fee structure, the manager removal provisions, and the investor information rights.
- Audited or reviewed financial statements for prior offerings, especially for value add deals where the renovation scope and construction management were central to the investment thesis. Families with prior real estate investment experience know that renovation budgets routinely exceed projections and will scrutinize the construction management history.
- A complete, investment by investment track record, not a summarized average return, but specific data for each prior investment showing acquisition date, exit date (or current status), capital invested, distributions made, and realized or projected return. Selective track records are a red flag that experienced family office investors identify immediately.
- Reference calls with prior investors and, often, with the sponsor's key service providers: the property management company, the construction manager, and sometimes the securities counsel who structured the offering. Sponsors who have built the kind of relationships with service providers and prior investors that support strong references have a competitive advantage in the family office market.
- Sometimes, a site visit to the subject property before committing capital, particularly for larger investments or first time sponsor relationships.

## Co-investment and Co GP Opportunities

Family offices with sufficient capital and real estate expertise sometimes seek co-investment rights alongside the fund: the ability to invest directly in specific assets alongside the fund's interest rather than solely through the commingled fund vehicle. Co-investment rights allow the family office to increase its exposure to specific deals it finds particularly compelling while reducing fee drag, since co-investment capital typically bears lower or no management fees and no or reduced carried interest on the co-invested amount.

A sponsor who offers co-investment rights to a family office as part of a larger capital commitment is offering something that has genuine economic value to the family office. The structure must be negotiated carefully: specifying the notification process for co-investment opportunities, the timeline within which the family office must commit, the economic terms applicable to co-invested capital, and how co-investment capital is aggregated with fund capital for calculation of the sponsor's promote. These terms should be documented in a side letter or co-investment agreement before any co-investment opportunity arises.

Co GP opportunities, in which the family office participates at the sponsor level rather than the investor level, are more complex arrangements that raise additional legal and regulatory questions, including the GP's fiduciary obligations, the allocation of management responsibilities, and the impact on the sponsor's Advisers Act analysis. These arrangements should be structured with specific securities and fund formation counsel involvement, not adapted from a standard operating agreement template.

## Registered Investment Advisers and Wealth Managers

Registered investment advisers (RIAs) and wealth managers who include alternative investments in client portfolios represent a distribution channel with meaningful capital concentration potential. An RIA relationship that results in a sponsor recommendation to multiple clients across multiple capital raises is one of the most efficient investor development outcomes available to a private real estate sponsor. Understanding how RIAs evaluate real estate investments for clients, and what compliance requirements govern their participation, is essential for sponsors who want to cultivate this channel.

### How RIAs Evaluate Real Estate Investments for Clients

RIAs have a fiduciary obligation to their clients. They must recommend investments that are in the client's best interest and consistent with the client's investment objectives, risk tolerance, and financial situation. This standard produces a due diligence approach that is more systematic and more client specific than what most individual accredited investors apply on their own behalf.

An RIA evaluating a private real estate offering for client suitability will typically assess whether private real estate is appropriate for the specific client's risk tolerance and investment objectives; whether the sponsor's track record and investment approach are consistent with the quality standard the RIA applies to alternative investment recommendations; whether the offering's economic terms (fees, waterfall, hold period) are reasonable relative to comparable offerings; whether the legal documents are professionally prepared and the sponsor's compliance program is in order; and whether the liquidity limitations of the investment are appropriate for the client's overall portfolio and liquidity needs.

Sponsors who receive interest from an RIA should be prepared to engage at a professional level on all of these dimensions. An RIA who concludes that a sponsor's documentation is inadequate, that the fee structure is unreasonable, or that the track record cannot be independently verified is not a poor evaluator. They are a sophisticated gatekeeper doing their job. The sponsor who consistently satisfies RIA due diligence has built an offering infrastructure that generates repeat RIA referrals.

### **Compliance Requirements for RIA Sourced Capital**

The RIA's participation in a private real estate offering requires careful structuring to ensure neither the RIA nor the sponsor creates a broker dealer compliance problem. As discussed in Chapter 21, an RIA who recommends a specific investment to their advisory clients cannot receive transaction based compensation from the issuer for doing so. That compensation structure triggers broker dealer registration requirements that an RIA does not possess. The RIA's compensation comes from the advisory fee their client already pays.

What the RIA can do is include the offering in a client's portfolio under the RIA's general investment management mandate, making the recommendation as part of the advisory services for which the client pays an ongoing fee. The sponsor can provide information materials about the offering, host due diligence calls, and maintain the relationship with the RIA. But the sponsor cannot pay the RIA a commission, referral fee, or any transaction based compensation for the clients the RIA directs to the offering.

From a documentation standpoint, an RIA investing on behalf of multiple clients creates a specific beneficial ownership consideration. Each underlying client investor is a beneficial owner of their portion of the investment and must be counted individually for purposes of the Section 3(c)(1) 100 beneficial owner limit. An RIA who invests on behalf of ten clients does not count as one beneficial owner. It counts as ten. Sponsors tracking their investor count under 3(c)(1) must understand this look through rule and confirm with the RIA how many underlying client positions will be created by the RIA's participation.

**⚠ RIA Clients Are Individual Beneficial Owners, Not a Single 3(c)(1) Slot**

*A registered investment adviser who invests on behalf of ten advisory clients in your Section 3(c)(1) fund is not contributing one investor to your beneficial owner count. It is contributing ten. The look through rules under the Investment Company Act count each underlying beneficial owner of the RIA's position, not the RIA as a single entity.*

*A fund approaching its 100 beneficial owner limit under 3(c)(1) must confirm with any prospective RIA investor how many underlying client accounts will be involved before accepting the RIA's subscription. An RIA who creates the 101st beneficial owner has pushed the fund outside the 3(c)(1) exemption. This is a problem that requires advance analysis, not after the fact remediation.*

## Institutional Investors: Pension Funds, Endowments, and Insurance Companies

Institutional capital (pension funds, endowments, foundations, insurance companies, and sovereign wealth funds) represents the investor segment with the most demanding standards, the longest decision timelines, and the most consequential relationships for a growing real estate fund platform. A single institutional LP commitment can anchor a fund at a scale that individual and family office capital alone cannot reach, and an institutional investor's ongoing participation across fund cycles signals to the broader market that the sponsor has achieved a threshold of professional credibility.

The path from emerging sponsor to institutional manager is not short, and it is not primarily determined by investment performance alone. Institutional investors evaluate the totality of a sponsor's organizational infrastructure (compliance program, reporting capabilities, regulatory posture, governance documents, and operational controls) with the same rigor they apply to financial performance. A sponsor who has delivered exceptional returns but whose compliance program is incomplete, whose reporting is inconsistent, and whose legal documents were prepared on a template without customization will not survive institutional diligence regardless of the IRR.

### What Institutional LPs Require

Institutional investors operate under investment policy statements that define the parameters of allowable investments and typically require that private real estate investments meet specific criteria before being submitted to an investment committee for approval. Understanding those

criteria, and building the offering infrastructure to satisfy them, is the work of years, not months. Common institutional requirements include the items below.

- Audited financial statements for each fund, prepared by a recognized CPA firm. Many institutional investors have minimum asset thresholds below which they will not invest, and minimum AUM requirements for the manager's overall platform. A sponsor managing their first fund at \$20 million will not typically be in consideration for a \$10 million commitment from a pension fund that requires a track record of managing at least \$100 million across prior funds.
- A formal compliance program consistent with the Investment Advisers Act, including a chief compliance officer, written policies and procedures, and an annual compliance review. Institutional investors often request a copy of the Form ADV and may ask for the most recent compliance review findings.
- Legal documents prepared by recognized securities counsel, with deal specific customization rather than off the shelf templates. Institutional LP counsel will read the full operating agreement and will identify template language that was not updated for the specific deal, a signal about the sponsor's legal infrastructure quality.
- A key person provision protecting investors from management changes. Institutional investors want assurance that the investment team they evaluated is the team that will manage the fund across its full life.
- An LPAC structure that gives institutional investors meaningful governance participation: the ability to approve affiliated transactions, review conflicts of interest, and provide oversight of the fund's operations without being in the day to day management role.

## ERISA Plan Assets Considerations

Pension funds and certain other institutional investors are employee benefit plans subject to the Employee Retirement Income Security Act (ERISA). When an ERISA plan invests in a private fund, the Department of Labor's plan asset regulation (29 C.F.R. § 2510.3-101) may cause the assets of the fund itself to be treated as plan assets of the ERISA investor, which would subject the fund's sponsor to ERISA's fiduciary standards and prohibited transaction rules. Those standards are substantially more demanding than the general fiduciary duties applicable to registered investment advisers, and the prohibited transaction rules restrict a wide range of normal fund management activities, including certain affiliated transactions.

The primary mechanism most private funds rely on to avoid plan asset status is the significant participation test (commonly called the 25% test) under the DOL plan asset regulations. If, immediately after each acquisition or transfer of an equity interest in the fund, less than 25% of the value of each class of equity interest in the fund is held by benefit plan investors (a defined category that includes ERISA plans, IRAs, and certain governmental plans), the fund is not



subject to the plan asset rules. Maintaining the benefit plan investor percentage below 25% is a continuing obligation throughout the fund's life. It must be monitored at each new investor admission and at each secondary transfer of fund interests.

For real estate funds specifically, a second path to avoiding plan asset status is the Real Estate Operating Company (REOC) exemption under the same DOL regulation. A fund qualifies as a REOC if at least 50% of its assets (other than short term investments pending long term commitment or distribution) are invested in real estate that the fund manages or develops, and the fund is engaged directly in the management or development of those real estate assets in the ordinary course. A real estate fund that satisfies the REOC requirements is not subject to the plan asset look through regardless of the percentage of benefit plan investor participation. For sponsors actively seeking institutional capital, the REOC qualification analysis should be conducted at fund formation, since the structural and operational requirements must be in place from the beginning to support the qualification.

Fund operating agreements and LP agreements for funds that may attract benefit plan investor capital should include a representation from each benefit plan investor about their ERISA status; a covenant from the sponsor to take reasonable steps to prevent the plan asset threshold from being exceeded; transfer restrictions that require the sponsor's approval of any transfer that would cause the threshold to be exceeded; and a mechanism for the sponsor to require divestiture by an existing investor if the threshold is inadvertently exceeded. These are not optional provisions. They are the legal infrastructure through which the fund maintains its exemption from the plan asset rules.

## **The Path from Sponsor to Institutional Manager**

Building the track record, organizational infrastructure, and market presence necessary to attract institutional capital is a multi-year process. The sponsors who achieve institutional relationships follow a recognizable progression: they build their initial track record through individual accredited investor capital, with the documentation and operational discipline of an institutional manager even before institutional investors are in the picture. They invest in compliance infrastructure, legal document quality, and reporting capabilities as if the SEC were-examining them tomorrow, because institutional LP counsel applies diligence standards that are at least as demanding as an SEC examination. They build relationships with institutional consultants and placement agents who introduce emerging managers to institutional allocation programs. And they continue performing, deal after deal, with the consistency that distinguishes a platform from a collection of one off transactions.

The most common mistake sponsors make in pursuing institutional capital is attempting to shortcut the organizational infrastructure investment, presenting a compelling investment track record while the compliance program is informal, the legal documents are templates, and the



reporting is inconsistent. Institutional investors and their advisers distinguish between a good operator and an institutional quality manager. A good operator with an excellent track record who has not built the organizational infrastructure that institutional capital requires is a sponsor to watch for the future, not one to commit capital to today.

## Self-Directed IRA and Solo 401(k) Investors

Self-directed IRAs and Solo 401(k) plans that invest in private real estate syndications represent a growing segment of the individual accredited investor population. The appeal is significant: retirement plan capital invested in private real estate can grow on a tax deferred (traditional accounts) or tax free (Roth accounts) basis, potentially compounding private real estate returns within a tax advantaged wrapper. But the compliance and operational dimensions of retirement plan investing in private syndications are complex enough that sponsors who do not understand them create problems for themselves and for their investors.

### UBIT and UDFI Considerations

The two primary tax complications of IRA and retirement plan investment in private real estate are Unrelated Business Taxable Income (UBTI) and Unrelated Debt Financed Income (UDFI). Both can subject retirement plan income to tax that would not apply to an individual direct investor, potentially undermining the tax efficiency rationale for using retirement plan capital.

**UBTI (Unrelated Business Taxable Income).** Income earned by a tax exempt entity (including an IRA) from an unrelated trade or business is subject to Unrelated Business Income Tax (UBIT), a tax that eliminates the tax exempt entity's normal exemption from income tax on that income. For a real estate syndication invested through an LLC taxed as a partnership, the IRA investor's allocable share of any income constituting an unrelated trade or business (which can arise from active property operations in certain structures, from debt financed income, or from other business activities of the LLC) may be subject to UBIT at the trust income tax rates. The UBIT analysis is fact specific and requires consultation with a tax adviser familiar with retirement plan tax rules.

**UDFI (Unrelated Debt Financed Income).** When an IRA invests in a property that is financed with debt (which describes most private real estate syndications) the portion of the investment's income and gain attributable to the debt financing is characterized as unrelated debt financed income, which is subject to UBIT. In a syndication where the fund uses 60% leverage, approximately 60% of the IRA's allocable share of income and gain may be subject to UBIT as UDFI. This applies to operating income distributions as well as to the gain recognized on disposition. Investors using retirement plan capital in leveraged real estate syndications should understand UDFI and its potential impact on the net after tax return from the investment before committing.

Sponsors whose investor base includes meaningful retirement plan participation should disclose the UBIT and UDFI exposure in the PPM's tax considerations section. This is material information for retirement plan investors evaluating the investment's after tax economics. A PPM that describes the investment's tax benefits without addressing the UBIT and UDFI implications for retirement plan investors has omitted material tax information for a significant portion of the potential investor population.

## **Custodian and Documentation Requirements**

An IRA cannot invest directly in a private real estate syndication. It must do so through a self-directed IRA custodian (a bank, trust company, or other qualified custodian that specifically permits alternative investment holdings) that holds the investment on behalf of the IRA account. The IRA owner instructs the custodian to direct the IRA's capital to the offering, and the custodian, not the IRA owner, is the record investor. This has several practical implications for the sponsor's closing process.

- The subscription agreement is executed by the custodian on behalf of the IRA, not by the IRA owner. The investor of record in the fund's records is the custodian for the benefit of the IRA: for example, ABC Trust Company FBO [IRA owner name] IRA. The accreditation analysis looks through the custodian to the IRA owner's own income and net worth.
- Capital contributions come from the IRA custodian's account, not from the IRA owner's personal bank account. Wiring instructions and subscription documentation must accommodate this structure.
- K-1s are issued to the custodian as the entity of record, and the custodian includes the IRA's allocable share of fund income on the IRA's tax return (Form 990-T if UBIT applies). The IRA owner does not receive a K-1 directly.
- Prohibited transaction rules under IRC Section 4975 restrict certain interactions between the IRA and disqualified persons, including the IRA owner, their lineal descendants and ancestors, and entities they control. A sponsor who is a disqualified person with respect to an investor's IRA cannot receive compensation from a transaction involving that IRA's investment. Sponsors who have family members or business associates investing their IRA capital in the sponsor's offerings should confirm with tax counsel that no prohibited transaction issues arise from the specific investment structure.

The custodian's involvement adds a layer of administrative friction to the subscription process. Custodians have their own forms, their own review timelines, and their own requirements for investment documentation. Sponsors who regularly accept IRA capital should familiarize themselves with the documentation requirements of the major self-directed IRA custodians and should build adequate lead time into the closing process for custodian review and approval.

## International Investors

International investors (high net worth individuals, family offices, and institutional capital from outside the United States) represent a meaningful and growing pool of capital interested in U.S. private real estate. The U.S. real estate market's size, transparency, rule of law protections, and long term appreciation track record make it one of the most sought after destinations for international capital, and sponsors who build the compliance infrastructure to serve international investors can access this pool without being limited to the domestic accredited investor market.

Serving international investors requires understanding two distinct regulatory frameworks that operate simultaneously: U.S. securities law, which governs how the offering is structured and marketed; and U.S. tax law, which imposes specific withholding and reporting obligations on investments by foreign persons in U.S. real estate.

### FIRPTA Withholding and Partnership Withholding

The Foreign Investment in Real Property Tax Act (FIRPTA) subjects foreign persons to U.S. income tax on gains from the disposition of U.S. real property interests (USRPIs), including interests in partnerships or LLCs that own U.S. real property. The withholding and tax obligations applicable to a foreign investor's position in a real estate fund operate through two distinct Internal Revenue Code provisions, both of which sponsors and their tax counsel must address.

At the fund level, when the fund earns effectively connected taxable income (ECTI) from its real estate operations or property dispositions, Section 1446(a) of the Internal Revenue Code requires the partnership to withhold and remit tax on the foreign partner's allocable share of that ECTI. The withholding rate is the highest tax rate applicable to the foreign partner: 37% for non-corporate foreign partners (the highest individual rate) or 21% for corporate foreign partners. The fund administrator must calculate and remit the Section 1446(a) withholding for each foreign partner using Form 8804 (Annual Return for Partnership Withholding Tax) and Form 8805 (Foreign Partner's Information Statement). For dispositions of USRPI by the partnership, Section 1445 may also apply in limited cases where the partnership's assets meet the 50/90 test under Treasury Regulations, though for most operating partnerships, compliance with Section 1446 satisfies the FIRPTA withholding obligations.

At the investor level, when a foreign investor sells their interest in the fund before disposition (a secondary transfer), Section 1446(f) of the Internal Revenue Code (added by the Tax Cuts and Jobs Act for transfers after December 31, 2017) generally requires the transferee (buyer) of that interest to withhold 10% of the amount realized by the foreign seller when any portion of the gain on the transfer would be treated as effectively connected income. This secondary transfer withholding obligation applies to the buyer, which is significant for structuring secondary

transactions involving foreign investor interests, since the buyer must account for the withholding obligation before completing the transfer. Treaty elections and partner certifications can reduce or eliminate the withholding in specific circumstances.

Tax counsel experienced with FIRPTA and partnership withholding must be engaged before any international investor is admitted to a real estate fund. The withholding calculations at the fund level and at the secondary transfer level, the Form 8804 and 8805 filing obligations, treaty election procedures for eligible foreign investors, and the Section 1446(f) certification mechanics for secondary transfers all require specific tax expertise that is distinct from the general real estate and securities law expertise described elsewhere in this handbook.

## Regulation S Compliance for Non U.S. Person Offerings

Regulation S provides a safe harbor from U.S. securities registration requirements for offers and sales of securities made outside the United States to non U.S. persons. For a real estate fund sponsor interested in attracting international capital, Regulation S opens the door to marketing to European family offices, Asian high net worth investors, Middle Eastern sovereign adjacent capital, and other international investor categories, without requiring those investors to participate in the U.S. registered securities framework.

The basic Regulation S framework relevant to most private real estate fund offerings imposes several conditions on the international offering: the offer and sale must be made offshore (outside U.S. territory); directed selling efforts within the United States are prohibited; purchasers must be non U.S. persons (a defined term under Regulation S that includes natural persons not resident in the U.S. and entities organized under foreign law with their principal offices outside the U.S.); and the securities must bear a legend restricting transfer to U.S. persons during the distribution compliance period, generally one year for equity securities of U.S. issuers under Category 3.

The distribution compliance period restriction is particularly important for real estate fund interests. During the one year period following the issuance, the foreign investor cannot transfer their fund interest to a U.S. person. After the compliance period expires, transfers to U.S. persons are permitted if the transfer otherwise qualifies for an independent exemption, typically requiring the U.S. buyer to be an accredited investor in a Regulation D compliant secondary transaction. These restrictions must be reflected in the fund's operating agreement and monitored throughout the compliance period.

**⚠ Regulation S Does Not Mean Unregulated. It Means a Different Regulatory Framework**

*Sponsors sometimes misread Regulation S as an exemption that eliminates regulatory obligations for international investors. It is not. Regulation S provides a safe harbor from U.S. securities registration requirements for specific offshore transactions, but the U.S. antifraud provisions still apply to misrepresentations made in connection with Regulation S transactions, and the applicable foreign securities laws of the investor's home jurisdiction may impose their own registration, disclosure, or suitability requirements that the sponsor must evaluate.*

*Every international investor relationship carries two sets of legal obligations: U.S. obligations (Regulation S compliance, antifraud provisions, FIRPTA and Section 1446 withholding) and foreign obligations (the securities law requirements of the investor's home country, which the sponsor should evaluate with local counsel in each jurisdiction where international investors are sought).*

*The sponsor who markets to international investors without this dual track analysis has not solved a compliance problem. They have created one.*

## Currency and Political Risk Disclosures

International investors in a U.S. real estate fund are investing in U.S. dollar denominated assets. For investors whose home currency is not the U.S. dollar, the investment's economic return in their home currency depends on the exchange rate at the time returns are distributed and at the time of final disposition, factors entirely outside the sponsor's control. A fund that generates a 15% IRR in dollar terms may produce a materially different IRR in euros or yen depending on currency movements over the hold period.

This currency exposure is a material risk for international investors that must be specifically disclosed in the PPM. The PPM's risk factors section should address that distributions and proceeds are payable in U.S. dollars; that the international investor bears currency exchange risk; that the sponsor does not hedge currency exposure on behalf of investors; and that adverse currency movements can significantly affect the investor's home currency return independent of the investment's performance in dollar terms.

Political risk disclosures are relevant for international investors primarily in the reverse direction: the risk that the investor's home country imposes capital controls, sanctions, or other restrictions that affect the investor's ability to receive distributions or repatriate proceeds from a U.S. real estate investment. While these risks are not primarily the sponsor's operational concern, they are material to the investor's decision making and should be identified in the PPM's risk factors as risks the sponsor cannot control and cannot remediate.

## Managing Investor Expectations

Managing investor expectations is not a communication strategy. It is a legal obligation with commercial consequences. Investors who received accurate expectations before investing, and who continue to receive honest updates throughout the hold period, are better decision makers, more forgiving when conditions change, and more likely to reinvest. Investors who received optimistic projections that reality has not supported, and who receive inadequate or evasive communication when things don't go according to plan, are investors who are evaluating their legal options.

### Setting Realistic Return Expectations

The expectation setting process begins with the offering documents and marketing materials, and the discipline to present projections that reflect genuine underwriting rather than the numbers needed to attract capital. Sponsors who project returns based on the assumptions that make the offering most attractive, rather than the assumptions most likely to prove accurate, are setting a trap for themselves and their investors. The gap between projected and actual performance is not merely a business problem. It is the first thing an investor's counsel measures when evaluating whether the offering documents were materially misleading.

Realistic expectation setting requires disclosing the assumptions that drive the projected returns specifically and completely. The rent growth rate assumed, the exit cap rate assumed, the renovation budget basis and contingency, the projected vacancy during renovation, the interest rate assumed on floating rate debt, the hold period assumed for IRR calculation: each of these is a variable whose actual value will differ from the projection, and investors are entitled to understand what the projection assumed and how sensitive the projected return is to changes in those assumptions.

It also requires presenting downside scenarios alongside the base case. A projection showing only the expected case, without any analysis of what the investment returns if occupancy comes in 10 points below projection or if the exit cap rate is 50 basis points higher than underwritten, is incomplete information. Sophisticated investors will conduct their own sensitivity analysis. Providing it in the PPM demonstrates analytical rigor and protects against the claim that the sponsor concealed the risks.

### Communicating Through Challenging Market Conditions

The quality of a sponsor's investor communication is most consequential, and most tested, when market conditions are unfavorable. A rising interest rate environment that increases debt service and compresses exit values, a softening rental market that delays lease up projections, a construction supply chain disruption that extends the renovation timeline and increases costs:

these are circumstances under which the instinct to minimize or delay disclosure is strongest and the consequences of doing so are worst.

Investors who receive honest, contextualized communication when the investment is underperforming can process that information, adjust their expectations, and make informed decisions about their continued involvement. They may be unhappy, but they are participants in a legitimate investment with honest disclosure. Investors who discover problems through sources other than the sponsor, or who receive a sudden disclosure of significant underperformance after a series of reassuring quarterly reports, are investors who feel deceived, regardless of whether any individual statement was technically false.

The communication framework for challenging conditions should include prompt disclosure when a material adverse development occurs, before the next scheduled quarterly report and through the material event notice mechanism in the operating agreement; context that explains what happened and why (market conditions, execution issues, or external factors); a candid assessment of the investment's revised trajectory and the assumptions underlying that assessment; and a clear description of what the sponsor is doing in response, not generic reassurances, but specific actions with specific timelines.

The sponsors who maintain strong investor relationships through downturns are those who communicate early, honestly, and specifically about problems, and who deliver on the response plan they describe. The worst outcome is a sponsor who promises a specific corrective action in a difficult quarterly report and then fails to deliver or fails to communicate further. Investors who were already concerned and then feel ignored become the most difficult investors of all.

| Investor Type                 | Primary Motivations                                                                                               | Due Diligence Approach                                                                                                       | Key Compliance Considerations                                                                                            |
|-------------------------------|-------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------|
| High net worth individual     | Passive income, tax efficiency, diversification, portfolio complement to public markets                           | PPM review, sponsor track record, property level underwriting, personal relationship with sponsor                            | Accreditation verification; antifraud standard applies to all marketing materials; full PPM disclosure of risks and fees |
| Family office                 | Risk adjusted returns, capital preservation, multi cycle relationship with trusted sponsors, co-investment access | Full legal document review, audited financials, complete investment by investment track record, reference calls, site visits | 3(c)(1) beneficial owner count; ERISA threshold if family office manages benefit plan assets; side letter negotiation    |
| Registered investment adviser | Client portfolio diversification, alternative income, fiduciary quality investment offerings                      | Manager due diligence questionnaire, compliance review, legal document review, suitability analysis per client               | No transaction based compensation to RIA; look through beneficial owner count for RIA clients; broker dealer analysis    |



| Investor Type                    | Primary Motivations                                                                                         | Due Diligence Approach                                                                                                       | Key Compliance Considerations                                                                                                                                                           |
|----------------------------------|-------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Pension fund or endowment        | Diversification, inflation hedge, long duration income, institutional quality manager                       | Full organizational DD, compliance program review, Form ADV review, LPAC structure, LP counsel review, key person provisions | ERISA plan asset rules (25% test or REOC exemption); prohibited transactions; LPAC governance                                                                                           |
| Self-directed IRA or Solo 401(k) | Tax deferred or tax free compounding of private real estate returns                                         | Custodian review of offering; IRA owner evaluates investment on standard accredited investor basis                           | UBIT and UDFI disclosure in PPM; custodian as investor of record; prohibited transaction analysis; K-1 to custodian                                                                     |
| International investor           | U.S. real estate market access, USD asset diversification, rule of law protection, potential currency hedge | Varies by investor type and jurisdiction; may apply home country investment standards in addition to U.S. analysis           | Regulation S compliance; Section 1446(a) partnership withholding on ECTI; Section 1446(f) 10% withholding on secondary transfers; currency risk disclosure; home country securities law |

## Practical Takeaways

- Understanding your investors is not a soft skill. It is a capital markets competency and a compliance obligation. Investors who did not receive information in a format and at a level of detail appropriate to their sophistication and decision making process have a basis for inadequate disclosure claims regardless of whether the PPM technically contained the required information.
- The accredited investor definition under Rule 501(a) of Regulation D includes the \$1 million net worth (excluding primary residence) and \$200,000 income (\$300,000 jointly) thresholds, and since the August 2020 amendments (effective December 8, 2020) also includes natural persons holding the Series 7, Series 65, or Series 82 license in good standing, knowledgeable employees of private funds investing in their employer's fund, and certain family clients of family offices.
- High net worth individual investors split into two subgroups requiring different communication: experienced real estate investors who need to understand what is specific and differentiated about this offering, and professionals new to private real estate who need structural education before investment thesis evaluation. Sponsors who sequence the conversation correctly close more and face fewer complaints.



- Family office relationships represent the highest value single investor category available to most private real estate sponsors. They require full legal document review, complete investment by investment track records, and reference quality prior investor relationships. The sponsors who cultivate these relationships by maintaining institutional quality documentation even before institutional investors are in the picture are the ones who attract family office capital when the time comes.
- RIAs who invest client capital in a private fund are not a single investor for Section 3(c)(1) purposes. Each underlying client account is a separate beneficial owner. An RIA investing on behalf of ten clients contributes ten toward the 100 investor cap. Sponsors approaching the 3(c)(1) limit must confirm the underlying client count before accepting any RIA subscription.
- Institutional investors require organizational infrastructure (compliance programs, audited financials, institutional quality legal documents, LPAC governance, key person provisions) that must be built before institutional due diligence begins. A strong track record without this infrastructure produces interest but not commitments from institutional investors.
- ERISA plan assets rules under DOL regulation 29 C.F.R. § 2510.3-101 are triggered when benefit plan investors hold 25% or more of any class of equity in a fund. Staying below this threshold is the most common path for private funds. For real estate funds specifically, the Real Estate Operating Company (REOC) exemption provides an alternative path that does not require monitoring the 25% threshold, but requires the fund to satisfy specific real estate investment and active management requirements that must be in place from formation.
- Self-directed IRA and Solo 401(k) investors carry UBIT and UDFI exposure that can significantly affect the after tax return from a leveraged real estate investment. This exposure must be disclosed in the PPM's tax section. Custodian administrative requirements (the custodian as investor of record, custodian executed subscriptions, K-1s to the custodian) must be accommodated in the closing process.
- International investors trigger two distinct U.S. tax withholding regimes. At the fund level, Section 1446(a) requires withholding on the foreign partner's allocable share of effectively connected taxable income at the highest tax rate applicable to the partner (37% for non-corporate foreign partners, 21% for corporate foreign partners), reported on Forms 8804 and 8805. At the secondary transfer level, Section 1446(f) requires the buyer of a foreign partner's interest to withhold 10% of the amount realized when any portion of the gain would be treated as ECI. Tax counsel with experience in both regimes must be engaged before the first international investor is admitted. Currency and political risk disclosures are material for international investors and must appear in the PPM.

- Regulation S for international investors is not an exemption from all regulatory obligations. It is a safe harbor from U.S. securities registration. The antifraud provisions apply. The investor's home country securities laws apply. The one year distribution compliance period restricts transfers to U.S. persons and must be implemented in the operating agreement's transfer restrictions.

## CHAPTER TWENTY FOUR

# Building a Capital Raise Plan

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There is a version of the real estate capital raise that many sponsors imagine and a version that actually happens. In the imagined version, the offering documents are finalized on schedule, investors who were informally interested convert smoothly into signed subscription agreements, capital arrives in the escrow account before the acquisition deadline, and the equity closing happens concurrently with the real estate closing without drama. In the version that actually happens, documents took longer because the investor specific disclosures required more revision than expected. Several soft circled investors took the final PPM to their attorneys, who raised questions that created a two week delay. The title company needed a form of investment certification from the LLC that nobody had prepared. The Form D deadline arrived seventeen days after the first closing and the compliance calendar had not flagged it.

The offering still closed. But it took six weeks longer than planned, consumed more of the sponsor's capacity than the underlying real estate transaction did, and created investor relations friction during the delay that would take months to repair.

Building an effective capital raise plan does not require predicting exactly which complications will arise. It requires building a plan rigorous enough that complications can be absorbed without cascading into larger failures. That planning discipline (knowing how much capital you need before you start, having more investor relationships developed than the offering will require, building extra time into every phase, confirming investor eligibility before accepting subscriptions rather than after) applies equally to every offering at every scale. The sponsors who close offerings on time and at target are not necessarily the ones with the most attractive deals. They are the ones who planned the process carefully and executed that plan with discipline.

This chapter works through each component of a capital raise plan for a private real estate syndication or fund: the three phase offering timeline and the compliance triggers embedded within it; how to define the offering's target size and terms; the mechanics of minimum raises and escrow; the discipline of soft circles versus hard commitments; building and maintaining the investor pipeline; coordinating the legal, financial, and marketing workstreams that must run simultaneously; and the common planning mistakes that produce the extended, friction filled capital raises that no sponsor wants and no investor appreciates.

## Why Capital Raise Planning Is Essential

Capital raise planning is essential for the same reason that any complex project with multiple interdependent workstreams and hard external deadlines requires careful planning: the

consequences of failure are disproportionate to the effort that prevention requires. A real estate acquisition with a fixed closing date cannot wait for a delayed equity capital raise. Investors who committed capital at the beginning of a six month raise period and receive neither their money back nor confirmation of the investment's status after that period are not patient. They are angry. A Form D that is filed twenty five days after the first closing because no one tracked the fifteen day deadline is a compliance failure that could have been prevented with a calendar entry.

The practical reality is that most capital raise problems are foreseeable. They arise from predictable sources: insufficient investor pipeline relative to the offering target, unrealistic document preparation timelines, undefined responsibility for compliance deadlines, and inadequate coordination between the legal, financial, and marketing teams that must execute the capital raise simultaneously. A capital raise plan that specifically addresses each of these failure modes is not a bureaucratic exercise. It is the operational infrastructure that determines whether the offering closes as planned or becomes a protracted, expensive ordeal.

The planning discipline also serves the offering's legal integrity. Compliance deadlines are not flexible. The Form D must be filed within fifteen calendar days of the first sale regardless of how busy the closing process was. State blue sky filings must be made within the applicable deadline for each investor state regardless of how many investors subscribed from new states in a compressed timeframe. A capital raise plan that treats these deadlines as known obligations with assigned owners and advance reminders is a plan that avoids the compliance failures that Chapter 18 described in detail.

## Defining the Offering: Size, Terms, and Target Investor Profile

Before any investor conversation begins, before any document is drafted, and before any marketing channel is activated, the offering's fundamental parameters must be determined. These decisions are not independent. They interact with each other in ways that require the sponsor to think through the full offering architecture before committing to any single element.

### Offering Size

The target offering size (the total equity capital the offering will raise) is determined by the specific real estate transaction's capital requirements, not by how much the sponsor believes they can raise or how large a round sounds impressive in marketing materials. The equity capital required is the difference between the property's acquisition price (plus transaction costs and required reserves) and the debt financing the property will carry. Over raising creates

dilution and reduces the equity return. Under raising creates a capital shortfall that cannot be remedied after the offering closes.

For fund structures, the target size involves an additional consideration: the portfolio's anticipated composition, the individual investment sizes that the fund's strategy will employ, and the management fee and expense structure that the fund requires to operate effectively. A fund that is too small to generate management fee income sufficient to cover operating expenses is a fund that will either underinvest in operations or charge fees disproportionate to its size. The minimum viable fund size for a professionally managed platform is a number that requires honest analysis, not aspiration.

## Terms and Investor Profile Alignment

The offering's economic terms (preferred return rate, distribution frequency, promote structure, hold period, minimum investment) must be calibrated to the target investor profile. Terms appropriate for institutional investors (longer hold periods, lower preferred returns, higher minimums, more complex waterfall structures) may not work for individual accredited investors who prioritize quarterly distributions and shorter holds. Terms appropriate for retail investors in a Regulation A+ offering are fundamentally different from those appropriate for a qualified purchaser 3(c)(7) fund.

The target investor profile also determines the exemption structure. If the offering will be marketed broadly to accredited investors through digital channels, Rule 506(c) is the appropriate framework and the accreditation verification obligation is non-negotiable. If the offering will be marketed only to investors with pre-existing relationships, Rule 506(b) is available and the general solicitation prohibition must be strictly observed. If the offering will reach retail investors, Regulation A+ with its offering circular qualification requirement is the path. These are not decisions that can be changed mid offering. The exemption chosen at the outset governs the entire capital raise.

## The Capital Raise Timeline

A realistic private real estate syndication capital raise spans roughly eight to sixteen weeks from initial offering launch to the first closing, depending on offering complexity, the sponsor's existing investor relationships, and the efficiency of the professional team. That timeline assumes no regulatory complications, no unusual investor diligence delays, and no material document revisions required after investor counsel review. It does not assume everything goes smoothly. It assumes a normal distribution of minor complications that a well planned process can absorb. For fund structures and larger offerings, the capital raise timeline frequently extends across multiple closings over six to twelve months.

The timeline has three phases: pre-launch, launch, and post close. Each phase has distinct activities across the legal, financial, and marketing workstreams. Each phase contains compliance triggers (deadlines that begin running the moment a defined event occurs, regardless of whether the sponsor was ready for them).

### **Phase 1: Pre-launch (Weeks 1 to 6, approximately)**

#### **Legal Workstream**

- Securities exemption selection and written confirmation by counsel
- Entity formation: SPV LLC or LP, manager entity, GP entity
- Offering document drafting: PPM, operating agreement or LP agreement, subscription agreement
- Bad actor questionnaire distribution to all covered persons and collection of completed responses
- Escrow account establishment with bank or licensed escrow company
- Review and approval of all marketing materials before publication
- Pre-sale state blue sky filings for states requiring advance notice

#### **Financial Workstream**

- Financial model finalization: acquisition proforma, hold period projections, sensitivity analysis
- Fund administrator engagement and service agreement execution
- Capital account structure and allocation methodology confirmation
- Waterfall calculation methodology documented and tested with hypothetical scenarios

#### **Marketing Workstream**

- For 506(c) and Reg A+: website finalization, investor materials preparation
- For 506(b): private communications prepared for existing investor database only
- Pitch deck and executive summary preparation, reviewed by securities counsel
- Investor pipeline assessment: soft circle outreach to known contacts

#### **Coordination Checkpoint (Week 4 to 5)**

- Counsel confirms exemption selection and reviews all marketing materials
- Financial model confirmed against offering document economic terms
- Document drafts circulated for sponsor review and comment
- Pipeline status assessed against offering target: is soft committed interest adequate?

## Phase 2: Launch and Capital Raise (Weeks 6 to 14, approximately)

### Legal Workstream

- Offering documents finalized and executed
- Subscription package delivered to interested investors
- Investor subscriptions reviewed for completeness and eligibility
- AML and KYC diligence on each incoming investor
- Form D filed within 15 calendar days of the first sale (date assigned; deadline calendared)
- State blue sky notice filings triggered as each new investor state appears

### Financial Workstream

- Capital confirmation from escrow bank to fund administrator
- Capital account entries for each investor at each closing
- Waterfall testing against actual investor positions

### Marketing Workstream

- Investor outreach and pipeline management
- Investor calls, presentations, and due diligence support
- Soft commitment tracking and systematic follow up
- Ongoing content publication (506(c) and Reg A+ only)

### Key Compliance Trigger: Form D

Filed within 15 calendar days of the first sale. The first sale is the date the first subscription agreement is accepted, not the date capital is received. Assign this deadline to securities counsel explicitly before the offering launches.

## Phase 3: Post Close Operations (Ongoing After First Closing)

### Legal Workstream

- Annual Form D amendment filed on anniversary of initial filing (calendared at initial filing)
- State annual renewal filings in states requiring them
- Bad actor monitoring: annual questionnaire updates, new covered persons flagged
- Operating agreement compliance obligations: distribution notices, voting procedures, investor reporting deadlines

### Financial Workstream

- Quarterly financial reports to investors

- K-1 preparation and delivery (March 15, or September 15 with extension)
- Distribution notices with waterfall calculations
- Annual audited or reviewed financial statements

#### Marketing Workstream and Investor Relations

- Quarterly performance updates to investor base
- Material event notices as they arise
- Investor relations program maintenance throughout hold period
- Relationship cultivation for future offerings with satisfied investors

#### ⚠ Five Compliance Deadlines That Cannot Miss

1. *Form D. Filed within 15 calendar days of the first sale. The first sale is the date the first subscription is accepted, not when capital arrives. Missing this deadline cascades into state notice filing failures and creates regulatory record problems. Assign this deadline to securities counsel before the offering launches.*
2. *State blue sky filings. Each investor state triggers its own filing obligation, with deadlines ranging from 15 to 30 days from the first sale to that state's investor. Track investor states in real time throughout the capital raise, not in a batch at the end.*
3. *Bad actor questionnaire. Complete for all covered persons before the first sale. If a new covered person joins the offering structure after launch, their questionnaire must be completed immediately.*
4. *Annual Form D amendment. Filed annually on the anniversary of the initial Form D filing. Calendar this at the time of the initial filing, not when you remember it a year later.*
5. *K-1 delivery. By March 15, or September 15 with extension. Consistently late K-1s are among the most damaging investor relations failures in real estate syndication. Build the timeline into the fund administrator's engagement letter.*

## Setting a Minimum Raise and Escrow Mechanics

The minimum raise (the amount of capital the offering must collect before the investment can proceed) is a structural protection for investors and a planning parameter for sponsors. It ensures that investors who commit capital early do so with the assurance that their investment will not proceed unless sufficient capital is raised to actually execute the investment strategy. In a real estate context, the minimum raise is typically set at the amount needed to close on the



property plus sufficient reserves to begin operating: essentially, the minimum viable capital structure for the investment to proceed.

## Contingency Versus Best Efforts Structures

Private real estate offerings generally use one of two capital raise structures. In a contingency structure (sometimes called an all or nothing raise) investor capital is held in escrow until a defined minimum is reached. If the minimum is not reached by a specified deadline, the offering is terminated and all investor funds are returned. In a best efforts structure, the sponsor closes on whatever capital has been raised, subject to a practical minimum below which the investment cannot proceed.

Most private real estate offerings for single asset acquisitions use a best efforts structure with a practical minimum, because the contingency structure's escrow mechanics add operational complexity and because the acquisition closing is typically scheduled before the equity raise is fully completed. Fund structures, by contrast, frequently use a minimum first closing requirement (the fund will not begin investing until a defined minimum capital commitment has been received) which is conceptually similar to a contingency structure but applies to the fund's investment activity rather than to the offering itself.

Rule 10b-9 under the Securities Exchange Act applies to offerings structured as contingency raises. If an offering is made on the condition that a minimum amount will be raised by a specified date, and if that condition is not met, the offering must be cancelled and all subscriber funds promptly returned. The companion Rule 15c2-4 imposes specific escrow obligations on broker dealers participating in contingency offerings, requiring the broker dealer to either deposit funds in escrow with an unaffiliated bank or hold them in a segregated bank account until the contingency is satisfied. For an issuer conducted offering without broker dealer involvement, Rule 15c2-4 does not directly apply, but the issuer's representations about returning funds if the contingency fails must be honored and the escrow arrangement should be structured to support that obligation. Whether interest accrues on returned funds depends on how the escrow account is structured. Sponsors typically use interest bearing escrow accounts in contingency offerings, and the subscription documents should describe the interest treatment so investors understand what they will receive if the contingency fails. Securities counsel should review any contingency structure before the offering launches.

## Escrow Mechanics

Investor capital in a private real estate offering is held in a conventional bank escrow account until the closing conditions are met (specifically, until the real estate acquisition closes and the equity capital is released to fund the acquisition). The escrow account must be established before any investor funds are accepted. The escrow agent (typically a bank, title company, or

licensed escrow company) holds the funds and releases them upon receipt of a release notice from the sponsor confirming that the closing conditions have been satisfied.

The escrow account is not an afterthought. It is the mechanism through which investors' capital is protected between their subscription and the investment closing. Sponsors who direct investor capital to their own operating accounts rather than to a proper escrow arrangement have created both a compliance problem and an investor trust problem. The subscription agreement should specify the escrow account details, the conditions for release, and the investor's right to return of funds if the minimum raise is not achieved or the acquisition fails to close.

For multi closing fund structures, the escrow mechanics are more complex. Each closing admits a new group of investors, who fund into escrow, which releases to the fund to fund investments as they are made. The fund administrator coordinates between the escrow bank and the fund's capital account system, confirming receipt of cleared funds before any capital deployment occurs. The sequencing (subscription, escrow receipt, capital confirmation by fund administrator, release of escrow to fund) must be established procedurally before the first closing and tested with the fund administrator to confirm all parties understand the workflow.

## Soft Circles Versus Hard Commitments

The distinction between a soft circle and a hard commitment is one of the most practically important concepts in capital raise management, and one of the most consistently misunderstood by first time sponsors.

A soft circle is a non-binding expression of investment interest, an investor's indication that they expect to invest a specified amount if the offering proceeds on the terms described. Soft circles are not subscriptions. They are not legally enforceable. They are not capital in the bank. They are indicators of probability that allow the sponsor to assess whether the pipeline is sufficient to support the offering's target raise and whether the acquisition should proceed to hard contract.

A hard commitment is a signed subscription agreement accompanied by executed wire instructions or a funded wire, a legally binding investment in the offering. Hard commitments are capital. They are what close the acquisition.

## Why the Distinction Matters

The confusion between soft circles and hard commitments produces one of the most common and most painful capital raise failures: a sponsor who signs a purchase agreement on a real estate acquisition based on soft circles, treating the soft committed interest as though it were certain, discovers at the hard close that 30% to 40% of soft circles did not convert into subscriptions. The acquisition deadline cannot be extended. The gap cannot be filled in time.

The deal falls through, the earnest money is forfeited, and the sponsor's investor relationships are damaged by the failure.

Experienced sponsors size their pipeline at two to three times the offering target in soft committed interest because they know that conversion rates from soft circle to hard commitment typically run between 30% and 60%, and that the specific conversion rate for any given offering depends on factors that cannot be predicted with precision: the quality of the investor relationships, the attractiveness of the deal relative to competing opportunities, investor liquidity at the time of commitment, and the quality of the offering documents.

First time sponsors consistently overestimate their conversion rates. Their optimism is understandable. They have worked hard to build investor relationships, they believe in the deal, and the soft circles they have received feel like commitments. But the mechanics of converting an interested investor into a signed subscription agreement involve a process (review of the PPM, investor counsel engagement, wire authorization, sometimes a formal investment committee decision) that takes time and produces attrition at each step.

## Managing the Soft Circle Process

Soft circles should be tracked systematically in a CRM or investor pipeline tool with the investor's name and contact information; the amount they have indicated interest in; the date of their indication; any conditions attached to their interest; and the current status of their engagement with the PPM and subscription documents. This tracking allows the sponsor to identify investors who have been sitting on a soft circle for several weeks without advancing, to prioritize follow up, and to assess pipeline adequacy at any point in the capital raise.

Soft circles should be updated regularly as the capital raise progresses. An investor who received the PPM three weeks ago and has not responded is not the same pipeline asset as an investor who received it yesterday. Realistic pipeline assessment requires honest categorization of each investor's current engagement level, not the optimistic assumption that every expressed interest will convert.

The soft to hard conversion process should have a defined timeline. The investor receives the PPM and subscription documents; the sponsor follows up at defined intervals (typically one week and two weeks after delivery); the investor's questions are answered; and the investor is asked for a decision by a specific date. Indefinite follow up without a timeline produces delays. Investors who understand that a closing is scheduled for a specific date are more likely to make timely decisions than those who believe the offering will wait for them.

## Building and Maintaining an Investor Pipeline

No technology platform, no polished website, and no marketing program substitutes for the foundational work of building investor relationships over time. The sponsors who consistently close offerings on time at target are not the ones with the most sophisticated marketing infrastructure. They are the ones who have spent years building relationships with investors who trust their judgment, have watched their prior investments perform, and understand what they are being asked to commit to when a new offering is presented. Relationship first is not a philosophy. It is a capital raise strategy with quantifiable advantages.

### **The Relationship First Foundation**

For 506(b) sponsors, the investor pipeline must be built before any specific offering is contemplated. Reaching out to potential investors after a deal is identified and hoping to establish pre-existing substantive relationships in time for the current capital raise does not meet the legal standard and does not produce strong conversion rates. The investors who convert reliably are those who know the sponsor, have followed prior investments, and trust the sponsor's execution: relationships built between offerings, not at the moment one arises.

The discipline required is treating investor relationship development as an ongoing operational function of the business, not a pre-launch checklist item for each specific deal. Sponsors who maintain regular communication with their investor database between offerings, who provide updates on current investments, who share educational content and market analysis, and who are available for conversations with interested investors at any point in the cycle build the kind of investor relationships that convert at higher rates and produce repeat participation across multiple fund cycles.

For 506(c) and Regulation A+ sponsors, digital marketing is an additional and powerful pipeline development tool, but the relationships that underpin it are still what determines conversion rate. A prospect who has followed the sponsor's content for eighteen months, understands the investment strategy, and has seen prior investment performance updates will convert at a substantially higher rate than a prospect who discovered the sponsor's website last week through a paid advertisement. Digital marketing builds audience. Relationships build investors.

### **CRM Systems for Investor Relationship Management**

An investor pipeline of meaningful size cannot be managed through memory and email folders. A customer relationship management (CRM) system, purpose built investor relations software or a general CRM adapted for the purpose, is essential for any sponsor managing relationships with more than thirty to forty prospective investors.

The investor pipeline CRM should record, at minimum, the date of first contact with each investor; the source of the introduction (direct relationship, referral, content marketing, conference, digital marketing); the investor's indicated interest range and timeline preferences;

the documentation of any pre-existing relationship basis for 506(b) compliance; notes from each investor conversation; soft circle amounts and conditions; subscription document delivery status; and follow up schedule. This record serves both the capital raise (allowing systematic follow up) and the compliance program (documenting the pre-existing relationship basis for each investor communication in a 506(b) offering).

The CRM is also where the sponsor tracks investment eligibility information: accreditation status, investor type (individual, entity, IRA, etc.), beneficial owner count for 3(c)(1) monitoring, and ERISA benefit plan investor status for funds tracking the 25% threshold. These are compliance tracking functions as much as they are pipeline management functions, and maintaining them in a centralized system that can be audited is the foundation of a defensible compliance program.

### Tracking Interest Levels and Managing Confidentiality

Investor interest levels are not binary, interested or not, and the CRM should reflect the spectrum of engagement. A tiered tracking system might categorize investors as: (A) Hard committed, signed subscription; (B) Strong soft circle, indicated specific amount, reviewing documents; (C) Warm, expressed interest, not yet reviewed materials; (D) Cold prospect, in database, not yet engaged with current offering. This categorization allows the sponsor to allocate follow up effort efficiently and to assess the realistic conversion value of the pipeline at any point.

Confidentiality management is equally important. Offering materials (PPMs, operating agreements, financial projections) are confidential documents that investors should not share with third parties without the sponsor's consent. Subscription agreements typically include a confidentiality representation, but the practical protection of confidential offering information begins at the point of initial distribution. Investor portals with access controls, PDF watermarking with investor specific identifiers, and clear communication about the confidential nature of the materials all reduce the risk of offering information reaching parties who have not completed the offering's eligibility verification process.

## Coordinating Legal, Financial, and Marketing Workstreams

The capital raise for a private real estate offering runs three concurrent workstreams (legal, financial, and marketing) each with its own critical path, its own set of dependencies, and its own professional team. These workstreams are interdependent in ways that first time sponsors consistently underestimate. A marketing workstream that launches before securities counsel has confirmed the exemption and reviewed the materials has potentially created a general solicitation problem. A financial workstream that finalizes the waterfall mechanics independently of the legal workstream may produce a waterfall description in the financial model that differs

from the operating agreement. A legal workstream that finalizes documents without confirming that the financial projections in the PPM are consistent with the model used in investor presentations has potentially created a material inconsistency.

Managing these interdependencies requires explicit coordination infrastructure, not assumptions that each team will figure out what they need from the others as they go.

## The Project Lead

Every capital raise needs a project lead: a single person with responsibility for tracking the status of all three workstreams and authority to make time sensitive coordination decisions. This is typically the sponsor's principal or an experienced operations director, not the securities attorney (whose role is legal advice and document production, not project management). The project lead is accountable for the offering closing on time and for compliance deadlines being met.

The project lead runs a weekly coordination meeting that includes the core team members from each workstream: securities counsel, the fund administrator's representative, and the marketing or investor relations lead. The meeting agenda covers the current status of each workstream's critical path items, interdependencies that are blocked, upcoming compliance deadlines, and investor pipeline status. The meeting should be structured, not conversational, with documented action items assigned to specific persons with specific deadlines. Sponsors who hold these meetings consistently report that they surface conflicts between workstreams at a point where they can be addressed with a brief discussion, rather than discovering the conflict at the closing table.

## The Three Critical Handoff Points

Three specific handoff points require-explicit protocol rather than informal communication.

**Financial model to legal documents.** The offering's economic terms (preferred return rate, distribution waterfall mechanics, promote percentage, catch up structure, fee amounts) must be identical in the financial model used in investor presentations and in the PPM and operating agreement. Before the PPM is finalized, securities counsel must confirm that the waterfall description in the PPM matches the financial model's calculation exactly. Any discrepancy (different preferred return rates, different promote percentages, different fee structures) is a material inconsistency between investor facing materials and the governing documents.

**Legal documents to marketing materials.** No public facing marketing materials about the specific offering should be published until securities counsel has confirmed the final exemption selection, the permissible marketing channels and content standards for that exemption, and that all marketing materials have been reviewed against the final offering documents for

accuracy and consistency. For 506(b) offerings, this handoff authorizes the private distribution of offering materials to pre-existing relationships. For 506(c) offerings, it authorizes public marketing to begin. This is the marketing workstream's green light, and it cannot come from anyone other than securities counsel.

**Legal and financial to closing.** Before the first investor subscription is accepted, the closing process must be fully operational: the escrow account established, the fund administrator's capital account system configured, the subscription review process defined, and the state blue sky filing calendar built. Each of these elements requires input from both the legal and financial workstreams, and their absence at the first closing creates problems that are more difficult to resolve after investor capital has been received than before.

### **Capital Raise Plan: Key Decisions and Who Owns Each**

#### **Decision: Which Securities Exemption Governs the Offering?**

- Owner: Securities counsel with sponsor input
- Timing: Week 1, before any other workstream can progress
- Why it matters: Determines permissible marketing channels, investor eligibility requirements, verification obligations, and Form D content

#### **Decision: What Is the Target Offering Size and Minimum Raise?**

- Owner: Sponsor with financial model review by fund administrator
- Timing: Weeks 1 to 2, before offering terms are discussed with investors
- Why it matters: Sets the capital structure for the investment and determines whether a contingency structure is required

#### **Decision: What Are the Complete Economic Terms (Preferred Return, Waterfall, Fees)?**

- Owner: Sponsor with securities counsel review and fund administrator input
- Timing: Weeks 1 to 2, before operating agreement drafting begins
- Why it matters: Must be consistent across PPM, operating agreement, and financial model; changes after documents are drafted require multi document revision

#### **Decision: What Is the Investor Pipeline Status Relative to Offering Target?**

- Owner: Sponsor
- Timing: Assessed in Weeks 2 to 3, before offering launch commitment
- Why it matters: Soft committed interest at 2x to 3x target is the minimum for a realistic close; launching without adequate pipeline produces extended delays

#### **Decision: Who Is Responsible for Each Compliance Deadline?**

- Owner: Sponsor assigns; securities counsel executes Form D and blue sky filings
- Timing: Before the first investor communication



- Why it matters: Unowned compliance deadlines are missed compliance deadlines

## Common Capital Raise Plan Mistakes

### Mistake 1: Confusing Soft Circles with Capital

The most consequential capital raise planning mistake is treating soft circles as though they were signed subscriptions. A sponsor who signs a purchase contract on an acquisition based on \$12 million in soft circles, without accounting for conversion attrition, may find themselves at the equity closing with \$7 million in hard commitments. Building a pipeline of two to three times the offering target in soft committed interest is not conservatism. It is the realistic planning assumption based on how capital raises actually work.

### Mistake 2: Underestimating Document Preparation Time

Sponsors consistently underestimate the time required to prepare, review, and finalize offering documents. A first time sponsor who has never reviewed a full PPM from the investor's perspective will not be able to provide the property specific, sponsor specific, and deal specific information the document requires in a single sitting. Multiple rounds of revision are standard. Investor counsel's review of the documents after delivery adds further time. Building a document preparation timeline that assumes everything will be completed in two weeks, when four to six weeks is the realistic minimum for a well prepared set, is a planning error that propagates through the entire capital raise timeline.

### Mistake 3: Building the Pipeline After the Deal Is Identified

For 506(b) sponsors, this mistake has both a compliance dimension and a practical dimension. The compliance dimension: relationships established after a specific offering is contemplated do not satisfy the pre-existing substantive relationship standard, and the investors developed in the weeks between deal identification and offering launch cannot legally be solicited under 506(b). The practical dimension: even for 506(c) sponsors who can legally solicit the new contacts, conversion rates for investors who encountered the sponsor for the first time during the capital raise are substantially lower than for investors who have been in the sponsor's pipeline for months or years. The pipeline must be built between offerings, not at the moment of need.

### Mistake 4: Missing the Form D Deadline

The Form D must be filed within fifteen calendar days of the date of first sale. That deadline begins running the moment the first subscription agreement is accepted, not when the final closing occurs, not when capital is received, not when the real estate acquisition closes.



Sponsors who do not assign explicit responsibility for the Form D deadline, with a specific deadline date calculated from the anticipated first closing, routinely miss it. The failure cascades into state blue sky filing failures and creates a regulatory record problem that is entirely preventable with a calendar entry.

### **Mistake 5: Starting Marketing Before Legal Confirmation**

Any marketing communication about a specific offering (a pitch deck, an email to investors, a social media post describing the opportunity) that is distributed before securities counsel has confirmed the exemption and reviewed the materials for compliance is a communication made without the legal foundation that determines whether it is permissible. For a 506(b) offering, pre-exemption confirmation marketing may constitute general solicitation. For a 506(c) offering, pre confirmation marketing may contain claims that are not supported by the final offering documents. The correct sequence is: exemption confirmed, documents reviewed, marketing launched. Not marketing launched in parallel with document preparation in hopes that everything will be consistent when the documents are finalized.

### **Mistake 6: Inadequate Fund Administrator Coordination**

The fund administrator (the entity responsible for maintaining the capital account records, calculating distributions, preparing K-1s, and serving as the operational backbone of the fund's accounting) must be engaged and fully briefed before the first investor capital is received. A sponsor who engages the fund administrator at or after the closing will find that the administrator needs several weeks to set up the capital account system, load the investor positions, and confirm the waterfall calculation mechanics, weeks during which any distributions, investor inquiries about their capital account, or K-1 preparation cannot proceed. Fund administrator engagement is a pre-launch task, not a post close task.

## **Practical Takeaways**

- Capital raise planning is not a bureaucratic exercise. It is the operational infrastructure that determines whether an offering closes on time and at target, or becomes a protracted, expensive ordeal that damages investor relationships and creates compliance exposure. The planning discipline that prevents the worst outcomes is not complex: know what you need, have more relationships than you think the raise requires, build extra time into every phase, and assign ownership for every compliance deadline.
- The five compliance deadlines that cannot miss: Form D within fifteen days of the first sale; state blue sky filings triggered by each new investor state in real time; bad actor questionnaire complete before the first sale; annual Form D amendment calendared at

the initial filing; and K-1 delivery by the September 15 extended deadline built into the fund administrator's engagement letter.

- Offering size must reflect the investment's actual capital requirements, not aspirational fundraising targets. Economic terms must be calibrated to the target investor profile. The exemption selection (506(b), 506(c), or Regulation A+) must be made before any marketing activity begins, because it determines the entire permissible capital raise architecture.
- Soft circles are not capital. They are probability weighted indicators of intent. Size the pipeline at two to three times the offering target in soft committed interest, because conversion rates from soft circle to hard commitment typically run 30% to 60%, and the specific rate for any given offering cannot be predicted with precision. First time sponsors consistently overestimate their conversion rates.
- The minimum raise and escrow mechanics protect investors and define the capital structure minimum at which the investment can proceed. Escrow must be established before any investor funds are accepted. Contingency structures require Rule 10b-9 compliance review, and broker dealer involvement adds Rule 15c2-4 escrow obligations. The fund administrator's confirmation of cleared funds must be established procedurally before the first closing, not discovered operationally at the closing itself.
- The investor pipeline must be built before any specific offering is contemplated, not at the moment a deal is identified. For 506(b) sponsors, this is a compliance requirement (pre-existing relationships must be genuine). For all sponsors, it is the practical determinant of conversion rate and close timing. Relationship development between offerings is how sustainable capital raise programs are built.
- A CRM system is not optional for any sponsor managing more than thirty to forty investor relationships. It is the operational infrastructure for pipeline tracking, compliance documentation (pre-existing relationship evidence for 506(b)), beneficial owner count monitoring, and systematic follow up that produce consistent capital raise execution.
- Coordinating the legal, financial, and marketing workstreams requires explicit protocols for the three critical handoffs: financial model to legal documents (economic terms must match exactly); legal to marketing (exemption confirmed, materials reviewed, marketing authorized); and legal and financial to closing (escrow established, fund administrator configured, state filing calendar built). These handoffs cannot be managed through informal assumptions about what the other team will do.
- A designated project lead, not the securities attorney, not the fund administrator, but the sponsor's own responsible principal or operations director, is the operational prerequisite for coordinated workstream management. Weekly structured coordination meetings with assigned action items are the mechanism through which conflicts between workstreams

are discovered at a point where they can be resolved quickly rather than at the closing table where resolution is expensive.

## CHAPTER TWENTY FIVE

# The Closing Process

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The closing of a private real estate syndication is the moment at which months of legal drafting, investor development, and offering preparation converge into a single coordinated sequence of events. Securities are issued, capital is deployed, real estate is acquired, and investors become equity holders in an LLC that owns a real asset. The closing is also the moment when the most consequential compliance failures tend to surface, not because sponsors become careless at closing, but because the closing reveals every gap in the preparation that preceded it.

The subscription processing, capital collection, entity governance, regulatory filing, and real estate acquisition mechanics that comprise a private real estate closing are individually familiar to most sponsors who have completed even one prior deal. But their coordination (running simultaneously, against a fixed real estate acquisition deadline, with investor specific diligence requirements that are rarely uniform across the investor population) produces a level of operational complexity that surprises sponsors who assumed that the capital raise was the hard part. The closing is its own discipline.

This chapter covers the full closing process for a private real estate syndication or fund: the pre-closing checklist across legal, financial, and compliance dimensions; the mechanics of subscription processing and investor onboarding; entity formation and the coordination of the equity closing with the real estate acquisition; escrow mechanics, lender closing requirements, and the proceeds flow; Form D and state blue sky filing coordination; post-closing obligations; and the common closing mistakes that create regulatory exposure, investor relations problems, and liability that careful preparation would have prevented.

## Pre-closing Checklist: Legal and Compliance

The pre-closing checklist is the sponsor's last systematic opportunity to confirm that every element of the offering's legal and compliance foundation is in place before investor capital is accepted and the real estate acquisition closes. Sponsors under pressure from an acquisition deadline treat the checklist as a bureaucratic formality. The consequences of that approach appear after closing: a subscription agreement that was accepted before the bad actor questionnaire was completed, a Form D deadline that passed because nobody tracked it, a state blue sky filing that was missed because the investor's state of residence was not captured at subscription. Each of these failures was preventable by a checklist item that was skipped.

The pre-closing checklist has three dimensions: legal readiness, which confirms the offering's legal foundation is complete and defensible; compliance readiness, which confirms all

regulatory obligations associated with the closing are satisfied; and operational readiness, which confirms the subscription processing, capital confirmation, and investor communication systems are functional before the first investor capital is accepted.

### Legal Readiness Checklist

- SPV entity fully formed: Certificate of Formation or Articles of Organization filed, EIN obtained, bank accounts opened, registered agent confirmed in state of formation and in each state where the entity will transact business.
- Operating agreement (or LP agreement) executed by manager or GP and reviewed for consistency with PPM. All economic terms, governance provisions, investor rights, and transfer restrictions confirmed in both documents.
- PPM finalized, dated, and distributed to all investors in the closing. Date of distribution documented in offering files.
- Subscription agreements executed by all investors. Manager acceptance of each subscription confirmed in writing. Subscription packages complete: PPM, subscription agreement, investor questionnaire, wire instructions.
- Bad actor questionnaire complete for all covered persons. Responses reviewed by securities counsel. No disqualifying events identified, or SEC waiver obtained for any pre-existing triggering event.
- Fund administrator engagement letter or administration agreement executed. Capital account system configured and tested with closing investor positions.
- Escrow account established with licensed escrow agent or bank. Escrow agreement executed with release conditions specified.
- Real estate purchase and sale agreement in effect. Closing conditions satisfied or waivable as of the anticipated closing date.
- Lender approval of entity structure obtained. Loan documents reviewed for transfer restriction covenants. Lender consent to investor admission structure confirmed in writing if required.
- Legal opinion from securities counsel confirming exemption availability (if required by institutional investors or lender).

### Compliance Readiness Checklist

- Form D prepared and ready for filing within 15 calendar days of the first sale. Filing responsibility assigned to securities counsel. Filing date reminder set on compliance calendar. Note: first sale is date of first subscription acceptance, not date of capital receipt.

- Pre-sale state blue sky filings completed for all investor states where required before marketing began. Post sale filing obligations identified for each state requiring filing within a specified number of days of the first sale to a resident of that state.
- Investor state tracking system active: mechanism in place to capture each investor's state of residence at the time of subscription and trigger the corresponding state blue sky filing within the applicable deadline.
- Annual Form D amendment calendar entry created for each anniversary of the initial filing, for every year the offering remains open.
- Annual bad actor questionnaire update scheduled for all covered persons.
- Investor reporting obligations calendared: quarterly report deadlines, annual financial statement deadlines, K-1 delivery deadline.
- Fund administrator capital account records confirmed to match the investor positions and economic terms in the operating agreement.
- AML and KYC diligence completed for all closing investors. Documentation retained in offering files.

### **⚠ Pre-closing Checklist Items Are Not Formalities. They Are the Offering's Last Line of Defense**

*Sponsors under pressure from a real estate acquisition deadline treat the pre-closing checklist as a bureaucratic exercise. The consequences appear after closing: a Form D deadline that passed because no one tracked it, a state blue sky filing missed because the investor's state was not captured at subscription, a subscription accepted before the bad actor questionnaire was returned by a covered person.*

*Each item on the pre-closing checklist identifies a specific failure mode with specific consequences. Run it completely. Confirm every item in writing. Do not close until every box is checked. The cost of a two day delay to resolve a checklist deficiency is a fraction of the cost of resolving a compliance failure discovered after investor capital has been accepted.*

## **Subscription Processing and Investor Onboarding**

Subscription processing is the sequence of steps through which an interested investor is formally admitted to the offering. It is not the moment an investor expresses interest, not the moment they receive the PPM, and not the moment their capital arrives in the escrow account. Subscription processing is complete when the sponsor has reviewed and accepted the

investor's subscription agreement, formally admitting them as a member of the LLC. That moment triggers the compliance clock for Form D and state blue sky filings. Getting that sequence right is the foundation of a clean closing.

## Reviewing and Accepting Subscription Agreements

The subscription agreement review is the sponsor's opportunity to confirm, before formal admission, that every investor meets the offering's eligibility requirements and that their subscription documentation is complete. This review is not merely administrative. It is a compliance function whose failure produces the investor specific exposure described in Chapter 18.

The review should confirm that the investor has signed and dated all required representations in the subscription agreement; that the investor qualifies as an accredited investor (and that the verification methodology used is appropriate for the chosen exemption: for 506(c), one of the three permitted verification methods (documentation review, written confirmation from a qualifying third party verifier, or the high minimum investment plus written representations approach under the SEC's March 12, 2025 no action letter to Latham & Watkins); for 506(b), the substantive accreditation qualification combined with the pre-existing relationship analysis); that any entity investor has provided evidence of organizational existence, authority of the signing person, and appropriate beneficial ownership information; that the investor's investment amount is within the offering's stated minimum and maximum; and that no information in the subscription package raises red flags requiring additional diligence before admission.

Manager acceptance of each subscription should be confirmed in writing: a countersigned subscription agreement, a formal acceptance letter, or a written notation in the offering's records with the acceptance date. The date of acceptance is the first sale date for that investor, which starts the Form D clock if it is the first investor in the offering. Do not conflate the date an investor signed the subscription with the date the manager accepted it. Both dates should be separately documented.

## AML and KYC Diligence on Incoming Investors

Anti money laundering and know your customer (AML and KYC) diligence is required for all investors in a private real estate offering, even though private real estate funds are not themselves financial institutions subject to the Bank Secrecy Act's customer identification program requirements. The AML and KYC obligation for private real estate sponsors arises from the antifraud provisions (sponsors cannot knowingly accept capital from sources that involve securities violations) and from the practical exposure of accepting investor capital without understanding who the investor is and where the money came from.

The minimum AML and KYC diligence for individual accredited investors in a private real estate offering includes confirmation of the investor's identity through government issued photo identification; confirmation that the investor is not on any OFAC sanctions list or other prohibited persons list; confirmation of the beneficial owner of any entity investor (with appropriate documentation of beneficial ownership for LLCs, trusts, and other entity investors); and a basic assessment of whether the investor's source of funds is consistent with their stated financial profile.

For entity investors (LLCs, family trusts, corporations) the beneficial ownership analysis is more demanding. The Financial Crimes Enforcement Network (FinCEN) administers two distinct beneficial ownership frameworks, both of which establish the 25% threshold as the working baseline for beneficial owner identification. The Customer Due Diligence (CDD) Rule, in effect since 2018, applies to covered financial institutions (banks, broker dealers, futures commission merchants, and mutual funds) and requires them to identify and verify the natural persons who own 25% or more of a legal entity customer. FinCEN modified the CDD Rule's repeat verification requirement by exemptive relief order (FIN-2026-R001) on February 13, 2026, but the 25% threshold for initial verification remains in place. The Corporate Transparency Act's separate beneficial ownership information (BOI) reporting framework was originally enacted to require most U.S. entities to file BOI directly with FinCEN, but a FinCEN interim final rule issued March 21, 2025 exempted U.S. domestic entities and U.S. persons from BOI reporting. Only foreign entities registered to do business in the United States remain subject to CTA BOI reporting, and they are not required to report U.S. person beneficial owners.

Real estate fund sponsors are not themselves covered financial institutions under the CDD Rule, and the CTA's BOI reporting framework no longer applies to U.S. domestic entities. But the 25% beneficial ownership analysis remains the working benchmark for sponsor AML and KYC diligence on entity investors: for any entity investor, the sponsor should identify the natural persons who directly or indirectly own 25% or more of the entity and confirm their identities. For complex entity structures with multiple layers, this analysis may require documentary support from the entity investor. A handful of states have enacted their own LLC transparency requirements (notably the New York LLC Transparency Act), and sponsors with significant investor concentrations in those states should consult counsel about any state level reporting that may apply to the investor's entity rather than to the fund itself.

AML and KYC documentation should be retained in each investor's file and should be refreshed if the offering has ongoing closings spanning more than twelve months. An investor whose AML and KYC documentation was collected at a first closing two years before a subsequent closing may need to be re verified if their circumstances have changed or if sanctions list status may have changed in the interim.



## Capital Calls and Wire Instructions

The mechanics of capital collection must be established before the first investor wires funds. Investors need specific, accurate wire instructions that direct their capital to the offering's escrow account, not to the sponsor's operating account, not to a generic entity account, and not to any intermediary account that creates a gap in the chain of custody between the investor's bank and the escrow agent.

Wire instructions should be provided in writing within the subscription package, and the offering's procedures should include a verification call or email confirmation to the investor before any wire is executed: a callback protocol designed to prevent wire fraud. Wire fraud targeting real estate transactions is pervasive, and the specific risk in a real estate closing is that an attacker intercepts the wire instruction communication and substitutes a fraudulent account number. A callback protocol (in which the sponsor or fund administrator calls the investor at a previously verified phone number to confirm the wire instructions before the wire is sent) is a standard best practice that prevents losses that are rarely recoverable after the wire has been executed.

The fund administrator should confirm receipt of each investor's wire and should confirm that the funds have cleared (not merely been received) before any capital deployment occurs. Wire transfers can be recalled by the sending bank under certain circumstances before clearing, which typically occurs within one business day of receipt. Capital deployment, whether into a real estate acquisition or a fund investment, should occur only after cleared funds are confirmed, not immediately upon wire receipt.

## Entity Formation and Deal Closing Coordination

The legal backbone of a private real estate syndication is the SPV: the special purpose vehicle, typically a Delaware LLC, that holds title to the real estate asset. The investor's membership interest is an interest in the LLC, not a direct ownership interest in the real property. The LLC holds the asset. Investors hold membership interests in the LLC. This structure is not merely a design choice. It is the mechanism through which investors' rights, management authority, and liability protection are organized within a framework that courts, title companies, lenders, and taxing authorities all recognize.

## Coordinating the Equity Close with the Real Estate Acquisition

The most operationally complex aspect of a private real estate syndication closing is the sequencing of two separate events: the equity closing (at which investor capital is collected and LLC membership interests are issued) and the real estate acquisition closing (at which the LLC acquires the property). These closings must be sequenced correctly, and their timing must be

explicitly planned, to avoid a situation in which one closes without the conditions for the other being satisfied.

The most common sequencing approach: investor capital is collected in escrow first, reaching the minimum raise threshold before the real estate acquisition closing occurs. Once the minimum is confirmed in escrow, the escrow agent releases funds simultaneously with the real estate closing. The funds flow from the escrow account to the real estate seller (via the title company handling the acquisition closing), and the LLC becomes the owner of the property. Membership interests are confirmed and investor confirmation letters are sent following the real estate closing, once capital accounts have been established by the fund administrator.

An alternative sequencing (acquiring the property first using bridge financing, then raising investor capital and repaying the bridge) creates a different sequence with its own disclosure requirements. The PPM for a bridged acquisition must accurately disclose the bridge financing arrangement and its terms, including the interest rate, the maturity date, and the risk that investor capital may not be raised in sufficient amounts to repay the bridge before maturity. The bridge lender's presence in the capital structure during the capital raise period is a material fact that investors need to evaluate the offering's risk profile.

For fund structures raising capital across multiple closings, the sequencing is more complex because the fund may be deploying into multiple investments at different times, each of which must be funded from investor capital received at the appropriate closing. The fund administrator's role in tracking which investor capital has been contributed and which capital calls have been made against committed capital is the operational backbone of the multi closing fund structure.

## Entity Formation Timing

The SPV must be formed and in good standing before any of the following occur: execution of the purchase and sale agreement for the property (the entity must exist to enter into contracts); opening of the offering escrow account (which is titled to the entity); or execution of the subscription agreement (which admits investors as members of the entity). In practice, entity formation is one of the first tasks completed in the pre-launch phase, typically in the first two weeks of the offering timeline.

Delaware is the standard formation jurisdiction for most private real estate syndication SPVs, for the same reasons Delaware is preferred across private fund structures: well developed LLC law, favorable judicial treatment of LLC governing documents, broad contractual flexibility in structuring member rights and management authority, and charging order protection for LLC interests. Most institutional investors are familiar with Delaware LLC structures and do not require additional jurisdiction education.

For SPVs holding property in states that impose transfer taxes on LLC membership interest transfers, the offering structure creates a specific planning issue. Some states treat the transfer of a majority interest in an LLC holding real property as a taxable real estate transfer, triggering deed transfer taxes or recording fees. This analysis requires coordination between securities counsel and real estate counsel familiar with the property's jurisdiction. It is not something either can evaluate independently.

## **Title and Closing Requirements**

The real estate acquisition closing produces a title insurance policy naming the purchasing entity (the SPV) as the insured. Individual investors do not receive separate title insurance coverage. Their protection derives from the LLC's clean title and from the operating agreement's provisions governing what happens if the LLC's title is challenged. The title company needs to insure the LLC's acquisition of the property. It does not need to analyze the LLC's internal ownership structure for title insurance purposes.

Standard title company requirements for a real estate closing involving an LLC purchaser include a copy of the LLC's formation documents (Certificate of Formation and operating agreement); evidence that the LLC has authority to purchase real property (typically addressed in the operating agreement); an incumbency certificate or authorization certificate confirming the authority of the specific person executing closing documents on behalf of the LLC; and evidence that the LLC is in good standing in its state of formation. Preparing these documents as part of the pre-closing checklist, not discovering they are needed at the closing table, keeps the closing on schedule.

## **Lender Closing Requirements and Proceeds Flow**

Commercial real estate acquisitions typically involve mortgage financing, and the lender's closing requirements impose their own checklist on top of the equity closing's requirements. Lender closing conditions commonly include receipt of a final appraisal confirming value sufficient to support the loan amount; satisfactory completion of environmental and property condition assessments; execution of all loan documents including the promissory note, deed of trust or mortgage, and any personal guarantee by the sponsor's principals; evidence of property and liability insurance naming the lender as additional insured and loss payee; and execution of any required reserve accounts (interest reserve, capital expenditure reserve) funded at closing.

The proceeds flow in a real estate syndication closing runs in a specific sequence: investor capital is released from escrow to the title company handling the real estate acquisition closing; the lender funds the mortgage loan proceeds to the title company; the title company disburses all proceeds according to the closing statement (to the seller, to pay off any existing debt on the property, to fund required reserves, and to pay closing costs and fees); the title company

records the deed to the LLC in the county where the property is located; and the title policy is issued naming the LLC as insured.

The sponsor must review the closing statement carefully before signing. This document allocates every dollar of inflow and outflow at the closing and must be consistent with the PPM's use of proceeds disclosure. Any allocation that differs from what the PPM described must be identified and evaluated for materiality. A closing statement that shows a higher acquisition fee than was disclosed in the PPM, or a lower reserve amount than was committed to investors, is a disclosure inconsistency that requires resolution before or at closing.

## Post-closing Obligations

The closing of the equity offering and the real estate acquisition is not the end of the compliance obligations. It is the transition from capital formation compliance to ongoing operations compliance. The post-closing environment for a private real estate syndication involves the regulatory filing obligations that attach immediately to the closing event and the investor relations obligations that begin the day the investment closes.

### Form D Filing Within 15 Days

The Form D must be filed with the SEC within 15 calendar days of the date of first sale. In a private real estate syndication, the first sale is the date the sponsor first accepts a subscription agreement from an investor, not the date capital arrives in escrow, not the date the real estate acquisition closes, and not the date the operating agreement is executed. The first sale is the legal event of subscription acceptance, and the 15 day clock starts running from that date.

This timing rule catches sponsors who think of the closing as the date the real estate transaction closes. If the first subscription was accepted three weeks before the real estate closing, the Form D deadline was fourteen days after that first subscription acceptance, potentially before the real estate transaction even closed. The compliance calendar must identify the first subscription acceptance date as the Form D trigger, not the real estate acquisition closing date.

The Form D filing is the responsibility of securities counsel, but securities counsel cannot file without information the sponsor provides: the total offering amount, the date of the first sale, the amount sold as of the filing date, the exemption relied upon, the type of securities offered, and the identifying information for all covered persons. A communication protocol for this information handoff (established before the offering launches, not improvised when the deadline is approaching) is the difference between a timely filing and a missed deadline.

### State Blue Sky Notice Filings

Every state where an investor resides is a potential blue sky filing obligation. Under Regulation D Rule 506, NSMIA preempts state registration requirements. States cannot require substantive review of the offering or block it from proceeding. But states retain the right to require notice filings and to charge fees. Most states require a copy of the Form D plus a state specific form and fee within a specified number of days of the first sale to a resident of that state.

The timing obligations vary significantly by state. Some states require pre-sale notice: a filing before any investor in that state can be solicited. Most states require post sale notice within 15 days of the first sale to a state resident. Some states have a 30 day post sale filing window. A minority require annual renewals. A multi-state investor population closing simultaneously (twenty investors across fifteen states) can produce fifteen simultaneous and distinct state filing obligations.

The state tracking system described in Chapter 24 is essential. Every investor's state of residence must be captured at the time of subscription, and the corresponding state filing must be triggered within the applicable deadline. Securities counsel must have a current state by state filing guide and a reliable process for receiving investor state information the moment subscriptions are accepted. Processing state filings in a batch at the end of the offering period (a common shortcut) produces missed deadlines in states with short filing windows.

### **⚠ State Blue Sky Filings Are Not Optional and Are Not All the Same**

*Sponsors who assume that Regulation D preemption eliminates all state compliance obligations are incorrect. States retain the right to require notice filings and annual renewals. Failure to file a required state notice can result in state enforcement action, investor rescission rights under the state's blue sky law, and restrictions on future offerings in that state.*

*The filing system must be active from the moment the first investor in each state subscribes, not assembled in a batch at the offering's conclusion. A compliance calendar that tracks each investor's state at subscription and automatically triggers the corresponding state filing obligation is the operational infrastructure that prevents these failures.*

## **Investor Confirmation Letters and Welcome Packets**

Within a defined period after the closing (typically within one to two weeks) each investor should receive a formal confirmation of their investment in the offering. This confirmation serves both investor relations and legal functions. From an investor relations standpoint, it confirms the investor's position, provides key contact information for investor relations and reporting, and

sets expectations for the investment's ongoing communication program. From a legal standpoint, it creates a written record of the investor's ownership interest, the amount invested, and the date of the investment: a record that may be relevant in any subsequent dispute about the investor's position.

The investor confirmation package should include a written confirmation of the investor's membership interest and the dollar amount invested; a copy of the executed operating agreement (or confirmation that the investor holds the copy they received with the subscription package); the investor portal login information and instructions for accessing the investor's account; the schedule for quarterly reporting, distribution notices, and K-1 delivery; contact information for the investor relations team; and a brief description of what the investor should expect in the immediate post-closing period: when they will receive their first investor update, when the first distribution is expected, and the general status of the property.

Sponsors who are disciplined about the investor welcome packet set the tone for the entire investor relationship that will follow over the hold period. Investors who receive a professional, organized, and timely welcome communication immediately after closing feel that they have made their investment with a professional operator. Investors who hear nothing for three weeks after the closing and then receive a disorganized K-1 login link feel the opposite. The investor welcome packet is the first operational signal of the investor experience they will have throughout the hold period.

## Multi Closing Mechanics and Investor Equalization

Many private real estate fund offerings use a multi closing structure: admitting investors and issuing membership interests in a series of closings over a period of several weeks or months while continuing to raise capital toward the target. Multi closing structures allow sponsors to begin deploying capital into the real estate acquisition or fund investments without waiting for the full offering to close, and they give later investors additional time to complete their diligence and funding.

Multi closing structures create a specific fairness issue: investors who close early begin bearing the economic risks and receiving the economic benefits of the investment from their closing date, while investors who close later may have delayed their participation for legitimate reasons. If the property appreciates or generates income between the first and second closings, early investors benefit from that activity while later investors who paid the same per unit price as early investors did not participate in the benefit.

### Equalization Mechanics

The conventional solution is investor equalization: requiring subsequent closing investors to pay an equalization amount representing their proportionate share of appreciation, income, or capital deployment that occurred between the first closing and their own closing. The equalization amount is calculated by the fund administrator and paid at the subsequent closing, with the proceeds distributed to first closing investors in proportion to their holdings.

The equalization calculation can take several forms: an interest charge on the subsequent investor's committed capital from the date of the initial closing (equivalent to the preferred return rate, making the subsequent investor's economics equivalent to an investor who had been in from the beginning); a charge equal to the subsequent investor's proportionate share of income generated by the fund's investments between the first and subsequent closings; or an adjustment to the subsequent investor's per unit price to reflect the change in net asset value between closings.

The operating agreement must specify the equalization methodology clearly, because disputes about equalization amounts between closing groups are common and contentious. The equalization calculation must be performed by the fund administrator before any subsequent closing occurs. The operating agreement should require the fund administrator to prepare and deliver an equalization calculation to the sponsor no less than five business days before each subsequent closing.

## Form D and Blue Sky Implications for Multi Closing Offerings

In a multi closing offering, the Form D is filed based on the date of the first closing: the first subscription acceptance in the offering's history. Subsequent closings do not create new Form D obligations. They update the amount sold in the offering that was already reported. The annual Form D amendment obligation runs from the anniversary of the initial filing, not from the date of any subsequent closing.

State blue sky filing obligations are triggered by each new investor's state of residence at the time of their subscription acceptance, not at the time of the initial closing. An investor from a new state who subscribes at a second or third closing triggers a state filing obligation in that investor's state within the applicable deadline for that state. The state filing tracking system must be active throughout the offering period, not completed as a one-time exercise at the initial closing.

## Common Closing Mistakes

### Mistake 1: Treating Subscription Acceptance as a Ministerial Act

Many sponsors treat subscription acceptance as a rubber stamp. If the investor has been through the sales process and expressed commitment, the subscription is accepted without



systematic review. This produces the specific problems that subscription review is designed to catch: an entity investor whose signing authority has not been confirmed, an investor whose accreditation is based on a credential that does not satisfy the chosen exemption's verification standard, a subscription amount below the offering's stated minimum, or a beneficial ownership structure that creates an AML or KYC concern.

A formal subscription review protocol (a checklist that is completed for every investor before the subscription is accepted) adds one to two hours of work per investor and prevents failures that take orders of magnitude more time and expense to remediate after the fact.

### **Mistake 2: Accepting Subscriptions Before Closing Conditions Are Met**

Accepting investor subscriptions before the offering's legal and compliance foundation is complete (before the bad actor questionnaire has been returned by all covered persons, before securities counsel has reviewed and approved the offering documents, before the escrow account is established) creates investor relationships in a legal context that may not support them. A subscription accepted before the bad actor questionnaire reveals a disqualifying event is a subscription accepted for an offering that may not have a valid exemption. The remediation for that problem is far more-expensive than the patience required to complete the checklist before accepting the first subscription.

### **Mistake 3: Missing the Form D Deadline Because of Closing Timeline Confusion**

The Form D 15 day clock starts at subscription acceptance, not at the real estate acquisition closing. Sponsors who think of closing as the real estate closing and track the Form D deadline from that date may miss the actual deadline by weeks. The first subscription acceptance date must be explicitly identified as the Form D trigger, and the 15 day deadline must be calculated from that date and assigned to securities counsel before any subscriptions are accepted.

### **Mistake 4: Not Having a Callback Protocol for Wire Instructions**

Wire fraud targeting real estate transactions is pervasive, sophisticated, and extremely difficult to reverse after the wire has been executed. The callback protocol (a phone call to the investor at a verified phone number to confirm the wire instructions before any wire is sent) is standard practice in institutional real estate transactions for exactly this reason. Sponsors who rely on email alone to deliver wire instructions, without a verification call, are accepting a fraud risk that has produced substantial losses in real estate syndications of every size.

### **Mistake 5: Failing to Coordinate the Closing Statement with PPM Disclosures**



The closing statement for the real estate acquisition allocates every dollar of proceeds at the closing. If any allocation differs from the use of proceeds description in the PPM (a higher acquisition fee, a lower reserve amount, an undisclosed additional cost) the closing statement creates a material inconsistency with the offering documents. Sponsors who sign the closing statement without reviewing it against the PPM have created a disclosure failure at the moment of closing. Securities counsel should confirm consistency between the closing statement and the PPM's use of proceeds disclosure before the closing statement is executed.

### Mistake 6: Treating Post-closing Compliance as a Future Problem

The annual Form D amendment, the state annual renewal filings, the K-1 delivery deadline, the quarterly investor reporting obligation: these obligations begin immediately after closing. Sponsors who treat them as future problems to be dealt with when they arise consistently miss deadlines, receive investor complaints about late K-1s, and accumulate compliance gaps that are embarrassing in subsequent due diligence and increasingly difficult to explain. Building the post-closing compliance calendar at the time of closing (calendarizing every recurring obligation with advance reminders) converts these from future problems into managed tasks. This takes two hours at closing and prevents months of remediation later.

## Post-closing Compliance and Operations Reference

The following table summarizes the post-closing obligations that arise immediately after the equity closing and the parties responsible for each.

| Post-closing Obligation                                              | Responsible Party                | Timing                                                                                                                |
|----------------------------------------------------------------------|----------------------------------|-----------------------------------------------------------------------------------------------------------------------|
| Form D initial filing                                                | Securities counsel               | Within 15 calendar days of first subscription acceptance                                                              |
| State blue sky notice filings (each investor state)                  | Securities counsel               | Varies by state, typically within 15 days of first sale to that state's investor; some states require pre-sale filing |
| Investor confirmation letters and welcome packets                    | Sponsor or investor relations    | Within 1 to 2 weeks of closing                                                                                        |
| Fund administrator capital account setup and investor position entry | Fund administrator               | Before closing; confirmed at closing                                                                                  |
| Escrow release to real estate acquisition closing                    | Escrow agent, fund administrator | Concurrent with real estate closing                                                                                   |
| Annual Form D amendment                                              | Securities counsel               | On anniversary of initial Form D filing, every year the offering remains open                                         |

| Post-closing Obligation                                 | Responsible Party                          | Timing                                                                                               |
|---------------------------------------------------------|--------------------------------------------|------------------------------------------------------------------------------------------------------|
| State annual renewal filings (states that require them) | Securities counsel                         | Per each state's specific annual renewal deadline                                                    |
| Bad actor questionnaire annual update                   | Securities counsel                         | Annually for all covered persons; immediately for any new covered person                             |
| Quarterly investor update delivery                      | Sponsor or fund administrator              | 30 to 45 days after each quarter end, per operating agreement                                        |
| Annual financial statements delivery                    | Fund administrator or CPA                  | 90 days after fiscal year end, per operating agreement                                               |
| K-1 preparation and delivery                            | Tax counsel or CPA with fund administrator | March 15 of year following taxable year (September 15 with extension)                                |
| AML and KYC annual refresh for existing investors       | Sponsor                                    | Annually for multi-year offerings; immediately if sanctions list status changes                      |
| Ongoing state blue sky filings for new investor states  | Securities counsel                         | Within applicable deadline for each new investor state at subsequent closings                        |
| Lender covenant compliance monitoring                   | Sponsor with real estate counsel           | Ongoing; specifically at each investor admission or transfer that could affect ownership percentages |

## Practical Takeaways

- The closing reveals every gap in the preparation that preceded it. The pre-closing checklist (legal readiness, compliance readiness, and operational readiness) is the last systematic opportunity to confirm that every element of the offering's legal and compliance foundation is in place before investor capital is accepted. Run it completely. Confirm every item in writing. Do not close until every box is checked.
- Subscription acceptance is the legal event of first sale. The Form D 15 day clock, the state blue sky filing obligations, and the antifraud provisions all attach at subscription acceptance, not at capital receipt, not at the real estate closing, and not at the date the operating agreement is executed. The first subscription acceptance date must be explicitly identified, and the 15 day Form D deadline must be calculated and assigned to securities counsel before any subscriptions are accepted.
- AML and KYC diligence is required for every investor, regardless of sophistication or prior relationship with the sponsor. For entity investors, the 25% beneficial ownership analysis is the working benchmark, drawn from FinCEN's Customer Due Diligence Rule

(applicable to covered financial institutions, with the February 2026 FIN-2026-R001 exceptive relief modifying repeat verification requirements) and consistent with prior CTA beneficial ownership concepts. U.S. domestic entities and U.S. persons are exempt from CTA BOI reporting following FinCEN's March 21, 2025 interim final rule, but the 25% beneficial ownership identification remains standard sponsor AML and KYC practice.

- Wire instructions must be delivered in writing and confirmed through a callback protocol before any investor wire is sent. Wire fraud targeting real estate transactions is pervasive and difficult to reverse. The callback protocol (a phone call to a verified number to confirm wire instructions) is standard practice and prevents losses that are rarely recoverable.
- Capital deployment should not occur until cleared funds are confirmed by the fund administrator, not merely upon wire receipt. Wire transfers can be recalled before clearing, which typically occurs within one business day of receipt. Clearing confirmation protects against capital deployed against funds that are subsequently recalled.
- The equity closing and the real estate acquisition closing must be explicitly sequenced. The most common approach (collecting investor capital in escrow until the minimum is reached, then releasing simultaneously with the real estate closing) requires coordination between the escrow agent, the fund administrator, and the title company that must be established before any capital is collected. The closing timeline must account for all parties' requirements.
- The closing statement for the real estate acquisition must be consistent with the PPM's use of proceeds disclosure. Any allocation that differs from what the PPM described (a higher acquisition fee, a lower reserve amount, an undisclosed cost) is a disclosure inconsistency that requires resolution before the closing statement is executed. Securities counsel should review the closing statement against the PPM before it is signed.
- State blue sky filing obligations are not eliminated by Regulation D preemption. They are limited to notice filings and fees. The filing system must be active from the moment the first investor in each state subscribes, with each investor's state captured at subscription and the corresponding filing triggered within the applicable deadline. Multi-state offerings closing simultaneously create multiple simultaneous state filing obligations that must be managed in real time, not assembled in a batch at the offering's conclusion.

Investor confirmation letters and welcome packets set the tone for the entire investor relationship. A professional, timely, and organized welcome communication (delivered within two weeks of closing) signals that the investment is being operated by a professional team. The welcome packet should include the investor's confirmed position, portal access, the reporting schedule, and expectations for the immediate post-closing period.

## CHAPTER TWENTY SIX

# Investor Relations and the Investor Communication Program

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The closing of a private real estate syndication is in many ways the easiest part. The offering period is finite. The legal documents are done. The property is acquired. Everyone's attention is focused, the team is coordinated, and the sequence of events is clearly defined. What follows (the years between closing and disposition) is where the real operational discipline of running a private real estate investment actually lives. It is also where sponsors who treated investor relations as a closing period afterthought discover how much work the ongoing part actually involves.

Fund administration obligations that arise after closing are familiar in concept: capital accounts, distribution calculations, quarterly and annual reporting, tax preparation, investor communications. None of these obligations are reduced or eliminated because the closing is complete. What changes is that they are now recurring functions that run continuously throughout the investment's hold period, without the deadline pressure and focused team coordination that characterized the capital raise, and without the motivated investor interest that the pre-closing period generated. Maintaining investor confidence and legal compliance across a three to seven year hold period requires a systematic, professional investor relations program that treats post-closing communication as a core business function, not an administrative residual.

Every investor communication (distribution notices, quarterly reports, annual financial statements, material event disclosures) is a communication made in connection with the ongoing ownership of a security, subject to the antifraud provisions of Section 17(a) of the Securities Act and Rule 10b-5 under the Exchange Act. The investor relations obligations of a private securities issuer do not diminish after the offering closes. They continue throughout the investment's life with the same legal force they carried during the offering period. Sponsors who treat post-closing communications as marketing materials rather than securities communications are misunderstanding both their legal obligations and the consequences of non-compliance.

This chapter covers the investor relations program for a private real estate syndication across its full life: initial investor onboarding communications; quarterly and annual reporting obligations; K-1 delivery requirements; communicating through challenging market conditions; investor portals and the technology infrastructure that supports the communications program; managing

investor inquiries and complaints; and the ongoing administration calendar that keeps every recurring obligation current without relying on memory or crisis response.

## Why Investor Relations Is a Core Business Function

Investor relations is the ongoing management of the relationship between the sponsor and the investment's equity holders: the communication program, reporting infrastructure, and service orientation that determine whether investors remain confident partners or become frustrated, litigious claimants. For most sponsors, this relationship receives significant attention during the capital raise period and substantially less after the closing. That allocation is backwards.

The investors who participated in the current offering are the most likely source of capital for the next offering. A sponsor who builds investor confidence through excellent communication, consistent reporting, and reliable operational execution generates a core investor base that reinvests across multiple fund cycles, refers their networks, and provides the kind of patient capital that supports a sustainable real estate platform. A sponsor who delivers strong returns but poor communication (late K-1s, sparse quarterly updates, difficult to reach investor relations) will find that investment performance alone does not produce the investor loyalty that a platform requires.

The legal case for treating investor relations as a core business function is equally direct. Post-closing investor communications are subject to the antifraud provisions. A quarterly report that omits a material development, a distribution notice that misdescribes the tax characterization of a payment, an annual statement that presents financial performance selectively: each of these is a potential securities violation independent of how the underlying investment performs. The investor relations program that is organized, professional, and accurate is not only better for investors; it is the sponsor's most effective ongoing liability management tool.

Sponsors who build institutional quality investor relations programs from their first offering, not waiting until they are managing sufficient capital to justify the investment, gain a compounding advantage. Each communication that is delivered on time, each K-1 that is accurate and delivered before the September deadline, each quarterly update that addresses both favorable and unfavorable developments honestly, builds the institutional credibility that attracts the next level of investor: the family office that requires professional reporting before committing, the registered investment adviser who will recommend the offering to clients only if investor communications meet their due diligence standard.

## Initial Investor Onboarding Communications

The initial investor onboarding communication (typically delivered within one to two weeks of the equity closing) establishes the sponsor's operational tone for the entire hold period. It is the investor's first experience of what life as an investor in this offering will feel like. A professional, complete, and prompt welcome communication signals that the investment is being operated by a team that takes its obligations seriously. A delayed or disorganized welcome signals the opposite, and investors who form that initial impression are less forgiving of subsequent shortcomings.

### **Welcome Letter and Investor Confirmation**

The initial welcome package should include a confirmation of the investor's membership interest: the amount invested, the date of their investment, their ownership percentage or unit count, and the contact information for investor relations inquiries. This confirmation is both an investor relations communication and a legal document. It creates the written record of the investor's position that may be referenced throughout the hold period and in any subsequent dispute about the investor's entitlement.

The welcome letter should explain what the investor should expect in the near term: when they will receive their first quarterly update, when the first distribution is projected, how to access the investor portal, and who to contact with questions or concerns. Setting these expectations at the outset prevents the investor anxiety that builds when investors have no frame of reference for what is coming and when.

### **Investor Portal Access and Orientation**

If the sponsor uses an investor portal (a secure online platform where investors can access their account information, review offering documents and reports, and track their investment history) the welcome package should include login credentials and a brief orientation to the portal's features. An investor portal that investors never learn to use provides no investor relations benefit regardless of how well it is designed.

The portal orientation should cover the minimum that investors need to function: how to find their capital account statement, how to access quarterly and annual reports, how to view their distribution history, and how to request a document or contact the investor relations team. For platforms with more sophisticated features (property performance dashboards, document signing capabilities, communication tools) additional orientation may be appropriate, but the basic navigation should not require tutorial attendance. If investors cannot access their own account information without a tutorial, the portal is too complex for the value it provides.

### **Distribution Mechanics and Tax Documentation**

The welcome package should explain, in plain language, how distributions will be processed and delivered. Not every investor understands what a K-1 is, why they receive it instead of a 1099, or what they should do with it when it arrives. Investors who are surprised by tax documentation they did not expect, or who receive a K-1 in September and believe they should have received it in February, create avoidable investor relations friction. A brief, plain language explanation of the tax mechanics of LLC membership in the welcome package prevents the majority of tax related investor inquiries.

## Ongoing Reporting Obligations

The operating agreement or LP agreement specifies the investor reporting obligations: what must be delivered, in what format, on what schedule. These contractual obligations are enforceable. A sponsor who fails to deliver the quarterly financial reports required by the operating agreement has breached the operating agreement, giving investors remedies under state contract and LLC law independent of any securities law violation. Building the reporting program around the operating agreement's specifications, not around what is convenient to produce, is the baseline from which the investor relations program operates.

For sponsors approaching the institutional capital market, the relevant benchmark is the ILPA Reporting Template, which the ILPA Model LPA incorporates by reference in Section 15.2. The ILPA Reporting Template specifies the content, format, and timing of quarterly and annual financial reporting, including capital account statements, fee disclosure, debt and subscription line disclosure (with IRR presented both with and without any credit facility), and management fee and carried interest detail. Real estate fund managers whose quarterly reports do not contain the information the ILPA Reporting Template specifies are operating below the institutional reporting standard, and institutional investors will negotiate upgraded reporting obligations through side letters.

### Quarterly Investor Updates: Content and Format

The quarterly investor update is the cornerstone of the post-closing investor relationship. Delivered within 30 to 45 days after each quarter end (the ILPA Model LPA specifies 45 days for institutional funds), it should provide investors with a complete picture of the investment's current state: financial performance, operational developments, and the sponsor's assessment of the investment's trajectory. The quarterly update that is comprehensive, honest, and delivered on schedule builds investor confidence regardless of whether the underlying news is favorable or unfavorable. The quarterly update that is evasive, delayed, or selective in what it discloses builds investor anxiety and legal exposure.

The quarterly update should include the elements described below.

**Property operating performance.** Occupancy rates, rental income collected, operating expenses by category, net operating income, and a comparison to the underwriting projections from the PPM. Investors are entitled to see how the property is performing against the plan they committed to, not just the absolute numbers, but the variance from what was projected and the sponsor's explanation of that variance.

**Capital account summary.** Each investor's beginning capital account balance, income and loss allocations for the quarter, distributions received during the quarter, and ending capital account balance. The capital account is the running record of the investor's economic stake in the entity. Updating it quarterly keeps investors accurately informed of their position and provides the accounting basis for K-1 preparation at year end.

**Distribution summary.** Distributions made during the quarter, with the amount per unit or per percentage interest, the total distributed, and the preliminary tax characterization of each distribution (ordinary income, return of capital, capital gain). Final characterization appears on the K-1. The quarterly report provides preliminary characterization subject to year-end true up. Investors who understand how their distributions are characterized for tax purposes before they receive their K-1 ask fewer questions and file their taxes more accurately.

**Material events.** Any significant developments affecting the property: major lease transactions, debt refinancing, capital improvement expenditures above a defined threshold, insurance events, litigation, changes in property management, or any other development that a reasonable investor would consider important to an ongoing evaluation of the investment. Material events that are disclosed promptly and specifically in the quarterly update protect the sponsor from claims that information was withheld. Material events that are omitted from the quarterly update and discovered by investors from other sources become investor relations crises and potential antifraud violations.

**Outlook and next steps.** The sponsor's current assessment of the investment's trajectory: what is working, what is not, what is being done about the things that are not working, and the expected timeline for planned transactions or significant decisions. The forward looking section of the quarterly update is where the sponsor demonstrates their judgment and credibility as an operator. Investors who receive consistent, realistic, and honest forward looking assessments from a sponsor maintain their confidence through challenges. Investors who receive consistently optimistic assessments that reality does not support grow skeptical of everything the sponsor says.

## Annual Reports and Audited Financial Statements

The annual report is a more comprehensive communication than the quarterly update. It covers the full fiscal year's financial results, provides the audited or reviewed financial statements



required by the operating agreement, and gives the sponsor an opportunity to provide a broader assessment of the investment's progress relative to its multi-year business plan. The annual report should be delivered within 90 days of the fiscal year end for most offering structures, with the specific deadline specified in the operating agreement. This is also the timing the ILPA Model LPA specifies for institutional fund reporting.

The question of whether the annual financial statements must be audited (independently examined by a CPA under generally accepted auditing standards) or may be reviewed (a less comprehensive engagement that provides limited assurance under AICPA review standards) depends on the operating agreement's requirements and the investment's investor composition. Institutional investors and family offices consistently expect audited financials. Individual accredited investors in smaller offerings may accept reviewed statements if the operating agreement permits. The audit question should be resolved in the operating agreement before the offering closes. Sponsors who discover post-closing that their operating agreement requires audited financials have created a cost obligation they did not plan for.

The annual report is also the document that prospective future investors will examine when evaluating the sponsor's track record and reporting quality. An annual report that is well organized, professionally prepared, and consistent with the quarterly updates that preceded it signals institutional quality operations. An annual report that is sparse, inconsistent with prior quarterly reporting, or that presents financial results in ways that are difficult to interpret signals the opposite. Future capital formation is partially determined by the quality of the current investment's annual reporting.

## **K-1 Delivery Timing and Accuracy**

The Schedule K-1 is the annual tax reporting document that every member of a pass through LLC must receive, reporting their allocable share of the entity's income, deductions, gains, losses, and credits for the taxable year. Investors use the K-1 to complete their personal or entity income tax returns. The K-1 must be delivered by March 15 of the year following the taxable year, with an extension available to September 15 if the entity's own tax return is extended.

Late K-1 delivery is one of the most consistent sources of investor complaints in private real estate syndication. Investors who cannot file their personal returns because the K-1 has not arrived, or who file tentative returns and then receive a K-1 with significantly different numbers than they estimated, are justifiably frustrated, and their frustration reflects directly on the sponsor regardless of whether the delay originated with the fund administrator or the tax preparer. Building the K-1 preparation process into the fund administrator's engagement letter, with a specific delivery target that allows the September 15 extended deadline to be met without extraordinary effort, converts K-1 delivery from a chronic problem into a managed obligation.

K-1 accuracy is equally important. An incorrect K-1 (wrong income allocations, incorrect basis information, mischaracterized distributions) creates tax compliance issues for investors that the sponsor is responsible for correcting through amended K-1s. Amended K-1s arrive after investors have already filed their returns, potentially requiring amended personal returns at the investor's expense and significant time burden. The fund administrator's quality control process for K-1 preparation, including a review of each investor's K-1 for consistency with the capital account records and a comparison of aggregate K-1 allocations against the entity's tax return, is the protection against errors that are expensive to correct.

## **Communicating Through Challenging Market Conditions**

The quality of a sponsor's investor communication is never more important, or more tested, than when the investment is underperforming. A rising interest rate environment that increases debt service and compresses exit values, a softening rental market that delays lease up projections, a construction cost overrun that extends the renovation timeline and increases the capital requirement: these are circumstances under which the instinct to minimize or delay disclosure is strongest and the consequences of doing so are most severe.

### **Transparency as a Liability Management Tool**

The legal case for transparency during challenging conditions is direct and often underappreciated. Investors who receive honest, contextualized, and timely communication about adverse developments, even significant ones, and who are told what the sponsor is doing in response are in a fundamentally different legal position than investors who discover problems from sources other than the sponsor, or who receive inadequate communication during a period of deteriorating performance and then a sudden adverse disclosure. The former investors may be unhappy. The latter investors are the source of rescission claims, regulatory complaints, and litigation.

The antifraud provisions apply to omissions as well as affirmative misstatements. A quarterly report that omits a material adverse development (a lender default notice, a major tenant's notice of non-renewal, a casualty event whose insurance recovery is uncertain) is not merely an incomplete communication. It is a potential violation of Rule 10b-5's prohibition on misleading omissions in connection with the purchase or sale of a security. Investors who make decisions about their investment (whether to sell their interest in a secondary transaction, whether to participate in an additional capital call, whether to support a proposed refinancing) based on quarterly reports that omit material adverse information have not received the disclosure the securities laws require.

The practical standard that serves both legal compliance and investor relations: disclose material adverse developments promptly, before the next scheduled quarterly report, and

through a material event notice rather than waiting for the next regular communication, with specific description of what happened, why it happened, and what the sponsor is doing about it. Investors who receive this kind of communication trust the sponsor more after the adverse event than before it, because they have evidence that the sponsor is honest when honesty is uncomfortable.

## Communicating Bad News Effectively

Bad news communications have specific qualities that determine whether they maintain or damage investor confidence. The qualities of an effective adverse communication are described below.

**Promptness.** Adverse information reaches investors from the sponsor before they discover it from other sources. A major tenant's bankruptcy filing is public record the day it is filed. An investor who reads about it in a news alert before the sponsor has communicated is not a confident investor. They are an investor who has evidence that the sponsor is not keeping them informed. Material adverse events should generate a sponsor communication within 24 to 48 hours of the event, not at the next quarterly report.

**Specificity.** The communication describes what happened with enough specificity that the investor understands the nature of the event. 'We are-experiencing some challenges with the leasing environment' is not a communication. It is an evasion. 'Our primary anchor tenant notified us on October 15 that it will not renew its lease expiring December 31, representing \$340,000 of annual base rent' is a communication. Investors who receive specific information can evaluate its significance and ask intelligent follow up questions. Investors who receive vague characterizations assume the worst.

**Context.** The communication explains why the event occurred (market factors, execution issues, or circumstances outside the sponsor's control) with enough honesty that investors can distinguish between challenges that reflect poor judgment and challenges that reflect the inherent uncertainty of real estate investment. A sponsor who always explains problems as resulting from external factors without acknowledging where their own decisions contributed produces skeptical investors. A sponsor who acknowledges their own role in the outcome while explaining the external factors produces investors who, appropriately, give credit for the honesty.

**Response.** The communication describes specifically what the sponsor is doing in response to the adverse development. Not 'we are working to address the situation' but 'we have engaged [specific leasing broker] and identified two replacement tenant prospects with letters of intent expected by [specific date].' Investors want to know what the team is doing, not just that the

team is aware of the problem. And they will remember what the response communication promised and evaluate subsequent communications against that promise.

**Realism about outcome.** If the adverse development has meaningfully impaired the investment's expected return, that reality should be acknowledged with a revised projection rather than maintained optimism that will eventually be contradicted by the actual outcome. Investors who have received consistently optimistic communications that reality has not supported are not sympathetic audiences when the final return is disclosed. Investors who received honest revised projections as the challenges emerged have had time to adjust their expectations and are less likely to experience the outcome as a betrayal.

### **⚠ Quarterly Reports Are Securities Communications, Not Progress Reports Written for Optimistic Consumption**

*The antifraud provisions of Section 17(a) and Rule 10b-5 apply to every quarterly investor update, annual report, distribution notice, and material event communication issued by a private real estate sponsor. A quarterly report that presents financial performance selectively (highlighting favorable metrics while omitting unfavorable ones, characterizing a developing problem as a minor concern when the sponsor knows it is significant, or omitting a material development to avoid an uncomfortable conversation) has crossed from spin into potential securities fraud territory.*

*The SEC's fiscal year 2025 enforcement results, published in April 2026, identify alleged misrepresentations and omissions about risks, use of proceeds, and conflicts as one of the principal recurring themes in actions against investment advisers, with the agency signaling that this remains a concentrated area of enforcement focus going forward. Recent cases such as the September 2025 settled action against an investment adviser for misleading investor communications in connection with an LP interest buyback proposal confirm that the SEC continues to bring enforcement actions against private fund sponsors based on misleading investor reports and material omissions from periodic updates. FINRA's 2026 Annual Regulatory Oversight Report similarly identifies private placements as a perennial focus area and flags selective performance presentations as a recurring compliance deficiency.*

*The fact that a communication was directed to existing investors rather than to the public does not reduce its legal significance. Build the quarterly report to the standard you would apply to a document you expected the SEC to read.*

## **Investor Portals and Technology**

Investor portals (secure online platforms that provide investors with access to their account information, offering documents, reports, and communication tools) have become the standard delivery mechanism for investor relations in private real estate syndications of meaningful scale. A well designed investor portal serves both the investor and the sponsor: investors receive immediate, self-service access to information that previously required a call to investor relations; sponsors have a documented, centralized record of every communication delivered and every document accessed, which is valuable in compliance documentation and in any subsequent dispute about what was communicated and when.

## Document Delivery and Investor Access

The investor portal should serve as the single source of truth for each investor's relationship with the offering, containing the complete record of the investor's account from subscription through current period. The core document and information categories that every investor portal should include are described below.

- Offering documents: the PPM, operating agreement, subscription agreement, and any amendments or side letters applicable to the investor's specific position. Investors who need to reference their operating agreement terms (a distribution waterfall dispute, a question about voting rights) should not need to search their email for the document they received at closing two years ago.
- Capital account statements: current and historical statements showing the investor's capital contributions, income and loss allocations, distributions received, and ending balance at each period end. The capital account statement is the investor's running financial record of their position. It should be available for every period since the investment closed.
- Quarterly and annual reports: the complete archive of all investor reports delivered since closing. Historical reports are frequently requested by investors who want to track the investment's trajectory or by their advisers who are conducting their own analysis. An easily searchable archive eliminates the friction of historical report requests.
- Distribution records: a detailed history of every distribution made to the investor, including the date, amount, per unit rate, and the characterization of the distribution for tax purposes. Investors who use the distribution history in their tax preparation or for their own financial planning require accuracy and accessibility.
- K-1 archive: current and prior year K-1s for the investor's position. K-1s are the most frequently requested tax documents from prior years. Investors who lose their K-1s, whose accountants request prior years for audit support, or who are selling their interest and need to calculate their adjusted basis request prior K-1s regularly. An accessible archive eliminates this as an investor relations burden.

- **Communication record:** a log of all communications sent to the investor through the portal, including quarterly update notifications, distribution notices, and material event disclosures, with the date and the recipient's acknowledgment if the portal captures it. The communication log is compliance documentation for the sponsor: evidence that specific information was delivered to specific investors on specific dates.

## Distribution Processing and Reporting

The mechanics of distribution processing (calculating each investor's distribution share, characterizing the distribution for tax purposes, obtaining authorization, executing payment, and delivering the distribution notice) are fund administration functions that benefit significantly from integration with the investor portal. The distribution notice that investors receive through the portal should document the total distribution amount, the per unit distribution rate, the investor's specific distribution amount based on their current interest, the tax characterization of the distribution, the date of payment, and the payment method used.

Distribution characterization (allocating the distribution among ordinary income, return of capital, capital gain, and other categories) requires coordination between the fund administrator and the tax preparer. The characterization used in the distribution notice should reflect the fund administrator's preliminary determination, clearly labeled as preliminary and subject to year-end true up on the K-1. Investors who receive a distribution notice characterizing a payment as ordinary income when the K-1 subsequently characterizes it differently will have questions, and those questions are better answered in advance by labeling the distribution notice characterization as preliminary.

The investor portal's distribution reporting should allow investors to see their complete distribution history at a glance: the running record of what they have received, when they received it, and how it was characterized. This self-service access to distribution history significantly reduces the volume of distribution related investor inquiries. It also provides the investor with the information they need to confirm that what they received is consistent with what the operating agreement's waterfall required, which is appropriate transparency for a securities investment.

## Managing Investor Inquiries and Complaints

Investor inquiries and complaints are a normal and expected part of managing a private real estate investment through a multi-year hold period. The investment will encounter unexpected challenges. The K-1 will arrive later than an investor expected. A distribution will be smaller than the investor calculated. A quarterly report will contain news the investor finds unwelcome. How the sponsor responds to these situations, promptly and substantively or slowly and evasively, is

one of the most consequential determinants of investor satisfaction and retention across multiple fund cycles.

## **Inquiry Response Standards**

Investor inquiries should receive a substantive response within 48 hours. Not a generic acknowledgment ('we received your question and will respond as soon as possible') but a substantive response that actually addresses the question. Investors who contact investor relations and receive an acknowledgment followed by silence for a week are not satisfied investors. They are investors who are recalibrating their trust in the sponsor's operational competence.

The specific mechanics of the inquiry response system should include a designated investor relations contact (or a small team for larger platforms) with defined response time standards; a protocol for escalating complex inquiries to the appropriate specialist (the fund administrator for accounting questions, securities counsel for regulatory questions); and a logging system that records each inquiry, the date received, the date responded, and the substance of the response. The log serves both operational management (identifying patterns in investor concerns that may signal broader issues) and compliance documentation (demonstrating that investor communications were handled promptly and specifically).

## **Handling Complaints**

Investor complaints (communications expressing dissatisfaction with an aspect of the investment, the communications, or the sponsor's conduct) require a different response framework than routine inquiries. The response to a complaint has both a service dimension and a legal dimension that must be managed simultaneously.

The service dimension: acknowledge the investor's concern specifically, explain the relevant facts as the sponsor understands them, and describe what the sponsor is doing in response. An investor who complains that a distribution was smaller than they calculated, and receives a response that specifically explains the waterfall calculation and the factors that produced the distribution amount, is a satisfied investor even if the distribution amount does not change. An investor who receives a form letter is not.

The legal dimension: complaints about investment performance, about disclosures, or about the sponsor's conduct in managing the investment are potential claims that may eventually reach securities counsel or a regulatory body. The communication records that document how the complaint was received and handled are the evidentiary record of the sponsor's response. Written responses should be accurate and complete, should not make concessions that are legally inadvisable, and should avoid language that could be read as admitting liability for anything that has not been carefully evaluated. When a complaint has potential securities law



dimensions (claims that the investor was misled, that the PPM contained material omissions, or that the sponsor breached their fiduciary obligations) securities counsel should be consulted before any substantive written response is issued.

## When to Escalate to Counsel

Not every investor complaint requires securities counsel's involvement. A complaint about a late K-1 or a delayed distribution notice is a service issue that the sponsor can address directly. But certain types of investor communications should be escalated to securities counsel before any substantive response is provided.

- Any communication that expressly threatens legal action or asserts that the investor has been defrauded or that the offering documents were misleading.
- Any communication from an attorney purporting to represent an investor in connection with a claim against the offering or the sponsor.
- Any communication from a state securities regulator or the SEC in connection with the offering or the sponsor's conduct.
- Any communication in which the investor requests documentation in a manner that suggests they are building an evidentiary record (requests for all communications, all financial statements, all subscription documents) rather than seeking to understand a specific aspect of the investment.
- Any complaint that appears to involve other investors or that suggests coordinated investor action.

These communications are potential enforcement or litigation triggers that require experienced securities counsel's involvement from the first response. The cost of counsel's involvement at this stage is modest compared to the cost of a poorly handled initial response that concedes points, provides documentation in an uncontrolled manner, or fails to assert applicable defenses.

## The Ongoing Administration Calendar

The investor relations and compliance obligations that run throughout a private real estate syndication's hold period are predictable, recurring, and manageable, provided they are organized in a systematic calendar that assigns responsibility, sets advance reminders, and tracks completion. Sponsors who manage these obligations reactively, responding when deadlines arrive rather than planning in advance, consistently miss deadlines, produce late deliverables, and generate compliance gaps that are embarrassing and expensive to remediate.



### **Ongoing Administration Calendar: Monthly Obligations**

- AML and KYC monitoring review: confirm ongoing sanctions screening program for all investors is current and no new OFAC hits have been flagged.
- Investor portal functionality check: confirm portal is displaying accurate account information, current report availability, and distribution history.
- Fund administrator reconciliation: confirm capital account records match subscription records and any secondary transfer activity is properly reflected.
- Review any investor inquiries received during the month and confirm all have received substantive responses within the 48 hour standard.

### **Ongoing Administration Calendar: Quarterly Obligations**

- Quarterly investor report preparation: property operating performance, capital account summary, distribution summary, material events, and outlook. Delivery within 30 to 45 days after quarter end per operating agreement (45 days under the ILPA Model LPA standard for institutional funds).
- Distribution processing: fund administrator waterfall calculation, tax characterization determination, distribution authorization, payment execution, and distribution notice delivery to all investors.
- Investor credential and accreditation status review (506(c) offerings): confirm all investor accreditation verifications remain current; initiate renewal for any approaching expiration.
- Review operating agreement compliance calendar for upcoming obligations.
- Property level review: occupancy, rental collections, operating expenses, capital expenditure status, and debt service coverage versus underwriting.

### **Ongoing Administration Calendar: Annual Obligations**

- Annual investor report: comprehensive fiscal year financial results, audited or reviewed financial statements, business plan progress assessment. Delivery within 90 days after fiscal year end per operating agreement.
- K-1 preparation and delivery: March 15 of year following taxable year (September 15 with extension). Fund administrator quality control review required before distribution to investors.
- Annual Form D amendment: filed on anniversary of initial filing, for every year the offering remains open.

- State blue sky annual renewals: for each state that requires annual renewal of the Regulation D notice filing.
- Bad actor questionnaire: distribute to all covered persons annually; review responses; confirm no new triggering events.
- Fund administrator engagement review: confirm service standards are being met; address any performance issues; confirm fee schedule for coming year.
- Investor accreditation renewal program (506(c) offerings): update accreditation verification for each investor approaching the five year mark from original verification, or when 506(c) subsequent closings occur.
- Insurance review: confirm all property and liability insurance policies are current and coverage levels remain appropriate for the investment.

### **Ongoing Administration Calendar: Event Triggered Obligations**

- Material event notice: distribute to all investors within 24 to 48 hours of any significant development affecting the investment (tenant vacancy, casualty event, lender communication, litigation, management change).
- OFAC hit response: if sanctions screening identifies an investor match, immediately freeze the investor's distributions and notify securities counsel for guidance on remediation.
- State blue sky post sale filings: triggered by any secondary transfer of investor interests to a buyer in a new state not previously filed.
- Investor complaint escalation: any complaint with securities law dimensions (misrepresentation claims, PPM omission claims, fiduciary duty allegations) or any attorney communication regarding the offering must be escalated to securities counsel before response.
- Investor status change: when an investor loses accredited status, experiences a significant change in circumstances (death, divorce, bankruptcy), or transfers their interest through a secondary transaction, update investor records and notify fund administrator.
- Capital call (fund structures): issue capital call notice per operating agreement requirements; confirm funding within the specified period; document defaulting investor consequences if applicable.
- Refinancing or major disposition: notify investors in advance of the transaction; provide disclosure consistent with operating agreement major decision provisions; confirm investor consent if required.

## Practical Takeaways

- Investor relations is a core business function, not a closing period administrative residual. The investors who participated in the current offering are the most likely source of capital for the next offering, and the institutional quality of the investor communications program is one of the primary determinants of investor retention across multiple fund cycles.
- Every investor communication (quarterly reports, annual statements, distribution notices, material event disclosures) is a communication made in connection with the ownership of a security, subject to the antifraud provisions of Section 17(a) and Rule 10b-5. The reporting obligations of a private securities issuer continue throughout the investment's life with the same legal force they carried during the offering period. The SEC's fiscal year 2025 enforcement results, published in April 2026, confirm that misrepresentations and omissions in adviser communications remain a concentrated focus of enforcement activity.
- The initial investor onboarding communication sets the operational tone for the entire hold period. A professional, complete, and prompt welcome package (delivered within one to two weeks of closing, with portal access, confirmed investment position, and clear expectations for what follows) signals that the investment is being managed by a team that takes its obligations seriously.
- Quarterly updates must cover property operating performance against underwriting projections, capital account summaries, distribution summaries with preliminary tax characterization, material events, and an honest forward looking assessment. The quarterly update that is comprehensive and delivered on schedule builds investor confidence regardless of whether the news is favorable. The quarterly update that is selective, delayed, or evasive creates the conditions for investor claims. The ILPA Reporting Template, incorporated into Section 15.2 of the ILPA Model LPA, is the institutional benchmark for quarterly and annual reporting content.
- K-1 accuracy and timely delivery (by September 15 with extension) are among the most consequential investor relations obligations in the fund administration program. Late K-1s generate investor complaints. Inaccurate K-1s generate amended returns, potential regulatory issues, and investor distrust. The K-1 preparation process should be built into the fund administrator's engagement letter as a defined deliverable with a contractual deadline.
- Transparency during challenging market conditions is both a legal obligation and a relationship preservation strategy. Material adverse developments must be disclosed promptly and specifically, before the next scheduled quarterly report, not at it. Investors who receive honest communications about problems are significantly less litigious than

investors who discover problems from other sources. Evasion produces the worst outcomes.

- The investor portal is the operational infrastructure of the investor relations program: the single source of truth for each investor's account information, document access, reporting history, and communication record. A portal that investors can use independently reduces the volume of routine inquiries the investor relations team must handle and provides the compliance documentation record of what was communicated and when.
- Investor complaints with securities law dimensions (claims of misrepresentation, PPM omissions, fiduciary duty violations, or any communication from an attorney representing an investor) must be escalated to securities counsel before any substantive response is issued. The cost of counsel's involvement at the complaint stage is a fraction of the cost of a poorly handled initial response.

**CHAPTER TWENTY SEVEN**

# Asset Management and Fund Operations

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Closing the investment is the beginning, not the conclusion. The real estate acquisition is complete, investor capital is deployed, and the legal structure is in place. But the investment's actual outcome is determined entirely by what happens between the closing date and the eventual disposition. Every dollar of value created or destroyed during the hold period flows from decisions made, or neglected, in the ongoing management of the asset and the fund. Asset management is where the investment thesis is either proven or disproven against the reality of an operating property in a real market.

The gap between a good deal and a good investment is almost always an execution gap. A property acquired at a fair price with a credible value add thesis can underperform badly if the renovation is mismanaged, the leasing strategy is wrong, the property management oversight is inadequate, or the financial monitoring reveals problems too late to do anything about them. The reverse is equally true: a property in a moderately attractive market, acquired at reasonable terms, can significantly outperform underwriting when asset management is disciplined and responsive. The investment return is not sealed at closing. It is earned during the hold period through hundreds of operational decisions.

For sponsors managing investor capital, asset management carries legal and fiduciary dimensions that pure property owners do not face in the same way. The operating agreement defines the business plan the sponsor committed to implementing, not merely as a description of intent, but as the documented framework against which investors will evaluate whether their capital was managed appropriately. Material deviations from the business plan, undisclosed cost overruns, failure to monitor property performance against underwriting, and decisions that cross the boundary of the manager's discretionary authority without obtaining the required investor or lender consent are not only operational failures. They are potential disclosure failures and fiduciary breaches with legal consequences.

This chapter covers the full scope of asset management for a private real estate syndication or fund: the asset manager's role in implementing and monitoring the business plan; the decision between in house and third party property management and how to structure that relationship for accountability; construction and renovation oversight; leasing strategy and occupancy management; the financial monitoring infrastructure that keeps the sponsor informed and investors protected; and the portfolio level management considerations that apply to fund sponsors running multiple assets simultaneously.

## The Asset Manager's Role

The asset manager is the person or team responsible for overseeing the investment's performance from closing through disposition. In most private real estate syndications, the asset management function is performed by the sponsor or a principal of the sponsor entity: the same person who underwrote the deal, structured the offering, and raised the capital. In larger fund platforms, a dedicated asset management team handles portfolio oversight while a separate acquisitions team sources new deals. Regardless of the organizational structure, the asset management function encompasses three core responsibilities: implementing the business plan the investors funded, monitoring performance against the underwriting assumptions on which that plan was based, and making the operational and capital decisions that maximize value across the hold period.

### Implementing the Business Plan

The business plan disclosed in the PPM is more than a financial projection. It is the documented investment strategy investors evaluated when committing capital. The renovations to be completed, the rental rate improvements to be achieved, the expense reductions to be implemented, the debt terms to be restructured, the leasing velocity to be achieved: these are the specific operational commitments that investors agreed to fund. The asset manager's first obligation is to translate these strategic commitments into an operational plan with specific initiatives, timelines, responsible parties, and measurable milestones.

A value add business plan that projects a 15% increase in effective gross income over 24 months needs to be decomposed into concrete actions: renovate a defined number of units per month beginning on a specific date; achieve a defined rent premium per renovated unit on new leases and renewals; implement specific expense reductions in defined categories by a defined date; bring identified vacant spaces to lease up within a defined timeframe. Without this decomposition, the business plan is a projection rather than an operational guide, and deviations from it will be discovered only when the quarterly financial report reveals that the numbers are not where they should be.

When the business plan cannot be implemented as designed, because construction costs are materially higher than budgeted, the rental market has shifted since underwriting, the anticipated tenant demand has not materialized, or a key assumption was incorrect, the asset manager faces the first major decision point in the investment's life. The options are: attempt to execute the business plan with adjustments that do not require investor notification; modify the business plan in ways that preserve investor returns while acknowledging the variance from the original strategy; or escalate the decision to investors when the operating agreement requires their consent for material strategy changes. Each path has different legal and investor relations implications, and the right choice depends on the severity of the variance, the governance

provisions in the operating agreement, and the disclosure standard the antifraud provisions impose.

## Monitoring Property Performance Versus Underwriting

The most valuable discipline in real estate asset management is systematic, regular comparison of actual property performance against the underwriting assumptions. This comparison, conducted monthly at minimum, reveals developing trends before they become entrenched problems. Occupancy tracking 500 basis points below projection in Month 3 is a leasing problem that a strategy adjustment can address. Occupancy 1,200 basis points below projection in Month 14, having gone unaddressed because the comparison was not being run, is a potential debt service problem that threatens the investment's ability to meet its loan covenants and generate the projected return.

The key performance indicators that every real estate asset manager must track monthly against the underwriting are described below.

**Net Operating Income (NOI).** The property's total revenue minus all operating expenses, before debt service and capital expenditures. NOI is the fundamental measure of a property's economic productivity and the primary driver of its value under capitalization analysis. NOI below budget signals either revenue underperformance, expense overruns, or both, each requiring a different operational response. For commercial properties, NOI growth of 5% or more annually is generally considered a positive performance signal. Flat or declining NOI demands investigation.

**Effective gross income and occupancy.** Occupancy is the most visible indicator of leasing health. For urban multifamily properties in strong markets, occupancy targets typically run 94% to 96%. For retail and industrial, 90% or higher is the standard benchmark. For office, the range is wider and increasingly market dependent. But occupancy must be evaluated alongside effective rent. A property achieving 95% physical occupancy by offering aggressive concessions may have lower economic occupancy than one at 92% with full contract rents being collected. Both physical and economic occupancy must be tracked separately.

**Average effective rent.** The rent actually being collected per unit or per square foot, net of all concessions. The underwriting assumed a specific in place rent trajectory over the hold period. Tracking actual effective rent against that trajectory reveals whether the leasing strategy is achieving the rate assumptions the investment requires. For value add programs, tracking the premium achieved on renovated units is a critical sub metric that reveals whether the renovation investment is generating the projected return.

**Operating expense ratio.** Operating expenses as a percentage of effective gross income. A property whose expense ratio is expanding, because utility costs, insurance, property taxes, or

maintenance are rising faster than revenue, will experience NOI compression even if top line revenue is on target. An expense ratio tracking consistently above the underwriting assumption signals that either the budget was understated at acquisition or that operational controls are insufficient.

**Debt Service Coverage Ratio (DSCR).** NOI is divided by total annual debt service. Most commercial real estate loans require the DSCR to remain above a covenant threshold, typically 1.20x to 1.35x for stabilized assets. A DSCR trending toward the covenant minimum is a lender level event that requires immediate attention and proactive outreach to the lender, not reactive response after a formal default notice.

**Capital expenditure tracking.** The status of capital improvement programs against the approved budget and schedule. Capital expenditures over budget affect cash position. Those behind schedule delay the rent premium achievement that the business plan depends on. Both dimensions must be tracked.

## Capital Expenditure Oversight

Capital expenditure decisions (the planned renovation program and the unplanned maintenance and repair items that arise during the hold) are among the most consequential operational decisions the asset manager makes. Approved capital expenditures that are poorly planned, inadequately supervised, or loosely documented produce cost overruns, timeline delays, and returns below the projections investors relied upon. Deferred maintenance that is not addressed promptly produces larger future costs and tenant retention failures that compound the original problem.

Effective capital expenditure oversight requires reviewing and approving capital budgets before work is authorized; establishing approval thresholds above which a sponsor principal (and in some cases investors, depending on the operating agreement's major decision provisions) must sign off on individual expenditures; reviewing monthly draw requests from contractors; confirming that expenditures are being made on the approved scope rather than on unauthorized additions; and tracking cumulative expenditures against the approved budget with enough frequency to identify overruns at a point when they can still be managed. A sponsor who discovers a 30% cost overrun at project completion rather than at 50% completion has lost the opportunity to make scope decisions that might have contained the damage.

For value add programs where capital expenditures are central to the investment thesis, the capital expenditure oversight function operates more like construction management than routine property oversight. Whether the sponsor engages a third party construction manager or self manages the renovation program, the oversight infrastructure must be capable of identifying problems before they compound. Change orders that are caught at authorization rather than at



project completion are manageable. Those discovered only when the contractor submits a final invoice are not.

## Property Management: In House Versus Third Party

Property management (the day to day operational management of the physical asset, including tenant relations, rent collection, maintenance coordination, vendor management, financial reporting, and lease administration) is the operational foundation on which the asset management plan is executed. A well managed property retains tenants, maintains its physical condition, collects rents efficiently, and provides the operational stability that allows the investment's financial plan to proceed. A poorly managed property loses tenants, allows maintenance costs to compound, accumulates delinquency that erodes effective income, and generates operational crises that consume the sponsor's attention at the expense of strategic decisions.

### When to Self-Manage Versus Hire Third Party Management

The threshold decision sponsors face on every acquisition is whether to manage the property through their own platform or engage a third party management company. The answer turns on three practical questions: Does the sponsor have the personnel, systems, and vendor relationships to manage this property type effectively? Is the sponsor's team in the same geographic market as the property? And can the sponsor's team provide the property with adequate management attention given all other demands on their time?

In house management makes the strongest case when the sponsor has an established property management platform with experienced personnel and systems in the specific market and asset type. Sponsors with 300 or more units under management in a concentrated geography (who have built the leasing infrastructure, maintenance response protocols, vendor networks, and financial reporting systems that effective management requires) can generally deliver superior management at lower cost than a third party manager, because the fixed cost of the platform is spread across a larger base. The margin on in house management at scale is real and meaningful.

Third party management makes the strongest case when the sponsor is geographically or operationally unable to provide the attention effective management requires. A sponsor acquiring a property 150 miles from their home office, where they have no management infrastructure, no local vendor relationships, and no ability to respond promptly to maintenance emergencies, is not positioned to self-manage effectively regardless of their capabilities in other respects. The physical presence, local market knowledge, and established subcontractor relationships that property management requires cannot be provided from a distance.

There is also a legal consideration that sponsors frequently overlook when evaluating self-management: the affiliated fee disclosure and conflict of interest implications of charging the fund a management fee for services provided by an entity related to the sponsor. Property management fees paid to a sponsor affiliated entity are a form of compensation that must be specifically disclosed in the PPM, are subject to whatever fee offset provisions the operating agreement contains, and may draw scrutiny from institutional investors as a potential conflict of interest. The SEC has emphasized in numerous enforcement actions that inadequate disclosure of affiliated fee arrangements constitutes a violation of the antifraud provisions of the securities laws. The economics of self-management must be evaluated against these disclosure and alignment considerations, not only against the comparison to the third party manager's fee rate.

### Property Management Agreement Key Terms

When engaging a third party property manager, the property management agreement is the legal framework that defines the scope of services, the compensation structure, the performance standards, and the conditions under which the sponsor can exit the relationship. Sponsors who sign the property manager's standard form agreement without negotiating key provisions are accepting terms written to protect the manager's interests, not the property owners. The property management agreement deserves the same scrutiny as any other significant contract the sponsor enters on behalf of the investment.

The provisions described below require specific attention in every property management agreement.

**Scope of services.** A detailed specification of what the property manager is responsible for (tenant marketing and leasing, rent collection and delinquency management, maintenance coordination and emergency response, vendor management and competitive bidding, financial reporting, lease renewals, and regulatory compliance) and what remains the sponsor's direct responsibility. Ambiguity about scope creates the gaps that tenants' needs fall into and that disputes between sponsor and manager exploit.

**Management fee.** The fee structure (typically 4% to 10% of collected rents for residential properties, 3% to 6% for commercial) must define what 'collected rents' means precisely: gross scheduled rents, actual collected rents, or effective rents after concessions. A management fee calculated on scheduled rents that the manager is not actually collecting creates misaligned incentives. The fee should be tied to collected economic rents to align the manager's financial interest with effective collections.

**Leasing fees.** The separate compensation for new lease execution and lease renewal (typically expressed as a percentage of the first year's base rent, often 50% to 100% for new leases and 25% to 50% for renewals, or as a flat per unit fee) must be specified clearly. Leasing fee

structures that reward new lease transactions more generously than renewals create incentives to allow existing tenants to vacate rather than renewing, which is the opposite of what most investment strategies require.

**Maintenance expenditure authority.** The dollar threshold below which the manager can authorize maintenance without prior sponsor approval (typically \$500 to \$2,500 per incident, depending on property size and type) and the emergency exception that allows larger expenditures when tenant safety or property preservation is at immediate risk. The threshold should be calibrated to the property's scale: too low, and every routine repair requires sponsor attention. Too high, and significant expenditures occur without oversight.

**Reporting obligations.** The specific reports the manager will deliver, on what schedule, in what format, and the deadline for each. Monthly financial packages (including income statement, rent roll, accounts receivable aging, and operating account reconciliation) should be delivered within a defined number of days after each month end. Quarterly operating summaries and an annual budget should be included. The consequences of reporting failures should be specified.

**Termination provisions.** The conditions under which the sponsor can terminate the agreement (both for cause and without cause) and the notice period, compensation during the notice period, and transition obligations. This is the single most important provision to negotiate. An agreement terminable only for cause, with a narrow definition of cause, or one that imposes punitive termination fees, leaves the sponsor locked into an underperforming relationship that is difficult and expensive to exit.

## Monitoring Third Party Property Managers

Engaging a professional property manager does not transfer the asset management oversight obligation. The sponsor remains accountable to investors for the property's performance regardless of who is managing it day to day. Monitoring the third party manager's performance is an ongoing asset management function that requires the same systematic discipline as monitoring the property's financial results.

The monitoring program for a third party property manager should include monthly review of the full financial package; quarterly site visits to evaluate the physical condition of the property and the management team's operational engagement; regular tracking of leasing metrics including days on market for vacant units, application conversion rates, and lease renewal rates; review of maintenance response times against the standards in the management agreement; and annual performance reviews comparing actual management performance against the benchmarks the agreement establishes.

### **⚠ The Property Management Agreement's Termination Provision Determines How Quickly You Can Fix a Management Problem**

*A property management relationship that is underperforming (persistent delinquency, consistently late reporting, maintenance response times that are generating tenant complaints, or leasing performance that cannot fill vacancies on a reasonable timeline) must be replaceable within a timeframe that limits its damage to the investment.*

*Before signing any property management agreement, confirm the right to terminate without cause on no more than 30 to 60 days' written notice, with reasonable transition assistance obligations from the departing manager. Agreements that permit termination only for cause, which define cause narrowly, or that entitle the manager to continued compensation through the end of a multi-year term regardless of termination are agreements that protect the manager at the sponsor's expense.*

*The moment of contract signing is the best and often the only moment to establish these terms. Negotiating favorable termination provisions before engagement is a fraction of the cost of being locked into an underperforming management relationship after a problem has developed.*

## **Construction and Renovation Oversight**

For value add investments where capital improvements are central to the business plan, construction and renovation oversight is the most consequential operational function during the early hold period. The renovation program's budget, timeline, and quality determine whether the property achieves the rent premiums the underwriting projected, and whether those premiums are realized on the schedule the pro forma assumed. Construction cost overruns and timeline delays are the most common cause of value add returns falling below projection, and they are also among the most preventable causes when a systematic oversight process is in place.

### **Construction Management Agreements**

When the renovation scope requires professional construction management (either because the sponsor lacks in-house construction expertise or because the scope and complexity of the work demands it) the construction management agreement is the legal framework for that relationship. The construction manager coordinates subcontractors, manages the construction schedule, reviews and certifies subcontractor invoices, and is responsible for delivering the completed project within budget and on schedule.

The construction management agreement should specify the exact scope of the construction manager's authority and responsibility; the compensation structure (a percentage of construction cost is common, ranging from approximately 3% to 5% for institutional commercial real estate work where the construction management function is provided by a property manager or sponsor affiliate, with broader market ranges of 5% to 15% applying to smaller residential renovations and stand-alone construction management engagements depending on scope complexity, with lower percentages for larger projects); the standard of care to which the construction manager is held; the approval process for subcontractor selection; the change order authorization and documentation requirements; the draw request preparation and certification obligations; the schedule maintenance and delay notification requirements; and the termination provisions if the project is materially behind schedule or over budget.

When the construction management function is performed by a sponsor affiliated entity, the construction management fee is an affiliated fee that must be disclosed in the PPM and that is subject to the fee offset and conflict of interest considerations described in the affiliated fee discussion earlier in this handbook. The market has trended toward the lower end of the percentage range for institutional capital, with some institutional investors requiring that the construction management fee be offset against the management fee or eliminated entirely on the theory that overseeing capital projects is part of the asset management function the management fee already compensates.

For sponsors self-managing renovation programs without a formal construction manager (particularly those running multifamily value add programs with their own crews) the absence of a construction management agreement does not eliminate the oversight functions that a construction manager would otherwise provide. Someone must maintain the subcontractor schedule, review completed work against the scope before approving payment, manage the draw request process, and escalate problems before they compound. Whether that function is performed by the sponsor's own personnel or a third party, the function must exist and be documented.

## **Budget Management and Change Order Control**

The construction budget approved at the time of acquisition is the baseline against which cost management is measured throughout the renovation program. Construction budgets that omit adequate contingency (the industry standard is 10% to 15% of hard construction costs for renovation programs, higher for gut renovations or properties with unknown conditions) produce overruns when the unexpected conditions that virtually always exist in renovation work are encountered. Sponsors who present renovation budgets to investors without meaningful contingency are either understating the program's true cost or accepting the risk of returning to investors for additional capital when the unanticipated costs appear.

Change orders (formal modifications to the original scope of work that affect the contract price, the schedule, or both) are the primary mechanism through which construction costs escalate beyond the approved budget. Effective change order discipline is not about refusing all scope changes. Construction programs inevitably encounter conditions that require modifications to the original plan. The discipline is ensuring that every change is authorized in writing before work begins, priced at competitive rates before authorization, documented with a specific justification, and tracked against the contingency budget in real time. Change orders accepted verbally, priced after the work is performed, and documented only when the invoice is submitted are the source of the construction cost surprises that sponsors attribute to unforeseen conditions but that are actually the result of process failure.

The change order approval process should define clearly who has authority to approve changes below a defined dollar threshold (typically the construction manager or the sponsor's project coordinator); who must approve changes above that threshold (a sponsor principal); what documentation must accompany a change order request (scope description, cost breakdown, schedule impact, and the reason the original scope cannot be maintained); and how approved changes are incorporated into the revised budget baseline and communicated to investors if they are material.

### **Draw Request Process and Lender Coordination**

Most commercial renovation programs are financed with a construction or renovation loan that funds in installments as work progresses. Each draw request requires the sponsor to document completed work, obtain required certifications, and submit the draw package to the lender (or the lender's inspection service) for review before funds are released. The draw process is both a cash management function and a loan compliance obligation.

A typical draw request package includes a schedule of values showing percentage of completion for each budget line item; sworn statements from the general contractor and principal subcontractors certifying that they have been paid for prior period work and that they release liens for amounts previously paid; conditional lien waivers for the current draw period from each contractor; a third party inspector's certification (if required by the lender) confirming that the work claimed is actually complete; and any updated insurance certificates or other documentation the loan agreement requires. Missing elements delay funding, which creates tension between when contractors need to be paid and when funds are actually available.

Lenders typically engage a third party construction monitoring service to review draw requests, a process that can take anywhere from three to ten business days from submission to fund release. Sponsors who submit draw requests expecting same week funding and discover the review timeline only at the first draw have created cash flow pressure that adequate planning would have prevented. Understanding the lender's specific draw review process, including the

inspector's site visit schedule and the administrative review timeline, must be part of the pre-closing planning rather than a post-closing discovery.

## Leasing Strategy and Occupancy Management

Leasing produces revenue, and revenue produces value. For virtually every real estate investment strategy (stabilization of underperforming assets, lease up of vacant space, execution of a value add renovation program, or repositioning of a property in the competitive market) leasing execution during the hold period is the primary driver of whether the investment achieves its projected return. The asset manager who understands how to design, monitor, and adjust a leasing strategy has the most important active management skill in the private real estate investment business.

### Developing the Leasing Strategy

The leasing strategy should be established at acquisition as part of the business plan, and refined as the asset manager develops ground level knowledge of the property and market during the early hold period. At minimum, the strategy must address the target tenant profile and qualification standards; the rental rate positioning relative to competitive comparable properties; the lease term structure and flexibility; the concession policy for new leases and renewals; and the marketing channels and platforms through which available space will be presented to prospective tenants.

Rental rate positioning is the most consequential leasing decision the asset manager makes. A property priced 10% above market asking rents will show higher projected NOI in the model but will experience materially higher vacancy periods and higher concession costs as tenants negotiate to bring effective rents to market. The net result is frequently lower economic performance than a market priced property achieves. The discipline of pricing based on competitive market analysis rather than on the rents the underwriting requires is one of the markers that distinguishes experienced asset managers from those still learning the trade.

For commercial properties (office, retail, industrial, and mixed use) the tenant mix strategy requires specific attention to synergistic relationships between tenants. An anchor tenant whose operations drive traffic to adjacent tenants creates measurable value to the property beyond the anchor's own rent contribution. Losing an anchor affects the performance of every co tenant. The leasing strategy must account for these interdependencies and prioritize tenants whose presence reinforces the property's overall performance rather than simply maximizing rents on individual spaces.

### Monitoring and Adjusting Leasing Performance



Leasing performance must be tracked at the unit or suite level, not just in aggregate. A multifamily property projecting 95% occupancy needs to monitor separately units currently vacant and the number of days each has been vacant; units on notice of non-renewal and expected to vacate within 60 days; applications pending and their expected conversion date; and the difference between asking rents and executed lease rents. These metrics tell different stories about the property's leasing health, and tracking them separately allows the asset manager to diagnose why performance is or is not meeting the projection.

For value add programs, tracking whether renovated units are achieving the underwritten rent premium is a specific and critical sub metric. A business plan projecting a \$200 per month premium on renovated units needs to track the actual premium on every renovated unit lease, not just whether the property's average rent has increased. A program achieving \$150 of a projected \$200 premium is generating 75% of the underwritten NOI improvement, which compounds throughout the hold period and substantially affects the investment's return. Identifying this gap at Month 4 of an 18 month renovation program allows for scope or strategy adjustments. Identifying it at Month 16 does not.

When leasing performance falls short of the business plan, the asset manager must diagnose the specific cause and adjust the strategy before the underperformance compounds. The most common causes and their response levers are described below.

- Asking rents above the competitive market: conduct an updated competitive survey, compare effective rents at two to four directly comparable properties, and adjust pricing. A week of lower rents is less expensive than extended vacancy.
- Inadequate marketing and tour generation: evaluate the property's presence across major leasing platforms, the quality of listing photography and descriptions, and the responsiveness of the leasing team to inquiries. Properties that receive adequate tours but have poor conversion rates have a different problem than properties that receive no inquiry.
- Physical condition affecting tour conversion: if prospective tenants are touring and not converting, the property's condition or the quality of unit presentations may be driving the rejection. Increasing renovation scope or upgrading common areas may be necessary.
- Excessive application to lease lag: extended time between application and executed lease loses prospective tenants who need to make timely housing or space decisions. Streamlining the screening and lease execution process reduces leakage at this step.

## Financial Monitoring and Reporting

Financial monitoring is the asset manager's primary tool for understanding the investment's real time status and identifying developing problems before they become entrenched. Many of the



operational problems described in earlier sections of this chapter manifest first in the financial statements: in occupancy trends, expense variances, and cash position. The asset manager who reviews those statements with enough frequency and enough granularity to identify the early warning signs retains the ability to respond. The asset manager who reviews them quarterly in summary form does not.

### Monthly Financial Package Review

The monthly financial package from the property manager or fund administrator should include, at minimum, the property income statement for the month and year to date versus budget; the rent roll as of month end showing each tenant or unit, lease term, monthly contracted rent, and payment status; the accounts receivable aging report showing outstanding balances by tenant and by age; operating expense detail by category; and the property's bank account statement reconciled to the operating accounts. These documents reviewed together, not the income statement in isolation, provide the complete picture of the property's financial health.

The income statement review should identify whether effective gross income is on track with the budget (and if not, whether the gap is attributable to occupancy, rental rates, concessions, or collections failures) and whether operating expenses are within budget by category. Operating expenses that run consistently above budget in a specific category (say, maintenance and repairs running 30% above projections for six consecutive months) signal either that the budget was understated at acquisition or that something in the property's physical condition or operational management is generating costs that must be understood and addressed.

The rent roll review should identify tenants on month to month leases who are near term vacancy risks; tenants with upcoming lease expirations within six months who require proactive renewal outreach before they begin evaluating alternative space; and any tenant whose name appears on the aging report with a pattern of late payment that has not been escalated. Rent rolls reviewed only in the aggregate miss the individual tenant level intelligence that asset management requires.

### Budget Versus Actual Analysis

Monthly budget versus actual analysis is the discipline that separates active asset management from passive ownership. Every significant variance (revenue below budget, expenses above budget) should be explained with specificity in a written narrative that accompanies the financial package. Not 'maintenance costs were higher than expected' but 'a roof membrane failure on the west wing of the building required emergency patching of \$6,200 in Month 7 and a full membrane replacement budgeted at \$38,000 for Month 9; the capital replacement was not included in the original operating budget and will be funded from the capital reserve account

established at closing; the remaining reserve balance after this expenditure will be \$42,000, which is adequate for anticipated near term capital needs.'

The budget versus actual narrative serves two simultaneous purposes: it demonstrates to the fund administrator, to the lender, and to investors that the asset manager understands what is happening at the property and is managing the variances actively; and it creates the contemporaneous documentation basis for investor quarterly reporting, lender communications, and any future evaluation of whether the property was managed competently. An asset manager who can explain every significant variance in the financial statements (its cause, its one-time or recurring nature, and the specific response to it) is an asset manager who has operational control. One who cannot is one who is reacting to results rather than managing them.

## Lender Covenant Compliance

Commercial real estate loans contain financial covenants that the borrower must maintain throughout the loan term. These covenants are not suggestions and are not subject to informal negotiation after a default event has occurred. The primary financial covenants in most commercial real estate loans are described below.

- **Debt Service Coverage Ratio (DSCR):** typically requiring NOI to remain above 1.20x to 1.35x of annual debt service. A DSCR that falls below the covenant floor is a loan default that gives the lender the right to exercise remedies, potentially including a cash management period, acceleration of the outstanding balance, and foreclosure proceedings.
- **Occupancy floors:** many loans require the borrower to maintain occupancy above a defined minimum, often 85% to 90%, with failure triggering a cash management event, a springing reserve obligation, or a technical default.
- **Reporting obligations:** most loans require delivery of quarterly operating statements, rent rolls, and annual audited or reviewed financial statements within specified periods. Failure to deliver required reporting is itself a loan default under most commercial real estate loan agreements, independent of the property's financial performance.
- **Major decision consent requirements:** property sales, additional debt, material leases above a defined size threshold, and capital expenditures above defined amounts require lender consent under most loan agreements. Acting without required consent is a default even if the action itself is operationally sound for the investment.

Asset managers must monitor covenant compliance continuously, not only when lender reporting is due. A DSCR trending toward the covenant minimum (because of occupancy decline, expense escalation, or both) should trigger proactive communication with the lender before the threshold is breached. Lenders who are informed of a developing problem in

advance of a default have meaningfully more flexibility to work with borrowers than lenders who discover a covenant breach from a quarterly report that confirms an already existing event of default.

## Portfolio Level Management for Fund Sponsors

Fund sponsors managing multiple assets simultaneously face asset management challenges that individual property management cannot address. Portfolio composition, concentration risk, aggregate performance reporting, cross asset comparison, and the strategic decisions that affect multiple assets simultaneously are dimensions of the management function that exist only at the fund level. The fund sponsor who manages each asset competently but who does not also manage the portfolio as a whole is operating without the perspective that protects investors from risks they cannot see from any single property's performance.

### Diversification Monitoring

The fund's investment guidelines (as described in the PPM and operating agreement) typically specify target diversification parameters across property type, geographic market, tenant concentration, and lease maturity profile. The portfolio level asset manager must monitor the actual composition against these targets and identify when concentration is developing in ways the investment guidelines did not contemplate.

Geographic concentration is the most common form of unplanned risk accumulation. A fund targeting diversification across four markets may find that three of its best executed acquisitions are in the same metropolitan area, producing 65% geographic concentration in a single market. This may be acceptable if that market's fundamentals are exceptionally strong, but it represents a deviation from the disclosed strategy that investors are entitled to be informed about, both as a disclosure obligation and as information relevant to their own portfolio allocation decisions.

Lease maturity concentration is a distinct portfolio level risk that individual asset management does not reveal. A portfolio where 40% of total annual base rent expires in a single 18 month window is exposed to a simultaneous re leasing requirement that could produce portfolio wide NOI decline during that period. Monitoring the aggregate lease maturity schedule across all assets, and factoring it into acquisition and disposition decisions, is a management discipline that no amount of individual asset attention captures. The portfolio level view exists only when someone is looking at the portfolio as a whole.

### Portfolio Rebalancing Decisions

Portfolio rebalancing (the disposition of assets whose risk return profile has changed relative to alternatives, and the reinvestment of proceeds into assets that better serve the fund's objectives) is a fund management decision that requires the portfolio level perspective. For

closed end fund structures with defined investment periods, meaningful rebalancing through new acquisitions is possible only during the investment period. After the investment period closes, rebalancing occurs primarily through disposition sequencing decisions.

Disposition decisions for individual assets must account for both asset specific conditions and portfolio level effects. An asset that has completed its value add program and is now fully stabilized presents an attractive disposition opportunity at current market pricing. But disposing of it may leave the portfolio with a higher proportion of assets still in execution, changing the fund's risk profile in ways that differ from what investors expected. Conversely, holding a stabilized asset past its optimal disposition window (because the sponsor is reluctant to realize gains and close the deployment opportunity) may be prioritizing the sponsor's economics over the investors' timeline interests. Both types of portfolio level reasoning must be visible in the disposition decision process.

## Fund Level Versus Asset Level Reporting

Investors in a multi asset fund need both dimensions of performance reporting: asset level detail that shows how each individual property is performing against its underwriting, and fund level synthesis that shows how the aggregate portfolio is tracking toward the fund's overall investment objectives. The quarterly investor report must deliver both, and the fund level synthesis must be more than a sum of the asset level reports. It must provide the portfolio statistics that allow investors to evaluate the fund's aggregate trajectory.

Fund level reporting should address weighted average occupancy across the portfolio; weighted average in place rent versus the weighted average underwriting assumption at acquisition; aggregate NOI and comparison to aggregate underwriting; total invested equity and percentage deployed relative to total committed capital; fund level IRR projection based on current performance and reasonable disposition assumptions; and the status of the fund's investment period and remaining deployment capacity. These metrics are the ones sophisticated investors use to evaluate whether the fund is on track and whether the sponsor is executing the strategy they funded. The ILPA Reporting Template, which the ILPA Model LPA incorporates as the standard for institutional fund reporting, specifies the content and format of fund level reporting that meets the institutional benchmark.

## Asset Management Calendar

The following table summarizes the asset management monitoring and reporting obligations that recur monthly, quarterly, and annually across the hold period.

| Asset Management Function      | Monthly Obligation                                           | Quarterly Obligation                                                          | Annual Obligation                                                      |
|--------------------------------|--------------------------------------------------------------|-------------------------------------------------------------------------------|------------------------------------------------------------------------|
| NOI monitoring                 | Compare to budget; explain variances above 5%                | Budget versus actual YTD narrative; variance trend analysis                   | Full year versus underwriting; revised multi-year NOI projection       |
| Occupancy and leasing          | Review rent roll; days vacant; pending applications          | Lease maturity schedule 6, 12, and 18 month look ahead; renewal activity      | Competitive market position analysis; leasing strategy assessment      |
| Capital expenditures           | Track actuals versus budget; review draw request submissions | Cumulative CapEx versus budget; project timeline versus schedule              | Annual CapEx budget for coming year; reserve adequacy review           |
| DSCR and loan covenants        | Monitor versus covenant floor with variance cushion          | Formal lender reporting if quarterly; proactive outreach if approaching floor | Annual lender reporting; loan covenant compliance certification        |
| Property manager performance   | Review financial package; delinquency aging                  | Site visit; maintenance response time metrics; leasing conversion rate        | Formal performance review versus management agreement standards        |
| Portfolio (fund sponsors only) | Not applicable for individual assets                         | Aggregate NOI; geographic concentration; lease maturity distribution          | Fund level IRR projection; deployment status; investment period status |

## Practical Takeaways

- The closing is the beginning. The investment's actual return is determined by asset management decisions made across the hold period, not by the acquisition price or the offering structure. A property acquired at fair terms with a sound business plan will underperform if the execution is poor. The reverse is equally true.
- The asset manager's three core obligations (implementing the business plan, monitoring performance against underwriting, and making the operational decisions that maximize value) are simultaneously operational and legal. Material deviations from the disclosed business plan, undisclosed cost overruns, and decisions that exceed the manager's discretionary authority are not only operational failures. They are potential disclosure failures and fiduciary breaches.
- Monthly monitoring of six key metrics (NOI versus budget, effective gross income versus underwriting, operating expense ratio, DSCR versus loan covenant minimum, renovation progress versus budget and schedule, and accounts receivable aging) provides the operational visibility needed to manage the asset proactively rather than reactively. Sponsors who track these monthly and can explain every significant variance have the control their investors and lenders expect.

- The decision between in house and third party property management turns on three practical questions: Does the sponsor have the right personnel and systems? Are they in the right geographic market? Can they provide adequate management attention? In house management at scale can be economically compelling. Third party management is the right answer when geographic or operational constraints prevent effective oversight. The affiliated fee disclosure and conflict of interest implications of in house management must be addressed in the offering documents regardless. Inadequate disclosure of affiliated fee arrangements has been the subject of SEC enforcement actions.
- The property management agreement's termination provision is the most important term to negotiate. Confirm the right to terminate without cause on 30 to 60 days' notice with reasonable transition assistance. An agreement terminable only for cause, with a narrow definition of cause, or that entitles the manager to continued compensation through the end of a multi-year term regardless of performance, locks the sponsor into a governance problem that may be discovered only after a significant management failure has already occurred.
- Construction budgets require contingency of 10% to 15% of hard costs for renovation programs, higher for gut renovations or properties with unknown conditions. Change orders must be authorized in writing before work begins, priced competitively before authorization, and tracked against the contingency budget in real time. Verbal change orders, retroactively priced, are the primary mechanism through which construction cost overruns occur in value add programs. Construction management fees paid to sponsor affiliated entities must be specifically disclosed in the PPM and are subject to fee offset analysis.
- Leasing performance must be tracked at the unit or suite level, not just in aggregate. For value add programs, tracking the rent premium achieved on renovated units specifically is required to evaluate whether the renovation investment is generating the projected return. A program achieving 75% of its projected premium is generating 75% of its projected NOI improvement, a compounding gap that materially affects the investment's final return.
- Lender covenant compliance requires continuous monitoring and proactive communication. A DSCR trending toward the covenant floor should trigger a lender conversation before the threshold is breached. Lenders who are informed of developing problems in advance retain flexibility that lenders who discover covenant defaults from routine reporting do not. The same principle applies to all covenant requirements: reporting, occupancy, approval obligations.
- Fund sponsors managing multiple assets must monitor portfolio level metrics (geographic concentration, aggregate lease maturity distribution, total NOI versus aggregate underwriting, and fund level IRR projection) in addition to individual asset

performance. Portfolio level risks are invisible to individual asset management. They become apparent only when viewed at the portfolio level. Quarterly fund level reporting must deliver both dimensions to investors, consistent with the ILPA Reporting Template benchmark for institutional fund reporting.

## CHAPTER TWENTY EIGHT

# Distributions and Fund Administration

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The distribution is the moment when investment performance becomes tangible to investors. A quarterly preferred return payment arriving in an investor's account confirms that the business plan is producing cash flow. A year end capital event distribution validates the value that a renovation program created. A final disposition distribution closes the loop on an investment committed to years earlier, converting paper ownership into realized returns. For sponsors, getting distributions right, meaning computed correctly, paid on schedule, documented accurately, and reported properly for tax purposes, is among the most important investor relations and compliance functions they perform.

Fund administration is the operational infrastructure through which distributions are calculated and processed, capital accounts are maintained, financial statements are prepared, K-1s are delivered, and the many compliance obligations running throughout the investment's life are tracked and fulfilled. It is not the glamorous side of fund management, but it determines whether investors receive accurate information, whether auditors find the books in order, and whether the fund survives regulatory scrutiny. Sponsors who treat fund administration as a cost center to be minimized often discover the consequences at the worst possible moments. A lender suddenly requires audited financials that have never been prepared. An investor disputes a waterfall calculation that was never properly documented. A K-1 error forces amended returns on thirty investors. A foreign investor withholding obligation was never calculated or remitted.

This chapter covers the full distribution and fund administration function: how distributions are structured and when they are made; the mechanics of working through a waterfall calculation in practice, with a step by step example; the choice between in house and third party fund administration and what a properly scoped engagement looks like; capital account maintenance; audited financial statement requirements; K-1 preparation and delivery obligations; and the FATCA and foreign account reporting obligations that apply when the investor base includes non U.S. persons.

## Distribution Policy and Cadence

The distribution policy, meaning when distributions are made, from what sources, and subject to what limitations, is established in the operating agreement or limited partnership agreement and governs every distribution the fund makes throughout the investment's life. The policy is not merely an administrative schedule. It is a legal commitment to investors that defines when they can expect to receive cash, what conditions the fund must satisfy before a distribution can be



made, and what reserves and liabilities must be addressed before available cash reaches investor accounts. Distributing cash that should have been retained in reserves, or withholding cash that the operating agreement requires to be distributed, are both legal violations of the agreement with potential investor claims as consequences.

## Operating Cash Flow Distributions

Operating distributions, meaning the periodic payments to investors from a property's net operating income after debt service, are the primary source of the preferred return payments that most real estate syndication operating agreements commit to. The operating agreement typically specifies the distribution frequency, with quarterly being most common for operating distributions and monthly in some structures, and establishes the process for determining distributable operating cash flow.

Distributable operating cash flow is not simply net operating income. It is NOI minus debt service, minus capital expenditures funded from operating cash flow, minus amounts the fund is required to retain in reserves, plus any interest earned on reserve accounts that is distributable per the operating agreement's terms. Each of those deductions must be calculated accurately before any cash flows to investors. Distributing cash that should have been retained, whether to cover anticipated capital expenditures, an upcoming debt service payment, or a required reserve balance, creates a shortfall that will eventually require either an investor capital call or a distribution reduction the operating agreement may not permit.

The operating agreement should specify the distribution frequency; the timeline within which distributions must be made after the end of each distribution period, typically within 30 to 45 days after quarter end; the calculation methodology for distributable cash; the reserve requirements and how they affect distributable cash; and the order in which distributable cash is allocated among investors, typically per their respective preferred return entitlements and, above the preferred return, in accordance with the waterfall provisions. Each element of this specification must be followed precisely. Deviations, even ones that appear harmless, can generate investor disputes about whether the operating agreement was applied correctly.

## Refinancing Proceeds and Return of Capital

When a property is refinanced during the hold period, replacing existing debt with new debt at a higher loan amount and extracting equity in the process, the refinancing proceeds available for distribution require distinct treatment from operating cash flow. Refinancing proceeds are not income. They are a return of capital, derived from the property's appreciated value and the increased loan amount the lender is willing to provide. That distinction has significant implications for how the proceeds flow through the waterfall.

In most real estate syndication operating agreements, refinancing proceeds flow through the same waterfall as disposition proceeds. That means that before the sponsor receives any promoted interest from the refinancing event, investors must receive any accrued unpaid preferred return and, in structures where a return of capital must precede the promote, a return of some or all of their original contributed capital. A refinancing that generates \$3 million in distributable proceeds is not simply \$3 million flowing 80/20 between investors and the sponsor. The operating agreement dictates precisely where that \$3 million lands in the waterfall, and whether the distribution moves the investment past a waterfall tier has real dollar consequences for the sponsor's economics.

The operating agreement's treatment of refinancing proceeds also affects how the preferred return accrual is tracked after the distribution. If a partial return of capital is made from refinancing proceeds, the preferred return going forward may accrue on the remaining unreturned capital rather than on the original contribution, reducing the going forward preferred return obligation. If the operating agreement does not specify the preferred return basis following a return of capital event, the calculation becomes contested. Sponsors who refinance and distribute proceeds without working through the waterfall implications carefully, and without documenting their calculation methodology, create the conditions for investor disputes that the operating agreement's ambiguity makes difficult to resolve.

## Reserve Requirements and Distribution Restrictions

Most real estate loan agreements and operating agreements require the fund to maintain minimum cash reserves: amounts set aside for anticipated capital expenditures, operating deficits, debt service shortfalls, and contingencies. These reserve requirements restrict the cash available for distribution. No distribution can be made, which would cause the fund's reserve balance to fall below the required minimum, regardless of how much cash the property has generated.

Common reserve types include the following. Operating reserves are cash held to cover unanticipated operating expenses. Capital or replacement reserves are cash accumulated over time to fund anticipated capital improvements and equipment replacement, often required by the lender at a specified monthly contribution rate. Debt service reserves are cash held to cover debt service during a temporary revenue shortfall, sometimes required by the lender at one to six months of debt service. Tenant improvement and leasing commission reserves, used in commercial properties, are cash accumulated to fund lease transaction costs for upcoming renewals and new leases.

The operating agreement should specify the target reserve level for each category, the funding priority (whether reserves must be fully funded before any distributions are made, or whether partial distributions are permitted when reserves are partially funded), and the circumstances

under which reserve amounts may be released for distribution (typically when the specific need for which the reserve was established has been satisfied, or when the fund administrator certifies that the reserve level is adequate). Distributing cash that reduces reserves below required levels is an operating agreement violation. Withholding distributions unnecessarily while excess reserves accumulate creates investor relations friction and potentially its own operating agreement issue.

## Calculating Distributions: Waterfall Mechanics in Practice

The distribution waterfall is the contractual mechanism that determines who receives what from each distribution event, in what order, and on what economic terms. Waterfalls are specified in the operating agreement with a level of technical detail that the casual descriptions in marketing materials rarely capture. The gap between how a waterfall is described to investors and how it actually operates under the operating agreement's precise language is one of the most common sources of investor disputes in private real estate funds.

The mechanics of waterfall calculation matter enormously. Slight differences in interpretation, such as whether the preferred return accrues on contributed capital or unreturned capital, whether the GP catch up is calculated on preferred return distributions alone or on all above capital distributions, and whether the tiers operate on a deal by deal basis or across the fund as a whole, produce different economic outcomes. These differences can shift tens of thousands of dollars from investors to the sponsor or in the opposite direction. Fund managers who calculate their own waterfalls without understanding the precise mathematical implications of the operating agreement's language frequently miscalculate distributions, and the error is often discovered only when an investor's independent advisor reviews the calculation.

## Working Through a Distribution Calculation

The example below works through a four tier waterfall calculation of the type commonly found in private real estate syndications. The assumptions are kept straightforward to allow the mechanics to remain visible. In practice, a fund administrator applies these mechanics to the specific numbers produced by the property's actual performance.

### Example Waterfall Calculation: Four Tier Structure

#### Assumptions

- Total investor capital contributed: \$5,000,000
- GP capital contributed: \$250,000 (5 percent of total equity, *pari passu* with LPs)
- Annual preferred return rate: 8 percent (non-compounding, accruing on unreturned capital)

## Example Waterfall Calculation: Four Tier Structure

- Hold period: 3 years
- Prior operating cash flow distributions: \$600,000 to LPs; \$30,000 to GP
- Available proceeds at disposition: \$8,500,000
- Waterfall structure: (1) return unreturned capital; (2) accrued preferred return; (3) GP catch up to 20 percent of all above capital distributions; (4) 80/20 split thereafter

### Tier 1: Return of Unreturned Capital

LP unreturned capital: \$5,000,000 minus \$0 prior return of capital equals \$5,000,000

GP unreturned capital: \$250,000 minus \$0 equals \$250,000

Tier 1 distributions: \$5,000,000 to LPs; \$250,000 to GP

Remaining proceeds after Tier 1: \$8,500,000 minus \$5,250,000 equals \$3,250,000

### Tier 2: Accrued and Unpaid Preferred Return

LP preferred return earned over 3 years: \$5,000,000 times 8 percent times 3 equals \$1,200,000

Less LP operating distributions already received: (\$600,000)

Unpaid LP preferred return: \$600,000

GP preferred return earned: \$250,000 times 8 percent times 3 equals \$60,000

Less GP operating distributions already received: (\$30,000)

Unpaid GP preferred return: \$30,000

Tier 2 distributions: \$600,000 to LPs; \$30,000 to GP

Remaining proceeds after Tier 2: \$3,250,000 minus \$630,000 equals \$2,620,000

### Tier 3: GP Catch Up (20 percent of all above capital distributions to GP)

Total LP above capital distributions to date: \$600,000 (Tier 2) plus \$600,000 (prior operating) equals \$1,200,000

GP catch up base: \$1,200,000 divided by 80 percent equals \$1,500,000 total at this tier

GP share: 20 percent of \$1,500,000 equals \$300,000 (LPs already received the 80 percent portion)

GP catch up distribution: \$300,000 (100 percent to GP until caught up)

Remaining proceeds after Tier 3: \$2,620,000 minus \$300,000 equals \$2,320,000

### Tier 4: Residual Split (80 percent LP / 20 percent GP)

LP share: \$2,320,000 times 80 percent equals \$1,856,000

GP share: \$2,320,000 times 20 percent equals \$464,000

### Summary of Disposition Distributions

LPs receive: \$5,000,000 (capital) plus \$600,000 (preferred) plus \$1,856,000 (residual) equals \$7,456,000

GP receives: \$250,000 (capital) plus \$30,000 (preferred) plus \$300,000 (catch up) plus \$464,000 (residual) equals \$1,044,000

Total: \$8,500,000 ✓

LP total return: \$7,456,000 plus \$600,000 (prior operating) equals \$8,056,000 on \$5,000,000 invested

LP equity multiple: 1.61x; LP IRR: approximately 17 percent (illustrative; depends on the timing of operating distributions)

Several mechanics in this calculation deserve specific attention, because they are consistently misunderstood or miscalculated.

**The GP catch up gross up.** The GP catch up is 20 percent of all above capital distributions to both parties combined, not simply 20 percent of the preferred return paid to LPs. The \$1,200,000 of LP above capital distributions represents 80 percent of the total distribution base, so the catch up must be calculated by grossing up to the 100 percent base (\$1,500,000) and paying the GP the 20 percent portion (\$300,000). Calculating the catch up as 20 percent of \$600,000 (the Tier 2 LP distribution alone) produces \$120,000, which is a \$180,000 error in the sponsor's favor that the operating agreement does not support.

**Operating distributions reduce the preferred return shortfall.** Prior operating distributions reduce the unpaid preferred return owed at disposition. LPs who received \$600,000 of operating distributions during the hold period have already received part of their 8 percent preferred return. The disposition calculation determines the remaining balance, not the full accrual. Sponsors who calculate the Tier 2 preferred return payment at the full three year accrual without crediting prior operating distributions are double counting the preferred return and underpaying themselves in later tiers.

**The preferred return basis affects the calculation throughout.** This example uses a non-compounding preferred return accruing on contributed capital. If the operating agreement uses a compounding preferred return, the annual accrual grows each year. If the preferred return accrues on unreturned capital rather than contributed capital, partial returns of capital reduce the accrual going forward. These specifications, namely compounding versus non compounding and contributed capital versus unreturned capital, are buried in the operating agreement's definitions and must be read precisely to produce a correct calculation.

## Allocating Income and Loss for K-1 Purposes

The waterfall determines who receives cash. The income and loss allocation provisions of the operating agreement, which are separate from the distribution provisions but must be coordinated with them, determine how the entity's taxable income, losses, deductions, and credits are allocated among investors for K-1 purposes. The two frameworks are related but distinct. A partner can receive a cash distribution without being allocated income, and can be allocated income without receiving a cash distribution, depending on how the operating agreement structures both.

Most real estate fund operating agreements use one of two income and loss allocation frameworks: the traditional allocation method or the targeted allocation method. Under the traditional method, income and loss are allocated first based on the operating agreement's economic provisions (the preferred return, the promote, and so on), with specific allocations

designed to track economic interests. Under the targeted allocation method, which is increasingly common in real estate fund operating agreements, income and loss are allocated each year to bring each partner's capital account balance as close as possible to the amount they would receive if the fund were liquidated on the last day of the year. The targeted allocation method simplifies the relationship between capital accounts and economic interests, but it requires careful annual calculation by the fund's tax advisers.

The income and loss allocation framework also determines how the partnership's depreciation deductions, typically the most valuable tax benefit of real estate investment, flow to investors. Depreciation accelerated through cost segregation studies (which reclassify property components from 39 year or 27.5 year depreciable life to 5 year or 15 year life, producing larger early year deductions) generates tax losses that reduce investors' taxable income from other passive sources. Whether those accelerated deductions flow to investors in proportion to their capital contributions, in accordance with the profit and loss allocations, or under a specific depreciation allocation schedule specified in the operating agreement depends on the operating agreement's exact language. Incorrect allocation of depreciation deductions produces incorrect K-1s for every investor.

### **⚠ Waterfall Calculations Are Not Self Executing, and Errors Are-expensive**

*The operating agreement establishes the waterfall's terms. The fund administrator executes the calculation. But the calculation produces a correct result only if the administrator is applying the operating agreement's precise mathematical specifications, including the definition of distributable cash, the preferred return basis and accrual methodology, the catch up calculation method, and the treatment of prior operating distributions.*

*Waterfall calculation errors are among the most common and most expensive fund administration mistakes. They typically favor either the sponsor (underpaying investors) or the investors (overpaying investors and depleting sponsor economics). Either type is problematic: underpaying investors creates legal exposure and investor relations crises; overpaying them depletes the sponsor's promoted interest and may require a clawback.*

*Every waterfall calculation should be reviewed by both the fund administrator and securities or fund counsel before the distribution is made. The calculation documentation, showing the inputs, the tier by tier analysis, and the resulting payments, should be retained in the fund's records. Investors are entitled to request this documentation, and sophisticated investors frequently do.*

## Fund Administration: In House Versus Third Party

Fund administration encompasses the accounting, reporting, compliance, and investor services functions that keep a private real estate fund's financial records accurate, its investor communications timely, and its regulatory obligations current. It is the operational backbone of everything the investor sees: the quarterly reports, the capital account statements, the K-1s, the distribution notices, and the financial statements that auditors examine and institutional investors review.

Real estate funds make up a meaningful share of the private capital fund universe globally, and the shift toward third party fund administration has accelerated considerably in the real estate segment. Two forces are driving the shift: institutional investors who treat an independent administrator as a hallmark of strong governance, and the increasing regulatory complexity that makes in house administration difficult to execute well without significant dedicated infrastructure.

### When to Outsource Fund Administration

The decision to outsource fund administration turns on three practical questions. Does the sponsor have the personnel and systems to administer the fund accurately and at the required reporting standard? Is the sponsor's team structured to provide the independence that institutional investors increasingly require? And does the sponsor's volume of administrative work justify the fixed cost of an in house function versus the variable cost of a third party provider?

Industry practice suggests a useful scale based framework for this decision. Emerging sponsors managing their first fund with 20 to 30 investors, whose investor base consists primarily of high net worth individuals and family relationships, can manage fund administration in house using purpose built fund management software, provided they have the accounting competence to maintain accurate capital accounts, calculate waterfalls correctly, and produce K-1s that satisfy IRS requirements. The risk at this scale is not the volume of work, but the quality of execution. A sponsor without fund accounting experience who attempts to self-administer a multi investor fund using spreadsheets will almost certainly produce errors that are expensive to discover and correct.

For sponsors raising institutional capital from family offices, registered investment advisers, or pension funds, third party fund administration is effectively required. Institutional investors apply their own due diligence to fund administration quality as part of their manager evaluation. An institutional investor who discovers that the fund has no independent administrator, and that capital accounts and waterfall calculations are maintained on a spreadsheet by the sponsor's assistant, is an institutional investor unlikely to commit capital regardless of the investment



strategy's merits. Third party administration signals the operational sophistication that institutional capital requires.

For established sponsors managing multiple funds simultaneously, third party administration frees the sponsor's team to focus on investment management and investor relations, the functions that directly generate returns, rather than on accounting, reporting, and compliance work that a specialized administrator can perform more efficiently and at lower cost per dollar of assets under management.

## What Fund Administrators Do (and Do Not Do)

A full service third party fund administrator typically provides the following core functions.

- **Capital account maintenance:** recording each investor's capital contributions, income and loss allocations, and distributions received; maintaining the capital account roll forward for each investor across the fund's life; and reconciling capital account balances to the fund's financial statements at each reporting period.
- **Waterfall calculations:** applying the operating agreement's distribution provisions to the distributable cash amounts determined by the fund's financial records; calculating each investor's distribution entitlement at each distribution event; and preparing the distribution calculation documentation that supports the payments made.
- **Financial statement preparation:** preparing the fund's financial statements (income statement, balance sheet, statement of changes in equity, and cash flow statement) at the required reporting frequency, monthly for management reporting and annually for audited statements.
- **Investor reporting:** preparing the quarterly and annual investor reports that the operating agreement requires; distributing those reports to investors on the required schedule; and maintaining the investor portal with current financial data and document access.
- **K-1 preparation:** preparing the Schedule K-1 for each investor reflecting their allocable share of the fund's income, losses, deductions, and credits for the taxable year; coordinating with the fund's tax advisers on income and loss allocations; and delivering K-1s on or before the September 15 extended deadline.
- **Capital calls and distribution processing:** managing the operational mechanics of capital calls (preparing call notices, tracking funded capital, confirming wire receipt) and distributions (preparing distribution notices, processing payments, maintaining distribution history records).



- **Regulatory filing support:** tracking the fund's compliance calendar; preparing the annual Form D amendment; coordinating with securities counsel on state blue sky filings; and maintaining the bad actor questionnaire records.

What fund administrators do not provide, and what sponsors must not assume they provide, is legal advice, securities law compliance advice, investment decision making, property level accounting, or asset management oversight. The fund administrator maintains the fund's financial records based on the transactions and allocations the sponsor directs. The administrator does not independently determine the correct income and loss allocation methodology, evaluate whether the waterfall calculation is consistent with the operating agreement's legal requirements, or advise on the securities law implications of distribution decisions. Those functions remain the sponsor's and their counsel's responsibility.

## Selecting a Fund Administrator

The fund administrator selection decision should be made before the fund's first closing, not when the first reporting deadline is approaching and the sponsor discovers they cannot produce accurate financial statements on their own. The selection criteria that matter most are described below.

**Real estate fund experience.** Fund administrators whose primary expertise is hedge funds or venture capital apply different accounting methodologies, use different technology platforms, and are unfamiliar with the real estate specific conventions: property level accounting, depreciation and cost segregation integration, FIRPTA withholding for foreign investors, and Section 1446 withholding calculations. Administrators with deep real estate fund experience bring standardized processes that reduce errors and accelerate reporting timelines.

**Technology platform and investor portal.** The fund administrator's technology platform determines the quality of data the sponsor receives, the accessibility of information investors can access, and the audit trail that regulators and institutional investors can examine. Platforms based on real estate specific fund accounting software, rather than adapted spreadsheets or generic accounting systems, produce more reliable results and provide the institutional grade reporting infrastructure that growing sponsors need. The investor portal's functionality, including what investors can see, when they can access it, and how financial data is presented, reflects directly on the sponsor's professionalism.

**Independence and segregation of duties.** A fund administrator who is affiliated with the sponsor, who shares personnel with the sponsor, or who applies the administrator's own judgment to allocation decisions that the operating agreement reserves to the sponsor does not provide the independent oversight that the engagement is supposed to deliver. The value of third party administration is precisely that the administrator is separate from the sponsor,

applying the operating agreement's terms to the actual financial records without direction from the party whose economic interests are affected by the calculation.

**Capacity and service standards.** A fund administrator who cannot deliver quarterly reports within 30 days after quarter end, who consistently misses K-1 deadlines, or who responds to reporting inquiries on a multi week lag is not fulfilling the engagement's core promise. Before engagement, confirm the administrator's current client load, their typical turnaround times for standard deliverables, and the specific personnel who will be assigned to the fund's account. The relationship with the fund administrator's team, not just the firm's brand, determines whether reporting is accurate and timely.

## Capital Account Maintenance

The capital account is the financial record of each investor's running economic position in the fund: the original contribution, adjusted upward by income allocations and downward by loss allocations and distributions, producing at each point in time the balance that represents each investor's economic claim against the fund's assets. Capital accounts are the foundation of the fund's tax accounting, the basis for K-1 preparation, and the record that determines what each investor is entitled to receive at disposition under the operating agreement's waterfall.

Capital accounts must be maintained on a tax basis, not on the GAAP financial statement basis, using the allocation methodology specified in the operating agreement. The tax basis capital account and the book value capital account can differ significantly when the property has appreciated in value, when accelerated depreciation has been claimed in excess of economic depreciation, or when the operating agreement uses targeted allocations that produce allocation patterns different from straight pro rata calculations. Both sets of records must be maintained, and they must reconcile to each other within the framework that the operating agreement and partnership tax rules establish.

The partnership tax rules require capital accounts to be maintained in accordance with the substantial economic effect rules of Treasury Regulation Section 1.704-1(b), which specify the mechanics of how contributions, allocations, and distributions affect capital accounts in a way that produces tax treatment consistent with the partners' economic deal. Departures from these rules, such as allocating losses to partners in a way that does not reflect their economic risk of loss, or maintaining capital accounts that do not accurately reflect each partner's true economic position, can cause allocations to be challenged on audit and reallocated by the IRS according to the partners' interest in the partnership rather than the operating agreement's specified allocations.

Capital account errors are among the most consequential fund administration failures because they compound across the investment's life. An error in Year 1's income allocation produces

incorrect beginning balances in Year 2, which affects Year 2's targeted allocation calculations, which affects the Year 2 K-1s, and so on through the fund's entire operating life. Discovering a multi-year capital account error at disposition, when the waterfall calculation depends on the accuracy of each investor's capital account balance, requires correcting multiple years of K-1s, notifying investors that their prior tax returns may need to be amended, and recalculating the fund's entire allocation history. The cost of retroactive correction is many times the cost of getting the calculation right annually.

## Audited Financial Statements

The operating agreement or limited partnership agreement specifies the financial statement requirements: whether the fund's annual financial statements must be audited by an independent public accountant, reviewed, or merely compiled, and the timeline for delivering them to investors. These requirements are contractual obligations, and failure to meet them is a breach of the operating agreement regardless of how the fund's underlying investment is performing.

### When Audits Are Required

Audited financial statements are required by the operating agreement in most real estate funds that include institutional investors, including family offices, registered investment advisers, pension funds, and endowments, because those investors' own governance requirements and fiduciary obligations require them to invest only in funds with independently audited financials. Some institutional investment policy statements expressly prohibit commitments to funds that do not provide annual audited statements. A sponsor who discovers post-closing that an institutional investor requires audited financials that the operating agreement does not require to be provided has created an obligation mismatch that must be resolved by amendment.

Audited financial statements are also relevant under the Investment Advisers Act custody rule (Rule 206(4)-2). Registered investment advisers with custody of client funds or securities must either obtain an annual surprise examination by an independent public accountant, or rely on the pooled investment vehicle audit provision, which requires that audited financial statements prepared by a PCAOB registered accounting firm be distributed to investors within 120 days of the fund's fiscal year end (180 days for funds of funds). The audit provision is the option most registered private fund advisers rely on, and it has made annual audited financials the standard for registered advisers managing funds, regardless of whether the fund's operating agreement independently requires them.

For sponsors who are not registered investment advisers and whose operating agreements do not specifically require audited statements, review level financials (which provide limited

assurance rather than the positive assurance of an audit) may be sufficient for the investor base. The appropriate level of financial statement assurance should be determined at the time of fund formation, based on the anticipated investor base and any regulatory requirements applicable to the sponsor.

## Selecting an Auditor with Real Estate Fund Experience

The choice of auditor for a private real estate fund is a meaningful decision. It affects the quality and timeliness of the audit, the credibility of the financial statements with sophisticated investors, and the fund's ability to attract future institutional capital. An auditing firm whose private fund experience is concentrated in technology venture funds or hedge funds will lack familiarity with real estate specific accounting issues such as income recognition for real estate operations, cost segregation methodology and its effect on depreciation, FIRPTA withholding calculations for foreign investors, the treatment of organization and offering costs, and the presentation of property level financials within fund level statements. A real estate fund audit requires that experience.

When evaluating auditors, sponsors should assess several factors: specific experience auditing private real estate investment funds (not just real estate operating companies); familiarity with the fund accounting platform the administrator uses (discrepancies between the administrator's records and the auditor's working papers create friction that delays the audit); the audit timeline the firm can commit to (most real estate fund audits must be completed within 90 to 120 days of fiscal year end, and auditors whose schedules are overcommitted during peak season miss these deadlines with regularity); and the partner level attention the engagement will receive (a brand name audit firm that assigns the fund's audit to inexperienced staff provides less value than a mid-size firm with experienced real estate fund partners who are personally engaged in the process).

## K-1 Preparation and Delivery Obligations

Schedule K-1 is the annual tax reporting document that each member of a pass through LLC receives, reflecting their allocable share of the entity's income, gains, losses, deductions, and credits for the taxable year. The K-1 is the primary tax document investors use to report the fund's tax items on their personal or entity returns. For real estate funds, the K-1 is often the most complex annual deliverable the fund administrator and tax adviser produce, and it is the document investors most consistently complain about when it arrives late or inaccurately.

The statutory deadline for K-1 delivery is March 15 of the year following the taxable year (the same deadline as the partnership return itself). The partnership return can be extended to September 15 with a six month automatic extension, and this extension applies to the K-1s as

well, meaning that K-1s may be delivered any time before September 15 without penalty, provided the extension was timely filed. Most real estate funds take the extension, because completing the property level accounting, reconciling depreciation allocations (particularly for cost segregation studies), calculating FIRPTA withholding amounts for foreign investors, and finalizing the income and loss allocations for a complex multi property fund within the March 15 deadline is operationally impractical for most fund administrators and tax advisers.

The K-1 preparation process for a real estate fund requires coordination among three parties: the fund administrator (who maintains the capital accounts and financial records), the property level accountant or bookkeeper (who provides the property level income and expense data from which fund level income is derived), and the tax adviser or CPA (who prepares the partnership tax return and the K-1s, applies the income and loss allocation methodology from the operating agreement, and coordinates any cost segregation studies or depreciation elections). Each party's deliverable depends on the prior party's completion, creating a sequential dependency that must be planned backward from the K-1 delivery date to ensure all components are completed on schedule.

### **⚠ Late and Inaccurate K-1s Are Among the Most Damaging Investor Relations Failures**

*Investors who cannot file their personal tax returns because their K-1 has not arrived are frustrated investors, regardless of how well the property is performing. Investors who receive a K-1 in July and then receive an amended K-1 in September because the original contained an error have to file amended personal returns, potentially at their own expense. Either scenario reflects negatively on the sponsor regardless of where in the fund administration chain the failure occurred.*

*The K-1 preparation timeline should be established contractually in the fund administrator's engagement letter and in the tax adviser's engagement, with specific delivery milestones for each component of the process. Sponsors who treat K-1 delivery as something that will get done whenever the advisers are ready will consistently deliver late K-1s. Sponsors who build the timeline into their engagement letters with contractual deadlines deliver on time.*

## **FATCA and Foreign Account Reporting**

The Foreign Account Tax Compliance Act, enacted as part of the HIRE Act of 2010 and implemented through Treasury Regulations under Chapter 4 of the Internal Revenue Code, is the framework through which the United States requires foreign financial institutions and certain

other non U.S. entities to report information about financial accounts held by U.S. persons to the IRS. It also requires U.S. persons with foreign financial assets above specified thresholds to report those assets on Form 8938. For real estate fund sponsors, FATCA's primary operational dimension is the documentation and withholding obligations it imposes when the fund's investor base includes foreign persons, or when foreign financial institutions invest in the fund on behalf of their clients.

Understanding FATCA's requirements in the real estate fund context requires distinguishing between two categories of obligation: the obligations FATCA imposes on the fund as a withholding agent when it makes payments to foreign investors, and the obligations FATCA imposes on foreign entity investors who must document their own status to avoid being subject to 30 percent FATCA withholding on certain payments.

### **The Fund as Withholding Agent**

A U.S. real estate fund that makes withholdable payments to foreign persons, which include U.S. source fixed or determinable annual or periodical income such as rental income, interest, and distributions, is a withholding agent required to apply FATCA's withholding and reporting rules. In practice, FATCA interacts with the fund's existing FIRPTA and Section 1446 withholding obligations in ways that require careful coordination between the fund administrator and the fund's tax advisers.

For a real estate fund with a mixed investor base (U.S. and non U.S. investors), the fund must collect the appropriate IRS forms from all investors before making distributions. Domestic investors provide Form W-9, certifying their U.S. status and tax identification number. Non U.S. individual investors provide Form W-8BEN, the Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals). Non U.S. entity investors provide Form W-8BEN-E, the entity equivalent. These forms establish the investor's foreign status for both Chapter 3 (general withholding) and Chapter 4 (FATCA) purposes, and they allow the fund to apply the applicable withholding rates, or exemptions, correctly.

A W-8BEN or W-8BEN-E is generally valid for a period starting on the date it is signed and ending on the last day of the third succeeding calendar year, typically a three year validity period, unless a change in circumstances makes the information incorrect. A foreign investor who provided a W-8BEN in Year 1 of the fund will need to provide a new form before the original expires, and the fund administrator must track these expiration dates and proactively collect updated forms before the existing forms expire. A payment made to a foreign investor without a current, valid W-8 on file must be treated as made to a U.S. person and is subject to backup withholding, or the fund must apply the full 30 percent FATCA withholding rate.

### **Foreign Investor Documentation and FATCA Status**

For foreign entity investors in a U.S. real estate fund, including foreign corporations, partnerships, trusts, and family offices, the W-8BEN-E requires the entity to identify its FATCA status from among a list of more than 30 categories. The correct FATCA category depends on the entity's structure, ownership, and activity. These determinations frequently require input from the entity's own tax advisers or legal counsel in their home jurisdiction.

The most relevant FATCA categories for foreign entity investors in U.S. real estate funds include the following.

- **Participating FFI (Foreign Financial Institution):** a foreign financial institution that has entered into an FFI agreement with the IRS to identify and report U.S. account holders. A foreign family office or investment vehicle that qualifies as a foreign financial institution must register with the IRS and obtain a Global Intermediary Identification Number (GIIN), which must appear on its W-8BEN-E.
- **Certified deemed compliant FFI:** a foreign financial institution that meets specific conditions allowing it to be treated as FATCA compliant without the full registration requirements. Various categories of certified deemed compliant status exist, each with its own qualifying conditions.
- **Active NFFE (Non-Financial Foreign Entity):** a foreign entity that is not a financial institution and that derives less than 50 percent of its gross income from passive sources and holds less than 50 percent of its assets as passive assets. Many foreign operating companies and family office entities that are not themselves investment vehicles may qualify as active NFFEs, which simplifies the FATCA analysis considerably.
- **Passive NFFE:** a foreign entity that is not a financial institution and that does not qualify as an active NFFE. A passive NFFE must identify and disclose its substantial U.S. owners (persons owning directly or indirectly more than 25 percent of the entity) on Part XXX of the W-8BEN-E. This requirement is particularly significant for foreign investment vehicles with U.S. beneficial owners.

The fund's responsibility under FATCA is to collect appropriate documentation from each foreign investor, apply the correct withholding treatment based on that documentation, and report the payments and withholding to the IRS on Forms 1042 and 1042-S (the annual withholding tax return and payment record for foreign persons). The fund's tax adviser should be engaged on FATCA compliance before the first distribution to a foreign investor, not at year end when the 1042 filing deadline is approaching.

## Common Reporting Standard (CRS) Considerations

The Common Reporting Standard, developed by the OECD and adopted by more than 100 jurisdictions, is the international equivalent of FATCA. CRS requires financial institutions in



participating jurisdictions to identify and report financial accounts held by residents of other CRS jurisdictions to their local tax authorities, which exchange the information automatically. U.S. real estate funds with foreign investors whose home jurisdictions participate in CRS may face reporting obligations under the foreign jurisdictions' CRS implementing legislation, obligations that run parallel to, but separately from, the U.S. FATCA framework.

CRS analysis for U.S. real estate funds is complex and jurisdiction specific. The fund's status as a financial institution for CRS purposes, the reporting obligations that status imposes, and the documentation required from investors depend on the laws of each participating jurisdiction in which the fund has investors. Sponsors whose investor base includes residents of CRS participating jurisdictions, which encompasses most of Europe, Canada, Australia, and many other major capital markets, should confirm their CRS obligations with tax counsel experienced in both U.S. and international tax matters before the first investor from those jurisdictions is admitted.

## Ongoing Compliance Obligations and Calendar

The compliance calendar for an actively operating private real estate fund includes a substantial number of recurring obligations, each with its own deadlines, responsible parties, and consequences for noncompliance. The table below summarizes the principal obligations for a typical fund.

| Obligation                                        | Responsible Party                 | Deadline / Frequency                                              | Consequence of Non Compliance                                                |
|---------------------------------------------------|-----------------------------------|-------------------------------------------------------------------|------------------------------------------------------------------------------|
| Quarterly financial reports to investors          | Fund administrator                | 30 to 45 days after quarter end per operating agreement           | Operating agreement breach; investor relations damage                        |
| Annual financial statements (audited or reviewed) | CPA or auditor                    | 90 to 120 days after fiscal year end                              | Operating agreement breach; loss of institutional investor confidence        |
| Partnership tax return (Form 1065)                | Tax adviser                       | March 15 (September 15 with extension)                            | Late filing penalty; K-1 cannot be delivered without completed return        |
| Schedule K-1 delivery to investors                | Tax adviser or fund administrator | March 15 (September 15 with extension)                            | Investor frustration; IRS penalties if willfully late; amended return burden |
| Annual Form D amendment                           | Securities counsel                | On anniversary of initial filing, every year the offering is open | Regulation D compliance failure; potential bad actor event                   |



| Obligation                                      | Responsible Party                 | Deadline / Frequency                                                    | Consequence of Non Compliance                                            |
|-------------------------------------------------|-----------------------------------|-------------------------------------------------------------------------|--------------------------------------------------------------------------|
| State blue sky annual renewals                  | Securities counsel                | Per each state's deadline                                               | State enforcement action; rescission rights                              |
| W-9 and W-8 collection and renewal              | Fund administrator                | At each investor admission; W-8 renewal every three years               | FATCA withholding at 30 percent on payments to undocumented payees       |
| FIRPTA and Section 1446 withholding calculation | Tax adviser or fund administrator | At each distribution to foreign investors                               | IRS penalties; interest on underpaid withholding; joint liability        |
| Forms 1042 and 1042-S (foreign withholding)     | Tax adviser                       | March 15 of year following the taxable year                             | Late filing penalties; IRS scrutiny of FATCA compliance                  |
| Forms 8804, 8805, and 8813 (Section 1446)       | Tax adviser                       | Form 8804 by March 15 (calendar year); Form 8813 quarterly installments | Penalties for failure to withhold or report; partnership joint liability |
| Capital account reconciliation                  | Fund administrator                | Monthly minimum; annually for year-end financial statements             | K-1 errors; audit findings; investor distribution disputes               |

## Practical Takeaways

- Distributions must follow the operating agreement's waterfall precisely, not a sponsor's summary description of it. The calculation requires applying the operating agreement's specific mathematical specifications, including the preferred return basis, the catch up methodology, the treatment of prior operating distributions in the tier calculation, and the order of tiers. Errors that seem small in individual distribution events compound across the fund's life and can shift material dollars between investors and the sponsor.
- Distributable cash is not NOI. It is NOI minus debt service, minus capital expenditures funded from operating cash flow, minus required reserve contributions, plus any interest income that is distributable per the operating agreement. Distributing cash that should be reserved is an operating agreement breach that creates future cash flow shortfalls. The calculation must be made accurately at each distribution event.
- Refinancing proceeds flow through the waterfall as a capital event, not as operating income. The specific tier at which refinancing proceeds are allocated, and whether the distribution moves the investment past a waterfall hurdle that triggers promote payments, has meaningful economic consequences for both investors and the sponsor.

Work through the waterfall implications of any refinancing distribution before the cash leaves the account.

- The GP catch up is the most consistently miscalculated element of the waterfall. The catch up is not 20 percent of the preferred return paid to LPs. It is the amount required to bring the GP's total share of above capital distributions up to 20 percent of all such distributions, which requires grossing up the LP distributions to calculate the total distribution base. The correct calculation produces a larger catch up than the common error, in the sponsor's favor. Getting it right protects against investor claims that the calculation was incorrect.
- Third party fund administration is effectively required for sponsors seeking institutional capital. Institutional investors treat an independent administrator as a hallmark of sound governance. A fund administered on a sponsor's own spreadsheets, with no independent review of capital accounts or waterfall calculations, will not survive institutional due diligence regardless of the investment strategy's quality.
- The fund administrator does not provide legal advice, does not independently determine correct allocation methodologies, and does not evaluate whether calculations are consistent with the operating agreement. Those functions remain with the sponsor and their counsel. The fund administrator executes calculations based on the directions and documents the sponsor provides. The quality of the calculation depends on the quality of those inputs.
- K-1 delivery timelines should be built into engagement letters with the fund administrator and tax adviser as contractual deadlines with specific milestone dates, not treated as a process that will complete whenever everyone is available. The K-1 preparation chain (property level accounting, fund level income reconciliation, income allocation calculation, K-1 drafting, review, and delivery) has multiple sequential dependencies that require advance planning to complete before the September 15 extended deadline.
- Capital account errors compound. An incorrect allocation in Year 1 produces incorrect beginning balances in Year 2 and affects every subsequent year's allocations, K-1s, and waterfall calculations. The cost of discovering and correcting a multi-year capital account error at disposition, including amended K-1s, investor notifications, and recalculated waterfall distributions, is many times the cost of getting the calculation right each year.
- FATCA documentation must be collected from every foreign investor before the first distribution, and W-8 forms must be renewed before they expire (every three years from signing, absent a change in circumstances). A payment made to a foreign investor without a current W-8 on file is subject to 30 percent FATCA withholding or backup withholding, regardless of applicable tax treaties or FIRPTA provisions. W-8 expiration

tracking is a fund administrator function that must be set up as a proactive workflow, not discovered reactively when a distribution is about to be made.

- FIRPTA and Section 1446 withholding for foreign investors are not disposition only obligations. Section 1446 withholding on a foreign partner's allocable share of effectively connected income applies to periodic operating distributions throughout the hold period, not only at the final disposition sale. This calculation must be performed at each distribution event, and the withheld amounts must be remitted to the IRS on Form 8804 (annual) with Form 8813 (quarterly installments), separate from the fund's regular FATCA compliance under Forms 1042 and 1042-S.

## CHAPTER TWENTY NINE

# Refinancing, Recapitalization, and Mid Hold Events

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Private real estate investments rarely unfold exactly as underwritten. Markets move. Interest rates change. Properties appreciate faster than projected or face headwinds the original business plan did not anticipate. Capital needs emerge mid hold that were not contemplated at acquisition. Investors who committed for a defined hold period develop liquidity needs or change their own strategic priorities. The original loan matures before the property is ready for sale. In each of these circumstances, the sponsor faces decisions about the investment's capital structure and ownership that go well beyond the operational management discussed in the preceding chapters.

Mid hold capital events, including refinancings, recapitalizations, preferred equity infusions, and debt restructurings, are among the most legally complex transactions that arise in private real estate fund management. Each involves modifications to the investment's existing legal structure that require careful analysis of the operating agreement's authorization provisions, the existing lender's consent rights, the tax implications for investors, and the disclosure obligations that the antifraud provisions impose. Each also generates investor relations consequences that the sponsor must manage thoughtfully, because mid hold capital events that are not well communicated create the impression, sometimes accurate, that the investment is not proceeding as planned.

This chapter addresses the full range of mid hold capital events in private real estate: when and why sponsors refinance, and how refinancing proceeds are treated legally and for tax purposes; the mechanics of recapitalization and the consent, dilution, and economic negotiation issues those transactions raise; preferred equity infusions and debt restructuring as responses to distress or capital need; and the lender consent and transfer restriction analysis that underlies all of these events. Understanding these transactions, their legal requirements, their investor implications, and the traps that sponsors encounter by acting without adequate legal and financial analysis, is essential for any sponsor managing a real estate investment through a full hold period.

## When and Why Sponsors Refinance

Refinancing, meaning the replacement of an existing mortgage with new debt on the same property, is among the most common mid hold capital events in private real estate. Most commercial real estate loans have terms of three to ten years, meaning that properties held for

the typical five to seven year syndication hold period will require at least one refinancing during the investment's life. Some refinancings are compelled by the existing loan's maturity date. Others are initiated by the sponsor as a strategic tool for returning capital to investors, improving the property's debt terms, or repositioning the investment's capital structure for the next phase of the business plan.

The four primary reasons sponsors initiate refinancing during the hold period, described in order of frequency, are the following.

**Loan maturity.** The most common reason is straightforward. The existing loan is approaching or has reached its maturity date and the property is not yet ready for disposition. A three year bridge loan used to finance a value add acquisition must be replaced or extended when the renovation program runs longer than anticipated, when the property's lease up takes longer than projected, or when market conditions make disposition unattractive at the time of loan maturity. Loan maturity refinancing is not elective. It is a business necessity, and sponsors who do not plan for it well in advance of the maturity date create a crisis that lenders and investors view as a management failure.

**Cash out refinancing to return investor capital.** When a value add business plan successfully increases the property's value through renovation, lease up, and operational improvement, the increased value allows the property to support a larger loan amount at standard loan to value ratios. The incremental loan proceeds, meaning the difference between the new, higher loan amount and the existing loan balance, can be distributed to investors as a return of capital. This is a genuine strategic benefit of successful real estate investment: returning investors' original equity while they retain ongoing ownership of the property and continue to receive distributions from operations.

**Improved debt terms.** A property acquired with bridge financing at an elevated interest rate may qualify for permanent financing at a meaningfully lower rate after the business plan is executed and the property is stabilized. Refinancing to permanent debt at a lower interest rate reduces debt service, increases distributable cash flow to investors, and improves the investment's debt service coverage ratio. All of these benefit investors without requiring any change to the equity structure.

**Extension of the hold period.** When market conditions make disposition unattractive, whether because of cap rate expansion that has compressed values, an unfavorable macro environment for investment sales, or a property specific condition that requires resolution before sale, a refinancing that replaces a maturing loan with a new term loan gives the sponsor the time needed to maximize value before disposition. This is a legitimate strategy that benefits investors when it is well communicated and well executed. It becomes a problem when the refinancing is

done without adequate investor disclosure or when the extended hold period serves the sponsor's interests at investors' expense.

## The Refinancing Decision Framework

The sponsor's decision to initiate a refinancing, as distinct from responding to a loan maturity, should be evaluated against a clear framework that considers investor interests alongside the sponsor's operational and economic interests. The relevant questions are: Does the refinancing improve investor returns by reducing the cost of debt, returning capital that investors can redeploy, or extending the hold period to a point where disposition will generate better returns? Does the refinancing require investor consent under the operating agreement, and if so, has that consent been obtained? Does the existing loan permit refinancing, or does it contain prepayment penalties, yield maintenance provisions, or defeasance requirements that materially affect the economics of an early refinancing? Does the new lender require personal guarantees or other recourse enhancements that the existing structure does not carry?

Refinancing decisions that serve the sponsor's interests, such as extending the management fee period, avoiding a disposition that would trigger the promote, or maintaining operational control of an asset the sponsor would prefer not to sell, without adequately serving investor interests, are potential fiduciary duty violations. The sponsor's promoted interest is earned by delivering investor returns. Decisions that prioritize the sponsor's revenue stream over investor economics are decisions that the operating agreement's fiduciary duty provisions may not authorize. Sponsors who are uncertain whether a contemplated refinancing decision falls within their discretionary authority should confirm that analysis with securities or fund counsel before acting.

## Cash Out Refinancing: Investor Return of Capital Versus New Distribution

Cash out refinancing is the most economically significant form of mid hold refinancing from investors' perspective. When a property's value has increased from its acquisition price, the property can support a larger loan. The difference between the new loan amount and the prior loan balance represents equity that can be extracted and returned to investors without requiring a sale. For investors, this is one of the most compelling features of private real estate: the ability to receive a meaningful return of capital while retaining ongoing ownership and continuing to receive operating distributions.

A straightforward example illustrates the mechanics. A multifamily property acquired for \$8 million is financed with a \$5.6 million loan (70 percent loan to value) and \$2.4 million of investor equity. After a successful value add renovation, the property is worth \$12 million. A new loan at

70 percent loan to value on the \$12 million appraised value supports \$8.4 million of debt. After paying off the \$5.2 million remaining balance on the existing loan (principal reduced from the original \$5.6 million by paydown during the hold), the refinancing generates \$3.2 million of net proceeds that can be distributed to investors. Those investors receive \$3.2 million in cash while retaining their equity ownership in a property that continues to generate operating income, a liquidity event that does not require selling the asset or recognizing a capital gain at that moment.

### **Tax Characterization of Refinancing Proceeds**

The tax treatment of cash out refinancing proceeds is one of the most favorable aspects of real estate investment from a tax planning perspective, and it is one that investors in private real estate syndications should understand clearly. The IRS treats loan proceeds, including cash out refinancing proceeds, as debt, not as income. An investor who receives \$200,000 from a cash out refinancing distribution does not recognize \$200,000 of taxable income in the year of receipt. The proceeds are tax free at the time of distribution because they represent borrowed money, not realized gain.

Instead, the refinancing distribution reduces the investor's adjusted basis in their partnership interest. This basis reduction is the mechanism through which the tax deferral works: the investor receives cash now without paying tax, but their future gain at disposition is increased by the amount their basis was reduced. When the property is eventually sold, the investor will recognize the gain that was deferred by the basis reduction, taxed at that time at applicable capital gains rates. The refinancing does not eliminate the tax. It defers it to the eventual disposition.

The basis reduction dynamic has an important limit. If a refinancing distribution exceeds the investor's remaining adjusted basis in their partnership interest, the excess is immediately taxable as a capital gain in the year of distribution, even though no sale has occurred. Consider an investor who contributed \$100,000 to the fund, has received prior distributions and loss allocations that reduced their basis to \$30,000, and then receives a \$50,000 refinancing distribution. That investor has received \$20,000 in excess of their remaining basis. That \$20,000 is a taxable capital gain in the year of the refinancing distribution, regardless of whether the property has been sold. Sponsors must alert investors to this possibility when distributing refinancing proceeds, and the fund's tax adviser must evaluate the basis impact for each investor before distributions are made.

**⚠ Refinancing Proceeds Are Tax Deferred, Not Tax Free, and Excess Distributions Are Immediately Taxable**

*Cash out refinancing distributions reduce the investor's adjusted basis in their partnership interest. The tax is deferred to the eventual disposition, not eliminated. When the property is sold, the investor recognizes additional gain because their basis was reduced by each prior distribution that was not matched by an equivalent income allocation.*

*More immediately consequential, a refinancing distribution that exceeds the investor's remaining adjusted basis is a taxable capital gain in the year of the distribution, regardless of whether the property has been sold. Investors who have received significant depreciation allocations and prior operating distributions may have lower remaining basis than they realize. The fund's tax adviser should calculate the basis impact for each investor before a large refinancing distribution is made and communicate the result to investors with adequate advance notice to allow for tax planning.*

*Sponsors who distribute refinancing proceeds without this analysis expose investors to unexpected tax liabilities that generate investor relations problems and, in some circumstances, investor claims.*

## Impact on Preferred Return Tracking and Waterfall Mechanics

A cash out refinancing distribution is not merely a check written to investors. It is a capital event that requires specific treatment within the operating agreement's waterfall and changes the calculation of certain ongoing obligations. The specific impact depends on two questions that the operating agreement must answer. Is the refinancing distribution treated as a return of capital, reducing each investor's unreturned capital contribution? And if the preferred return accrues on unreturned capital, rather than on original contributed capital, does the return of capital reduce the preferred return basis going forward?

In most real estate syndication operating agreements, refinancing proceeds flow through the waterfall as a capital event, similar to disposition proceeds but without triggering the promote, because the property has not been sold. The tier structure applied to refinancing proceeds typically first returns unreturned capital to investors and the sponsor in proportion to their contributions; second pays any accrued but unpaid preferred return; and third, if proceeds remain, applies the applicable split between investors and the sponsor. The specific tier treatment determines whether the sponsor receives any promoted interest from the refinancing proceeds, an economically significant question when the refinancing generates material proceeds above what is needed to return capital.

After the refinancing distribution, if the preferred return accrues on unreturned capital, the preferred return calculation going forward applies to the reduced unreturned capital balance. An



investor who contributed \$500,000, received \$300,000 as a return of capital from the refinancing, and has a preferred return that accrues on unreturned capital will going forward accrue their preferred return on the remaining \$200,000, not on the original \$500,000. This reduces the fund's ongoing preferred return obligation and accelerates the point at which future distributions flow to the promote tier. The fund administrator must update the preferred return calculation methodology following every refinancing distribution that reduces unreturned capital.

## Recapitalizations: Bringing In New Capital Mid Hold

A recapitalization is a restructuring of the investment's capital stack, meaning the mix of debt and equity that finances the property, that goes beyond a standard refinancing by changing the equity ownership structure, not merely the debt. Unlike a refinancing, which replaces one loan with another without altering the investor ownership relationships, a recapitalization introduces new equity capital into the investment, potentially changes the distribution of economic rights among existing and new investors, and in many cases requires modifications to the operating agreement and the waterfall that govern how returns are shared.

Recapitalizations arise in two fundamentally different contexts that produce different legal and economic dynamics. Value creation recapitalizations occur where a successfully executed business plan has created equity value and the sponsor wants to monetize some of that value while retaining the property. Rescue recapitalizations occur where an investment is under financial stress and the sponsor needs new capital to stabilize the property, address a loan maturity default, or fund capital improvements the operating cash flow cannot support. The legal and investor relations considerations differ substantially between these two contexts, although the operational mechanics of each involve many of the same elements.

### Investor Consent Requirements

The operating agreement governs whether a recapitalization requires investor consent, and the answer is almost always yes, although the specific consent threshold varies. A recapitalization that introduces new equity into the fund, dilutes existing investors' percentage interests, modifies the distribution waterfall, or changes the governance rights of existing investors is a material modification of the terms on which those investors committed capital. Most operating agreements treat these modifications as major decisions requiring at minimum majority investor approval, and many require supermajority or even unanimous consent depending on the nature of the modification.

The specific provisions to review in the operating agreement before proceeding with any recapitalization include: the definition of 'major decisions' or 'major events' that require investor approval; the consent threshold for each category of major decision (majority of units outstanding, majority of capital contributions, supermajority, or unanimity); whether the

admission of new members and the modification of the waterfall are treated as distinct major decisions with different thresholds; and any anti-dilution provisions that protect existing investors from being diluted below a defined minimum ownership percentage or return threshold without their individual consent.

A recapitalization completed without the required consent is not merely an operating agreement breach. It is a modification of the terms of investors' securities investment without their knowledge or approval, which carries potential securities law dimensions under the antifraud provisions. An investor who discovers that their ownership percentage was diluted, or that the waterfall economics were modified in ways that reduce their return, without the consent the operating agreement required, has a basis for claims that extend beyond contract law. Securing the required consents before the recapitalization closes, not after, is the only defensible approach.

## Dilution Mechanics and Anti-Dilution Protections

Every recapitalization that introduces new equity capital dilutes the existing investors' percentage ownership of the fund. If the fund has \$5 million of existing equity and the recapitalization introduces \$2 million of new equity, the existing investors who previously owned 100 percent of the fund's equity now own approximately 71 percent (their \$5 million out of the new \$7 million total equity base). The remaining 29 percent belongs to the new investors. This dilution of percentage ownership does not necessarily dilute the existing investors' ultimate dollar return, because the recapitalization also changes the fund's value base and capital structure. But whether existing investors are made whole economically by the recapitalization depends entirely on how the transaction is structured.

Anti-dilution protections in the operating agreement are designed to prevent existing investors from being diluted in ways that reduce their economic return below what they were promised when they committed capital. Common forms of anti-dilution protection include the following.

- **Preferred return floor:** existing investors' preferred return continues to accrue on their original contributed capital regardless of dilution, ensuring that the introduction of new equity does not reduce the preferred return obligation to existing investors.
- **Return of capital priority:** existing investors' unreturned capital retains its priority position in the waterfall regardless of the capital structure changes made in the recapitalization, so that new equity investors cannot achieve senior economics that push existing investors' return of capital lower in the distribution sequence.
- **Minimum ownership floor:** the operating agreement specifies that existing investors cannot be diluted below a defined minimum ownership percentage without their individual consent, regardless of how new equity is admitted.

- **Pre-emptive rights:** existing investors have the right to participate in the new equity round at the same terms offered to new investors, allowing them to maintain their existing percentage ownership by investing additional capital.

In the absence of specific anti-dilution provisions, existing investors' only protection is the operating agreement's general consent requirements and the sponsor's fiduciary duty to structure the recapitalization on terms that are fair to existing investors. In practice, the adequacy of those protections, and whether the recapitalization's specific terms satisfy them, requires careful legal analysis before the transaction closes. Sponsors who rely on the absence of specific anti-dilution language as permission to structure the recapitalization on whatever terms the new capital providers require are taking on significant investor relations and legal risk.

## New Investor Terms Versus Existing Investor Terms

One of the most contentious aspects of mid hold recapitalizations is the differential treatment of new and existing investors. New capital providers typically enter with negotiated terms that reflect the property's current conditions, the fund's current performance relative to underwriting, and the market environment at the time of the recapitalization, which may be materially different from the conditions under which existing investors committed capital. This creates a structural tension. New investors are investing in a known asset at current market terms, while existing investors made their commitment based on projected terms and the original business plan. Their respective interests are not naturally aligned.

Common differentials between new and existing investor terms in recapitalizations include the following.

**Priority in the waterfall.** New capital providers often negotiate for a priority return of their capital ahead of existing investors, recognizing that they are taking a top up position in an investment that has already been partially de risked by the execution of the original business plan. This priority may be structured as a preferred equity tranche with liquidation preference ahead of the existing common equity, or as a reset of the waterfall that gives new capital a first money out position. Whether this priority is permissible under the existing operating agreement's anti-dilution protections depends on the specific language of those provisions.

**Reset of the promote.** When a recapitalization is used to bring in a new co GP or equity partner at the sponsor level, the parties must negotiate how the existing promote is affected. A full promote reset, treating the recapitalization as if it were a new investment from scratch, benefits the new equity partner at the expense of the existing LP base, whose accumulated preferred return and capital return position may effectively start over. A partial promote reset, or a structure that grandfathers the existing investors' position through the recapitalization, is more protective of their interests but more complex to document.

**Management fee adjustments.** New capital providers who participate at the fund level may negotiate for a reduction or restructuring of the management fee that the sponsor charges the fund, recognizing that the management fee is a cost that affects all investors' returns. Existing investors who were promised a specific fee structure in the PPM may have claims if that structure is unilaterally modified through the recapitalization without their consent.

**⚠ Recapitalization Disclosure Is Not Optional. It Is a Securities Obligation.**

*A recapitalization that modifies the terms of existing investors' securities interests is a material event that must be disclosed to those investors promptly, specifically, and completely. This disclosure obligation is not merely a contractual requirement under the operating agreement. It is a requirement of the antifraud provisions of the federal securities laws, which prohibit material omissions in connection with the ongoing ownership of securities.*

*Existing investors are entitled to know the valuation at which new capital is being admitted; the economic terms offered to new capital providers and how those terms compare to existing investors' terms; the effect of the recapitalization on existing investors' unreturned capital, preferred return accrual, and distribution waterfall position; any changes to the sponsor's management fee or promoted interest structure; and the governance implications of any new investors who receive voting or consent rights in the recapitalized structure.*

*A recapitalization that proceeds without full disclosure to existing investors, or that is disclosed in general terms that obscure the economic impact on their position, is a potential securities law violation regardless of how it is structured legally.*

## Preferred Equity Buyouts and Debt Restructuring

When a real estate investment encounters financial stress, whether a loan maturity that cannot be refinanced at acceptable terms, a debt service shortfall from operating underperformance, or a capital need the fund's reserves and operating cash flow cannot meet, the sponsor faces decisions that are more urgent and more consequential than the strategic recapitalizations described in the preceding section. In these distressed circumstances, the range of capital solutions available narrows, the economic terms of available solutions are unfavorable, and the legal complexity of the transactions increases substantially because every party in the capital stack has its own rights, remedies, and incentives that may not align with the sponsor's.

### Preferred Equity as a Mid Hold Capital Solution

Preferred equity is an ownership interest in the entity that owns the property, structured to have economic characteristics similar to debt: a stated return (the preferred return on the preferred equity, distinct from the common equity preferred return), priority over common equity in the distribution sequence, and, in most preferred equity structures, specific remedies if the preferred return accrues and is not paid, including the right to remove the common equity manager and take control of the property.

In the context of a distressed mid hold investment, preferred equity typically functions as rescue capital. A new equity investor provides capital that the existing common equity investors cannot or will not contribute, in exchange for a priority position in the capital stack that subordinates the existing common equity's economic rights. The preferred equity investor receives first money out status. Its capital plus accrued preferred return must be repaid in full before any distributions reach the existing common equity investors. This priority substantially protects the preferred equity investor's capital at the expense of the existing common equity investors, whose returns are deferred until the preferred equity is fully satisfied.

The terms of preferred equity are negotiated based on the severity of the distress, the property's underlying fundamentals, and the bargaining position of the respective parties. In current market conditions, preferred equity returns for distressed or rescue capital situations have ranged from 12 percent to 18 percent or more annually, reflecting the elevated risk of a capital in distress position and the compounding nature of most preferred equity structures, where unpaid preferred return accrues on the accrued unpaid balance (compound accrual) rather than merely on the original investment. A preferred equity investor whose return accrues at 15 percent compounded on a \$1 million investment that remains unreturned for three years receives approximately \$1.52 million at exit. The existing common equity investors must therefore generate at least \$1.52 million from the property's eventual proceeds before any distributions reach them, regardless of how much capital they originally contributed.

Agency lenders treat subordinate capital with care, and the specific rules differ between Fannie Mae and Freddie Mac. Freddie Mac generally prohibits mezzanine debt and other secured or second lien financing behind its senior mortgage, while permitting carefully structured preferred equity under detailed program requirements that the operating agreement must satisfy. Fannie Mae permits both mezzanine financing (when originated by an approved DUS lender affiliate, or approved on a case by case basis) and preferred equity, each subject to its own pre review and documentation conditions. The takeaway in either case is the same. Before any preferred equity or other subordinate capital is admitted, the existing lender must review the proposed structure and confirm its compliance with the loan agreement's transfer restriction and subordinate debt provisions, and the borrower must allow time for that approval process within the recapitalization timeline.

## Debt Restructuring

When the primary cause of financial stress is the existing loan itself, whether an adjustable rate loan whose rate has increased substantially, a loan maturing in a market that does not support refinancing at adequate proceeds, or a loan whose covenants are in default, the sponsor must negotiate with the existing lender to restructure the debt on terms that allow the investment to survive and recover. Debt restructuring is a negotiation with the lender about modifying an existing contract. It does not require investor consent in the same way that equity recapitalizations do, although the operating agreement may require investor notification of a material loan modification.

The most common debt restructuring mechanisms in commercial real estate are the following.

**Loan extension.** The lender agrees to extend the loan's maturity date, typically by one to two years, allowing the sponsor additional time to execute the business plan and achieve conditions that support refinancing or disposition. Extensions typically require a fee (often 0.5 percent to 1.0 percent of the outstanding principal), may require a partial principal paydown, and typically adjust the interest rate or add additional covenants. Extension is the least disruptive restructuring option and the one lenders are most willing to consider when the property's underlying fundamentals are sound.

**Interest rate reduction or forbearance.** In cases where the debt service burden is causing a cash flow shortfall, the lender may agree to temporarily reduce the interest rate or to capitalize accruing interest (converting it to principal) for a defined forbearance period. Forbearance agreements typically require strict compliance conditions. Any deviation from the agreed plan terminates the forbearance and triggers the original default remedies.

**Loan modification (principal write down).** In cases of severe distress where the property's current value is significantly below the outstanding loan balance, meaning a loan to value inversion, the lender may agree to a principal reduction in exchange for other concessions (additional equity from the sponsor, a modification of the loan's terms, or the lender's participation in future appreciation if the property recovers). Principal write downs are uncommon but not unheard of in workout situations where the alternative for the lender is a lengthy and expensive foreclosure process.

**Deed in lieu of foreclosure or short sale.** When neither extension nor modification is viable and the property cannot support the existing debt, the sponsor may negotiate with the lender to transfer the property without formal foreclosure (deed in lieu) or to sell the property for less than the outstanding loan balance with the lender's agreement to release the lien (short sale). Either transaction typically discharges the borrower from further loan obligation, with the significant exception of any personal guarantee that extends to the deficiency balance.

## **Lender Consent Issues and Transfer Restrictions**

Every mid hold capital event, whether a refinancing, a recapitalization, a preferred equity infusion, or a debt restructuring, must be evaluated against the existing loan documents before it is implemented. Commercial real estate loan agreements contain provisions that restrict the borrower's ability to modify the property's ownership structure, admit new investors, add subordinate debt, or make other changes to the capital stack without the lender's prior written consent. These provisions are not mere formalities. Violating them is a loan default that gives the lender the right to exercise remedies, including acceleration of the outstanding loan balance.

### **Transfer Restriction and Due on Sale Provisions**

Almost every commercial mortgage loan agreement contains transfer restriction provisions that limit the borrower's ability to transfer ownership of the property or the entity that owns it without the lender's prior written consent. For an LLC that owns a real estate asset, these provisions typically restrict the transfer of any ownership interest in the LLC (both direct membership interests and indirect interests through a holding company); the admission of new members; changes in the managing member or general partner; and any other transaction that constitutes a change of control under the loan agreement's definition.

The scope of these restrictions varies significantly by lender, loan program, and the specific loan agreement. Agency loans (Fannie Mae and Freddie Mac) for multifamily properties typically have well defined and standardized transfer restriction provisions that permit transfers to affiliates and to qualified replacement entities under specified conditions, but prohibit arm's length transfers without consent and credit review. Bridge loans and CMBS loans have their own transfer restriction provisions that may be broader or narrower depending on the specific loan terms.

A recapitalization that admits new equity investors is a transfer of a portion of the ownership interest in the borrower entity, and therefore is typically subject to the loan's transfer restriction provisions regardless of whether the property itself changes hands. A sponsor who completes a recapitalization by admitting new investors and modifying the operating agreement without obtaining lender consent has potentially triggered a loan default even if the property's performance is strong and debt service is current. The lender's remedy may not be immediate foreclosure, but it does give the lender leverage it did not previously have, and it places the sponsor in a defensive position with respect to the lender at precisely the moment when the sponsor needs maximum flexibility.

### **Due on Encumbrance and Subordinate Debt Restrictions**

In addition to transfer restrictions, most commercial mortgage loan agreements prohibit the borrower from incurring additional debt secured by the property or the entity that owns it without



the lender's prior written consent. This prohibition is typically stated as a due on encumbrance clause: any additional encumbrance on the property constitutes a default. The prohibition extends to subordinate mortgages, mezzanine loans, and, in many loan agreements, to preferred equity arrangements structured in ways that give the preferred equity investor effective security or foreclosure like remedies against the property.

The boundary between permissible preferred equity (which most lenders allow as an equity arrangement) and prohibited subordinate debt (which most lenders prohibit) is one of the most significant and most frequently litigated questions in real estate capital structure law. Lenders are increasingly focused on whether preferred equity arrangements, particularly those with mandatory redemption provisions, step down economics, or default remedies that include the right to foreclose on or transfer the underlying property, are functionally equivalent to mezzanine debt and therefore subject to the loan's subordinate debt prohibition. A preferred equity structure that crosses this line, even if it is technically documented as equity, may trigger a loan default if done without lender consent.

Before any preferred equity is admitted or subordinate capital is introduced into the capital stack, the existing lender's transfer restriction and subordinate debt provisions must be reviewed by counsel experienced in real estate finance. In many cases, the lender's consent is required, and the process of obtaining that consent takes time, involves the lender's own legal review, and may result in conditions or fees that affect the economics of the preferred equity transaction. Building the lender consent process into the timeline for any recapitalization or preferred equity transaction is a planning requirement, not an afterthought.

### **⚠ Lender Consent Analysis: What to Check Before Any Mid Hold Capital Event**

*Transfer restriction provisions. Does the loan restrict transfers of ownership interests in the borrower entity? What constitutes a 'transfer' under the loan agreement's definitions? Is the admission of a new member or limited partner a restricted transfer? What consent process is required, and what is the lender's review timeline?*

*Subordinate debt and preferred equity provisions. Does the loan prohibit subordinate mortgages, mezzanine loans, or additional liens? Does the prohibition extend to preferred equity arrangements? What is the lender's test for whether preferred equity is treated as debt? For agency loans, does the agency program specifically permit preferred equity, and on what conditions?*

*Change of control provisions. Is there a defined 'control' concept in the loan agreement? Does the recapitalization result in a change of control that triggers consent obligations?*



*Does the existing guaranty survive a change of control, and will the lender require a replacement guarantor?*

*Prepayment and yield maintenance provisions (for refinancing). Does the loan carry a prepayment penalty? If so, what is the applicable period? Is there a yield maintenance or defeasance requirement? What is the lockout period during which prepayment is prohibited entirely? What is the economic cost of early payoff relative to the benefit of refinancing?*

*DSCR and LTV covenant implications. Does the existing loan have financial maintenance covenants that could be affected by the capital event? Will the new debt service under a refinancing affect DSCR coverage? Is the new loan to value consistent with lender covenants on additional debt?*

## Mid Hold Capital Events: Comparative Analysis

The table below summarizes the key legal and operational dimensions of the most common mid hold capital events. It is intended to assist sponsors in structuring and sequencing the necessary analysis before proceeding.

| Event                               | Operating Agreement Issues                                                                                                                                               | Lender Consent Issues                                                                                                                            | Tax Issues                                                                                                                       | Investor Disclosure                                                                                            |
|-------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------|
| Standard refinancing (rate or term) | Typically within sponsor's discretionary authority; review for any major decision consent requirement for loan modifications                                             | Prepayment penalties; yield maintenance; lockout period; consent required if loan documents restrict refinancing without approval                | No immediate tax event; basis adjustments if loan amount increases above investor basis                                          | Material event notice if loan terms change materially; disclosure if hold period is being extended             |
| Cash out refinancing                | Distribution of proceeds requires waterfall analysis; preferred return tracking update required; may require investor consent if material modification of economic terms | Same as rate or term, plus lender review of increased LTV; agency programs may restrict cash out amount or require minimum DSCR post refinancing | Proceeds reduce investor basis; excess over basis is taxable capital gain; fund adviser must calculate basis impact per investor | Full disclosure of proceeds amount, waterfall treatment, basis impact, and any investor specific taxable event |
| Value creation recapitalization     | Almost certainly a major decision requiring investor consent; admission of                                                                                               | Transfer restriction consent typically required; change of control analysis;                                                                     | Existing investors may recognize gain if interest is sold; valuation for                                                         | Full disclosure of recapitalization terms, dilution impact, new                                                |

| Event                                | Operating Agreement Issues                                                                                                              | Lender Consent Issues                                                                                                                  | Tax Issues                                                                                                                                             | Investor Disclosure                                                                                                                            |
|--------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------|
|                                      | new members; modification of waterfall; anti-dilution analysis                                                                          | replacement guarantor may be required                                                                                                  | new equity admission must be supportable                                                                                                               | investor economics, effect on existing waterfall, any promote reset                                                                            |
| Rescue or distress recapitalization  | Investor consent required; anti-dilution analysis; preferred equity investor's governance rights may require special approval           | Lender approval required; intercreditor agreement if preferred equity has debt like remedies; Non-Recourse carve out exposure analysis | Complex analysis required; rescue capital may generate cancellation of debt income if existing debt is modified; preferred equity tax characterization | Immediate material event disclosure; full disclosure of distress conditions, new capital terms, existing investor dilution, governance changes |
| Debt restructuring or loan extension | Major decision provisions may require investor consent for material loan modifications; notification obligations in operating agreement | Lender driven process; extension fees; modified covenants; additional equity may be required; guaranty reassessment                    | Loan modification may trigger OID rules; principal write down produces cancellation of debt income at entity level, passed through to investors        | Material event disclosure; disclose nature of distress, restructuring terms, investor economic impact, any additional capital required         |

## Practical Takeaways

- Mid hold capital events (refinancings, recapitalizations, preferred equity admissions, and debt restructurings) are among the most legally complex transactions in private real estate fund management. Each touches the operating agreement's consent provisions, the existing lender's transfer restriction rights, and the antifraud disclosure obligations simultaneously. Acting without adequate legal analysis in any one of these dimensions creates liability exposure that well timed counsel involvement would have prevented.
- Cash out refinancing distributions are tax deferred, not tax free. The proceeds reduce the investor's adjusted basis in their partnership interest, and the deferred tax is recognized at disposition. More immediately, a distribution that exceeds the investor's remaining adjusted basis creates a taxable capital gain in the year of the distribution, regardless of whether the property has been sold. The fund's tax adviser must calculate the basis impact for each investor before any large refinancing distribution is made and communicate the result to investors with adequate advance notice.

- Refinancing proceeds flow through the waterfall as a capital event and must be allocated in accordance with the waterfall's tier structure. The preferred return tracking must be updated after any return of capital, because if the preferred return accrues on unreturned capital, the distribution reduces the going forward preferred return obligation. The fund administrator must update the preferred return calculation methodology following every refinancing distribution.
- Every recapitalization that admits new equity, modifies the waterfall, or changes existing investors' economic rights requires investor consent under the operating agreement. The specific consent threshold (majority, supermajority, or unanimity) must be confirmed before the transaction is documented. A recapitalization completed without required consent is not merely a contract breach. It is a potential securities law violation under the antifraud provisions.
- Preferred equity admitted mid hold to address financial distress carries governance rights, typically including the right to remove the manager and control disposition, which change the fund's governance structure materially. These governance changes require investor disclosure and likely investor consent. The preferred equity investor's remedies against the existing common equity investors must be documented in the fund's amended governing documents, not merely in the preferred equity investment agreement.
- Agency lender treatment of subordinate capital is rule driven and lender specific. Freddie Mac generally prohibits mezzanine debt while permitting carefully structured preferred equity. Fannie Mae permits both, each under specific program requirements. Before any subordinate capital is introduced, the existing lender's transfer restriction and subordinate debt provisions must be reviewed by counsel, and the boundary between permissible preferred equity and prohibited subordinate debt must be confirmed for the specific loan agreement. The general rule does not override the specific contractual language.
- Debt restructuring negotiations with lenders occur in the shadow of the lender's remedies. The lender knows it can accelerate the loan and pursue foreclosure, which gives it leverage in the negotiation. Sponsors who approach loan restructuring with experienced real estate and finance counsel, with a clear understanding of the property's value relative to the loan balance, and with a proposed restructuring plan that credibly addresses the source of the distress, achieve meaningfully better outcomes than those who approach the lender without that preparation.
- Transfer restriction provisions in loan documents cover more than the sale of the property. They typically cover any transfer of ownership interests in the borrower entity, including the admission of new members in a recapitalization. Completing a

recapitalization without confirming lender consent requirements under the loan documents is a loan default that the lender may not forgive, regardless of the investment's financial health. Build the lender consent timeline into the recapitalization planning from day one.

- Existing investors have a right to specific, timely disclosure of every mid hold capital event that materially affects their investment. The antifraud provisions apply continuously, not only during the offering period. A recapitalization, a preferred equity infusion, or a debt restructuring that materially changes the investment's risk profile, economic terms, or governance structure must be disclosed to existing investors promptly, specifically, and completely, including the economic impact on their unreturned capital, preferred return accrual, waterfall position, and governance rights

**CHAPTER THIRTY**

# Disposition: Selling the Asset or Fund Portfolio

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The disposition is the investment's final chapter and its definitive test. Every underwriting assumption, every operational decision, every investor communication over the hold period ultimately flows to a single event: the sale. The realized return, meaning the number that will define the investment in every investor's memory and in the sponsor's track record, is determined by the combination of execution during the hold period and execution at exit. A sponsor who managed the asset well for five years and then executed the disposition poorly has left significant value on the table. One who navigated a difficult hold period and then executed an outstanding sale has delivered an outcome that the underwriting alone would not have predicted.

For sponsors, the disposition is also the moment of greatest legal and fiduciary complexity in the investment's lifecycle. Broker selection involves duty of care considerations. Purchase agreement negotiation involves representations, warranties, and indemnification obligations that persist after closing. Investor consent requirements impose procedural obligations that cannot be ignored because a transaction timeline is pressing. The final waterfall distribution must be calculated precisely, with all tax implications understood and communicated before cash is distributed. Depreciation recapture creates tax consequences for investors that were not visible during the hold but that arrive suddenly at disposition. Clawback calculations may require the sponsor to return previously received promote payments. And for investors seeking to defer their tax consequences through a 1031 exchange, the disposition triggers a cascade of time sensitive obligations that cannot wait for the closing statement to be finalized.

This chapter covers the complete disposition process for a private real estate syndication or fund: exit strategy planning and the triggers that should initiate the sale process; the sale process from broker selection through purchase agreement execution; investor consent requirements; the final waterfall distribution and the tax implications for investors; entity wind down and dissolution; 1031 exchange planning considerations; and the additional considerations that arise when a fund is selling its entire portfolio rather than a single asset.

## Exit Strategy Planning

Exit strategy planning is not a closing period task. The best dispositions are executed by sponsors who began thinking about exit conditions, market timing, and buyer universe before the investment closed, sponsors who structured the business plan with a specific disposition

thesis in mind and who monitored market conditions throughout the hold period with an eye toward identifying the optimal exit window. Sponsors who first turn their attention to the exit strategy when the loan is maturing or investors are asking for their money back are operating reactively in a process where proactive positioning creates material value.

## Hold Period and Disposition Timing

The operating agreement typically specifies a target hold period, commonly three to seven years for value add investments and five to ten years for core or stabilized investments. This target is not a contractual commitment to sell. It is the planning horizon around which the business plan was organized and the hold period that investors accepted when they committed capital. The sponsor generally has discretionary authority to sell within a range of timing around the target, subject to investor consent requirements for dispositions that fall significantly outside the stated hold period.

Optimal disposition timing is the intersection of three conditions. First, the property has executed its business plan (the renovation is complete, the lease up is achieved, the operational improvements are realized). Second, the investment market is receptive (cap rates at exit are at or below the exit cap rate assumed in the underwriting). Third, the debt structure is compatible with an exit (the loan is not in a lockout period, prepayment penalties are manageable, or the loan can be assumed by the buyer). When all three conditions are met simultaneously, the case for proceeding with disposition is strong. When one or more conditions are absent, the sponsor must evaluate whether waiting for better conditions will generate returns superior to selling now.

The hold period decision has a time value of money dimension that sponsors sometimes underweight. A property that is fully stabilized, meaning it is generating the expected NOI with no remaining business plan execution to complete, is essentially a static return asset. The equity invested is generating a steady preferred return and, in many cases, has already triggered a promote through the stabilization achievement. Continuing to hold that stabilized asset ties up investor capital that could be redeployed into higher returning opportunities. In a market where cap rates are stable or compressing, the argument for continuing to hold a fully executed business plan is weaker than sponsors who enjoy the management fee income from ongoing operations sometimes acknowledge.

## Market Conditions and Disposition Triggers

The primary market conditions that should trigger or accelerate disposition planning are the following. Cap rate compression occurs when exit cap rates are lower than the underwriting assumed, property values are higher than projected, and selling now captures upside that may not persist. Strong buyer competition occurs when there are multiple credible buyers for the asset type and a well-run process will generate competitive bidding that maximizes proceeds.

Favorable debt assumption conditions occur when the property carries assumable debt at a below market interest rate that enhances buyer economics and expands the buyer universe.

Conditions that counsel against proceeding immediately with disposition include the following. A loan in lockout or with substantial defeasance costs effectively reduces the seller's net price. Lease expirations within 12 to 18 months create occupancy uncertainty that the market will price as risk. Renovation programs not yet fully reflected in stabilized NOI mean that buyers will underwrite to trailing NOI, not to the projected stabilized NOI the sponsor sees in the model. An acquisition cost basis that puts the sponsor below the minimum return thresholds investors committed to makes a disposition at current values a financial disappointment regardless of market conditions.

### **Alignment of Sponsor and Investor Interests at Exit**

The disposition decision is one of the few points in the investment lifecycle where the sponsor's economic interests and investors' economic interests may not be perfectly aligned, and where the operating agreement's fiduciary duty provisions and investor consent requirements are most directly implicated. The sponsor earns management fees as long as the fund holds the property. The sponsor earns the promote only when the property is sold and the waterfall is calculated. Investors receive their full return only at disposition. These different economic structures create different incentive profiles for the timing of the exit.

A sponsor whose management fee revenue is substantial relative to the promote earned at the projected exit return has an economic incentive to delay disposition that investors do not share. A sponsor whose promote has already been partially captured through interim distributions during the hold has less urgency to execute a strong exit than one whose entire promote depends on the disposition price. These misalignments are not hypothetical. They arise regularly in real estate fund management and are the subject of investor claims when the sponsor's disposition timing decision appears to have served the sponsor's interests over investors'.

The operating agreement's answer to this tension is the investor consent requirement for disposition, a provision that requires investor approval above a defined threshold before the property can be sold and ensures that investors have meaningful input into the timing and terms of the exit. Sponsors who understand the incentive misalignment at exit, and who actively manage it through transparent communication about the disposition rationale, the market conditions driving the timing, and the proceeds calculation, build investor relationships that support future capital formation. Sponsors who make disposition decisions without adequate investor communication, or who time the exit in ways that maximize the management fee period rather than investor returns, do the opposite.

## The Sale Process

The mechanics of selling a commercial real estate asset in a syndicated fund context are substantively similar to any commercial real estate sale, with the additional legal and investor relations dimensions that the fund structure imposes. The sale process from broker selection to purchase agreement execution involves decisions at each stage that affect the proceeds realized, the timeline achieved, the representations the sponsor makes, and the closing conditions the sponsor must satisfy.

### Broker Selection and Marketing Strategy

The disposition broker, meaning the commercial real estate brokerage firm retained to market the property and manage the sale process, is the sponsor's primary market access point for the disposition. The broker's relationships with active buyers for the specific property type in the specific market, their understanding of pricing and deal structure, and their ability to generate competitive bidding are the primary determinants of whether the sale achieves the top of the market range or leaves proceeds on the table. Broker selection is not a formality. It is a material decision that directly affects investor returns.

The selection process for a disposition broker should evaluate the broker's specific track record with recent comparable sales in the same submarket and property type; the size and quality of their buyer database for this asset profile; the fee structure (disposition fees typically range from 0.5 percent to 2 percent of gross sale price depending on property size, with lower percentage fees on larger transactions); whether they will market the property through a broad process or a targeted process; and the composition of the team that will actually handle the assignment, not just the senior principal who presents for the assignment.

Marketing strategy decisions, meaning whether to run a broad marketed process with a controlled auction or to target a select list of known buyers, affect the timeline, the proceeds, and the confidentiality of the disposition. Broad marketed processes with formal bid deadlines typically generate the widest buyer competition and the highest prices when the asset is high quality, the market is liquid, and the seller has adequate time to run a full process. Targeted seller outreach to a curated list of known buyers can produce faster execution and better confidentiality when speed matters more than maximizing competition, or when the asset has characteristics that appeal to a narrow buyer universe. The operating agreement's investor consent provisions, if they impose a disposition timeline, affect which marketing approach is operationally feasible.

The disposition fee paid to the broker is a cost of sale that reduces net proceeds to investors. Most operating agreements permit the sponsor to pay a disposition fee to an affiliated property management company or disposition consultant in addition to the third party broker fee, a



practice that institutional investors scrutinize as a potential conflict of interest. If the operating agreement permits an affiliated disposition fee, it must be disclosed in the investor communication announcing the pending sale. If it was not disclosed in the original PPM, paying an affiliated disposition fee at exit may create an investor relations problem regardless of the operating agreement's technical authorization.

## **Confidentiality Agreements and Data Room Management**

Before providing any prospective buyer with detailed property financials, rent rolls, operating statements, or other non-public information about the investment, the sponsor should require execution of a confidentiality agreement, also called a non-disclosure agreement. The confidentiality agreement restricts the prospective buyer's use of the information to evaluation of the specific acquisition and prohibits disclosure to third parties. For a fund investment, the confidentiality agreement should also address confidentiality of the fund's terms and structure, not only the property specific information.

The data room, meaning the organized collection of property information made available to prospective buyers during their due diligence, should be curated by the sponsor and the disposition broker before the marketing process begins. A well organized data room includes historical operating statements for three to five years; current rent roll with lease abstracts for all tenants; property inspection reports and deferred maintenance assessments; environmental reports (Phase I and Phase II if applicable); title commitment and survey; current property tax assessments and appeal history; insurance certificates and claims history; capital expenditure records for the hold period; and any lender required documents that a buyer would need to evaluate a loan assumption. Documents that are not in the data room create requests from buyers who discover their absence during diligence, adding friction and delay to the closing timeline.

## **Letter of Intent and Purchase Agreement Negotiation**

The letter of intent is the document through which the sponsor and the selected buyer agree on the primary economic and structural terms of the sale before the formal purchase agreement is drafted. Most letters of intent are non-binding (with the exception of specific provisions like exclusivity and confidentiality), but they establish the framework within which the purchase agreement will be negotiated. Terms that are left ambiguous in the letter of intent become negotiating points in the purchase agreement at a stage when neither party has significant leverage to change the deal structure.

Key letter of intent terms that deserve careful attention from the seller's perspective include the purchase price; the earnest money deposit and its refundability conditions; the due diligence period length (commercial real estate letters of intent commonly provide 30 to 60 days of due

diligence); whether the earnest money goes hard at execution of the purchase agreement or at the end of the due diligence period; the closing timeline after the due diligence period ends; the scope of seller representations and warranties; any exclusivity period during which the seller cannot market to other buyers; and any conditions precedent to closing beyond due diligence.

The purchase agreement is the binding contract that governs the actual sale transaction. For a fund that owns a commercial property, the purchase agreement's representations and warranties, meaning the seller's affirmative statements about the property's condition, legal status, and financial performance, survive the closing for the specified survival period and can generate post-closing indemnification claims if they are breached. The scope of the representations and warranties in a fund sale is a heavily negotiated point. Sellers want narrow, qualified representations with short survival periods. Buyers want broad representations with long survival periods and robust indemnification backstops. Where these terms land has real economic consequences for the fund's investors, because post-closing indemnification claims reduce their net proceeds and may reopen the waterfall after the final distribution has been made.

## Investor Consent Requirements for Disposition

The operating agreement or limited partnership agreement governs whether investor consent is required before the property can be sold, the required consent threshold, and the process for soliciting and documenting that consent. These provisions are one of the most important features of the governance framework from investors' perspective. They ensure that investors have meaningful input into the transaction that definitively determines their return on the investment they committed capital to years earlier.

The most common disposition consent structures in private real estate syndication operating agreements are the following.

**Majority consent for all dispositions.** Any disposition requires approval by a majority (or defined supermajority) of the fund's membership interests or capital contributions. This structure gives investors meaningful control over the exit but can create execution problems when a credible buyer has a time sensitive offer and the consent solicitation process takes weeks.

**Manager discretion within a defined hold period window.** The manager has discretionary authority to sell during a defined window around the target hold period, for example any time between Year 4 and Year 7 of a five year target hold, without requiring investor consent. Dispositions outside this window require consent. This structure provides operational flexibility during the expected exit window while protecting investors from premature or unduly delayed dispositions.

**Proceeds threshold trigger.** The manager may sell without investor consent provided the gross sale proceeds are at or above a minimum price per unit or per percentage interest that is specified in the operating agreement. This structure protects against below floor dispositions while allowing the manager discretion to sell when the market exceeds the minimum threshold.

Whatever the consent structure, the sponsor must comply with it precisely before the purchase agreement is executed. A disposition that closes without the required investor consent is a breach of the operating agreement, and potentially a securities law violation if it constitutes a material modification of the investment terms without the approval the governing documents required. Obtaining consent after the fact, or relying on a post-closing ratification by investors, is not a substitute for obtaining the required consent before the binding commitment to sell is made.

The consent solicitation should include a summary of the proposed transaction and its key terms; the proposed purchase price and a comparison to the underwriting exit assumption; the estimated net sale proceeds after selling costs, loan payoff, and reserves; the estimated final waterfall distribution per investor; the tax implications of the sale at a high level; and any material representations or warranties in the purchase agreement that create post-closing indemnification exposure. Investors who are given adequate information to evaluate the disposition decision are more likely to provide consent promptly and are better positioned to provide informed consent. This is both better investor relations and a stronger factual basis if the consent is later challenged.

## Calculating and Distributing Sale Proceeds

The final waterfall distribution at disposition is the most consequential single calculation in the fund's life. It determines every investor's ultimate realized return and the sponsor's total promoted interest. Because the calculation applies the waterfall mechanics to the fund's full economic history (every capital contribution, every operating distribution, every prior capital event), it is also the most complex distribution calculation the fund administrator will produce. Errors in the final waterfall are detected by investors who calculate their own expected return and find a discrepancy, which generates investor disputes and potentially investor claims at the worst possible moment in the fund's lifecycle.

### Working Through the Final Waterfall Distribution

The final waterfall applies the operating agreement's waterfall provisions to the net sale proceeds, meaning the gross sale price minus the outstanding loan payoff (including prepayment penalties or defeasance costs if applicable), minus selling costs (broker commission, legal fees, title costs, transfer taxes), minus any required reserves to be held

pending post-closing obligations (such as representation and warranty indemnification), minus any accrued but unpaid fund level expenses.

The resulting net distributable proceeds flow through the waterfall tiers established in the operating agreement. A four tier structure (return of unreturned capital, accrued preferred return, GP catch up, residual split) was illustrated in detail in Chapter 28. The final disposition waterfall applies those same mechanics, but the stakes are higher because this distribution closes out the investment. There is no subsequent distribution to correct an error, and the calculation must account for every prior distribution across the entire hold period.

Key inputs to the final waterfall calculation that must be accurate include each investor's total capital contributions (original investment plus any subsequent capital calls); each investor's total distributions received during the hold period (operating distributions, refinancing distributions, and any prior return of capital events); the resulting unreturned capital balance for each investor; the accrued preferred return for each investor based on the preferred return rate, the preferred return basis (contributed capital or unreturned capital), and the holding period, reduced by any prior distributions that satisfied the preferred return obligation; and the GP's corresponding capital, preferred return, and catch up amounts if the GP invested alongside LPs.

### **Tax Implications for Investors: Capital Gains and Depreciation Recapture**

The disposition triggers tax consequences for investors that were not visible during the hold period and that, for investors who did not plan for them, can be surprisingly large. The sponsor is not responsible for individual investors' tax outcomes, but is responsible for ensuring that investors receive accurate information, including an estimate of the disposition's likely tax impact, in advance of the closing so that they can make informed decisions and engage their own tax advisers.

**Long term capital gains.** Gain on the sale of real estate held for more than 12 months is taxed as long term capital gain, at federal rates of 0 percent, 15 percent, or 20 percent depending on the investor's income level, plus the 3.8 percent net investment income tax for high income investors. For most investors in private real estate funds, the applicable long term capital gains rate is 20 percent, producing a maximum federal rate of 23.8 percent on the capital gain portion. This is substantially more favorable than ordinary income tax rates (up to 37 percent at current federal top marginal rates), one of the key reasons real estate syndication is an attractive investment structure for high income accredited investors.

**Unrecaptured Section 1250 gain (depreciation recapture on real property).** When depreciable real property is sold, the gain attributable to depreciation claimed during the hold period must be recaptured at a maximum federal rate of 25 percent, higher than the standard long term capital gains rate but lower than ordinary income rates. This gain is called

unrecaptured Section 1250 gain and specifically applies to the straight line depreciation taken on the building structure during the hold. The depreciation that reduced taxable income annually during the hold period effectively shifts from a current year deduction to additional gain at disposition. The IRS treats it as a loan of tax deferral rather than a permanent tax benefit.

**Section 1245 recapture from cost segregation (ordinary income).** If the property underwent a cost segregation study during the hold, reclassifying components of the building from 39 year or 27.5 year depreciable life to shorter 5 year, 7 year, or 15 year life, the accelerated depreciation on those reclassified personal property and land improvement components (carpeting, appliances, specialized equipment, certain improvements) is subject to recapture as ordinary income at the investor's full marginal tax rate, which can reach 37 percent for high income individuals. This is the recapture trap that most surprises investors who were attracted to the cost segregation depreciation benefits during the hold. Those benefits come back at ordinary income rates rather than the 25 percent maximum that applies to building structure depreciation. The combined tax impact on sophisticated investors requires specific pre-sale planning.

**Passive loss release.** Any passive losses allocated to investors during the hold period that were suspended under the passive activity loss rules, because the investor's passive income was insufficient to absorb them in the year they were allocated, are released at disposition and can be applied to offset the gains from the sale. For many investors, suspended passive losses are a meaningful offset to the capital gain tax otherwise due. Investors who have accumulated significant suspended passive losses should confirm with their tax advisers how those losses interact with the sale proceeds before the closing.

### **⚠ Depreciation Recapture Is the Tax Consequence Nobody Plans For Until It Arrives**

*Investors who received K-1s showing passive losses from depreciation allocations during the hold period often assume that those losses reduce their tax at disposition. The mechanism is more complex and less favorable than that assumption suggests.*

*Section 1250 property (building structure): straight line depreciation claimed during the hold is recaptured at a maximum federal rate of 25 percent, not at capital gains rates of 15 percent or 20 percent. A \$500,000 depreciation deduction accumulated over a five year hold on a multifamily building creates \$125,000 of federal tax at the 25 percent recapture rate, plus any state tax, at disposition.*

*Section 1245 property from cost segregation: accelerated depreciation on personal property components (5 year, 7 year, and 15 year assets identified through cost*

*segregation) is recaptured at ordinary income tax rates up to 37 percent. Investors who benefited from front loaded depreciation deductions through cost segregation will find those benefits clawed back at ordinary income rates at disposition, a surprise for investors who did not model the exit tax implications when they committed capital.*

*Communicate the estimated depreciation recapture amounts to investors at least 90 days before the anticipated closing, with enough detail for each investor to work with their own tax adviser. The communication should not be the first time investors learn that this obligation exists.*

## Clawback Calculations and Sponsor Return Obligations

Some real estate fund operating agreements contain clawback provisions, meaning obligations that require the sponsor to return previously received promote distributions if, when the fund's complete economic performance is evaluated at the end of the investment period, the total promote distributions received exceeded what the sponsor would have been entitled to under the waterfall applied to all cash flows in aggregate. Clawbacks are most common in fund structures (where the sponsor may have received promote distributions from individual property dispositions throughout the fund's life) rather than in single asset syndications.

The mechanics of a clawback calculation compare two numbers: the total promote the sponsor actually received from all prior distributions during the fund's life, and the total promote the sponsor is entitled to under a final waterfall calculation applied to all the fund's cash flows (contributions, operating distributions, and disposition proceeds) across the entire investment period. If the sponsor received more from prior distributions than the final calculation entitles them to, the excess must be returned to investors.

Clawback provisions in operating agreements are often subject to tax gross up provisions that account for the fact that the sponsor paid income taxes on prior promote receipts and therefore may not have the full Pre-tax amount available to return. The tax gross up is a negotiated concept that typically calculates the clawback obligation as the after tax amount, recognizing that returning a Pre-tax promote dollar is not economically the same as receiving it, given that income tax was paid at receipt.

The clawback obligation is one of the most contentious provisions to enforce at the end of a fund's life. Sponsors whose prior distributions may have created a clawback obligation should work with fund counsel to calculate the clawback amount before the final distribution is made, communicate the amount to investors with a clear explanation of how it was calculated, and confirm how the clawback will be funded (from proceeds held at final closing or, if the sponsor

has already received all promote distributions, from the sponsor's own resources). Disputes about the clawback calculation, which involve the same waterfall mechanics that are difficult in any distribution event, should be resolved before the final distribution is made, not after.

## Entity Wind Down and Dissolution

After the real estate closing and the final waterfall distribution to investors, the fund's operating entity must be wound down and dissolved. Dissolution is not immediate upon the closing of the sale. It follows a period of winding down the entity's affairs, which includes paying all remaining liabilities, obtaining releases from vendors and service providers, filing final tax returns, and distributing any remaining assets.

The wind down checklist for a real estate syndication entity typically includes the following steps.

- Confirm receipt of all sale proceeds and completion of the escrow reconciliation.
- Pay all remaining vendor invoices, property management fees, and fund operating expenses.
- Release the property management agreement, fund administrator engagement, and any other service agreements, with final payment of amounts due.
- Obtain lender release of any personal guarantees given by the sponsor in connection with the property loan.
- Release or allow to lapse any remaining insurance policies covering the property, retaining D&O or errors and omissions coverage for the post-closing representation and warranty survival period.
- Prepare and file the final federal and state partnership tax returns (Form 1065 and applicable state returns), and deliver final K-1s to all investors.
- File a final Form D amendment with the SEC confirming that the offering is complete.
- File state blue sky final reports and confirmations as required by each investor state.
- Distribute any remaining funds in the entity's accounts (typically residual cash from the operating period) in accordance with the operating agreement.
- File the Articles of Dissolution or Certificate of Cancellation with the state of formation (typically Delaware), and file similar terminations in any state where the entity was registered to do business.

The dissolution process takes a minimum of three to six months after the real estate closing, primarily because the final K-1 preparation and partnership tax return cannot be completed until all of the fund's income, deductions, and gains are finalized. This requires the disposition to be



complete and all post-closing adjustments to be settled. Investors should not expect the formal entity dissolution to be simultaneous with their distribution of sale proceeds.

## 1031 Exchange Planning at Exit

Section 1031 of the Internal Revenue Code allows taxpayers who sell real property held for business or investment purposes to defer recognition of capital gain by reinvesting the sale proceeds into like kind replacement property within specified timelines. This deferral can be substantial for real estate investors with significant appreciated and depreciated property, deferring not only the long term capital gains tax but also the Section 1250 depreciation recapture. For many investors in private real estate syndications, the tax deferral available through a properly structured 1031 exchange represents a compelling reason to reinvest in real estate rather than take the proceeds in cash.

The tension in the syndication context is that the fund entity, meaning the LLC or LP or a special purpose vehicle owned by the LLC or LP, is the titleholder of the real property, not the individual investors. A 1031 exchange must be conducted by the same taxpayer who relinquished the property. Individual investors who receive their distribution from the fund after the closing cannot personally conduct a 1031 exchange, because they never held title to the real property. The fund did. This structural incompatibility between the syndication structure and individual 1031 exchange eligibility is one of the most common sources of investor disappointment at disposition, and it is a dynamic that the PPM should disclose clearly when investors first commit capital.

### The Structural Challenge: Fund Level Versus Investor Level 1031 Rights

If the fund entity itself wants to exchange the relinquished property for a like kind replacement property using a 1031 exchange at the fund level, the individual investors do not receive their capital back. Instead, they roll their investment into the replacement property. This is a fund level exchange that requires the investors to agree to continue their investment in a new property, which most investors in a fund approaching the end of its stated hold period are not willing to do. Fund level 1031 exchanges are uncommon in private real estate syndications precisely because investor preferences at the end of the hold period, many of whom want liquidity, make it difficult to achieve the investor consent necessary to extend the investment into a replacement property.

Individual investors who want to conduct their own 1031 exchanges have two primary alternatives in the syndication context: tenant in common (TIC) structures and Delaware Statutory Trust (DST) investments. In a TIC structure, each investor holds direct fractional ownership of the real property, which makes each investor a separate titleholder who can exchange their interest in the TIC for like kind replacement property. The IRS issued guidance



on TIC arrangements in Revenue Procedure 2002-22, which sets forth conditions under which a TIC arrangement will not be treated as a partnership for federal tax purposes. TIC structures are complex to administer, are limited to 35 co-owners under Rev. Proc. 2002-22, and create practical governance challenges, but they preserve individual 1031 eligibility.

DSTs are a more modern vehicle in which investors hold beneficial interests in a trust that holds real property. In Revenue Ruling 2004-86, the IRS ruled that a properly structured DST will be treated as an investment trust rather than a business entity, with the result that a beneficial interest in the DST is treated as a direct interest in the underlying real property for federal tax purposes, qualifying it as like kind replacement property for 1031 exchange purposes. The ruling identified seven restrictions (commonly known among practitioners as the seven deadly sins) that the DST must satisfy to qualify, including limitations on the trustee's power to dispose of trust property, renegotiate leases, refinance debt, or accept additional capital contributions after the trust's offering closes. The DST has become the predominant structure for syndicated 1031 replacement property since 2004, largely displacing the TIC for newly formed offerings.

### **Practical 1031 Planning for Syndication Investors**

For investors in a traditional LLC or LP syndication who wish to conduct a 1031 exchange at disposition, the practical options are limited but deserve discussion with tax counsel before the disposition closes. The investor cannot receive the sale proceeds and then attempt a 1031 exchange. Constructive receipt of the proceeds, even for a day, destroys 1031 eligibility. If the fund structure does not accommodate individual investor 1031 elections, those investors who want to defer their gain must accept the tax consequences of the disposition rather than participating in the exchange.

The key timelines for a 1031 exchange, applicable at the fund level if the entity conducts the exchange, are strict and non-negotiable under the IRS regulations. The taxpayer has 45 days from the date of the relinquished property's closing to identify replacement properties in writing, delivered to the qualified intermediary. Identification must follow one of three rules. The Three Property Rule permits identification of up to three properties of any value. The 200 Percent Rule permits any number of properties with aggregate value not exceeding 200 percent of the relinquished property's value. The 95 Percent Rule permits any number of properties, but the taxpayer must close on at least 95 percent of the aggregate identified value. The taxpayer has 180 days from the relinquished property closing to complete the exchange by acquiring the replacement property.

A qualified intermediary, a disinterested third party who holds the exchange proceeds between the relinquished property closing and the replacement property closing, is required for any delayed 1031 exchange. The taxpayer cannot have actual or constructive receipt of the proceeds during this period. If proceeds ever touch the taxpayer's account, 1031 eligibility is

destroyed. The qualified intermediary must be engaged before the relinquished property closes, not after, because the qualified intermediary must be party to the sale agreement before the closing occurs to ensure the taxpayer never has constructive receipt. Qualified intermediary selection matters. The industry is unregulated and intermediary insolvencies have stranded exchange funds, eliminating investors' ability to complete their exchanges.

## **Fund Level Disposition: Selling the Entire Portfolio**

A fund level disposition, meaning the sale of the entire fund or all of its remaining assets as a portfolio transaction, presents a different set of legal, economic, and investor relations considerations than a single asset sale. Portfolio sales are executed when a buyer acquires the entire fund entity (a sale of interests rather than assets), when all remaining assets are sold simultaneously or sequentially in a coordinated exit, or when the fund is being wound down at the end of its stated investment period. Each structure has different tax and legal implications.

### **Asset Sale Versus Entity Sale**

In a single asset syndication, the disposition is virtually always an asset sale. The LLC that owns the property sells the property to the buyer, receiving the purchase price and then distributing the net proceeds to members. In a multi asset fund, the sponsor has the option of structuring the exit as either an asset sale (the fund sells individual properties and distributes proceeds as each property closes) or an entity sale (a buyer acquires the fund's ownership interests, paying the members directly for their interests rather than acquiring the underlying assets).

An entity sale, sometimes called a fund buyout, is attractive to buyers who want to acquire the full portfolio in a single transaction and who are willing to acquire the existing legal structure rather than cherry picking individual assets. For investors, an entity sale can be more tax efficient than an asset sale if the buyer is willing to pay a price that reflects the fund's basis in the assets, reducing the depreciation recapture that would arise in an asset sale. For the sponsor, an entity sale simplifies the wind down and can accelerate the distribution timeline. The tradeoff is that buyers of fund interests are assuming the fund's existing legal liabilities, representations, and warranties, which typically results in purchase price adjustments or escrow holdbacks that are not present in asset sales where the buyer can negotiate the representations they receive.

### **Sequential Versus Simultaneous Portfolio Sales**

For a multi property fund conducting an asset sale exit, the sponsor typically has discretion over whether to sell all assets simultaneously, in a marketed portfolio sale to a single buyer, or sequentially over a period of time. Each approach has different investor implications. A

simultaneous portfolio sale produces a clean exit, one closing date, one final distribution to investors, one final set of K-1s, and typically attracts buyers who want diversified cash flow rather than individual assets. It may sacrifice price on individual assets that would command a premium if marketed individually.

Sequential individual asset sales allow the sponsor to optimize pricing for each property by marketing it to its most likely buyer rather than to a portfolio buyer who values diversification rather than individual asset quality. But sequential sales create investor relations complexity. Investors in a fund with ten properties receive partial distributions as each property sells, their remaining capital is concentrated in the unsold properties, and the hold period extends until the last property is sold. The fund administrator must maintain the capital accounting for a shrinking portfolio across multiple years of partial distributions, and the K-1s for each intervening year reflect the evolving composition of the fund.

## Practical Takeaways

- Exit strategy planning begins at acquisition, not at disposition. Sponsors who enter an investment with a clear disposition thesis (who the likely buyers are, what conditions will produce an optimal exit, and what business plan execution is required to achieve the target return) execute superior dispositions. Sponsors who turn their attention to the exit only when the loan is maturing or investors are asking for their money back are making reactive decisions in a process that rewards proactive positioning.
- Disposition timing is a fiduciary decision with potential conflict of interest dimensions. A sponsor whose management fee income exceeds the expected promote has an economic incentive to delay disposition that investors do not share. The operating agreement's investor consent requirements exist precisely to provide investor input at this moment. Transparent communication about the disposition rationale (why the timing is right, how the pricing was established, and how the transaction serves investor interests) is both good practice and legal protection.
- Broker selection directly affects investor returns. The disposition broker's relationships, market knowledge, and ability to generate competitive bidding are the primary determinants of whether the sale achieves the top of the market range. A disposition broker selected for relationship reasons rather than competence leaves proceeds on the table. The affiliated disposition fee, if the operating agreement permits one, must be disclosed to investors before the transaction closes and should be disclosed in the initial PPM.
- The letter of intent establishes the framework for the purchase agreement at a stage when both parties have maximum flexibility. Terms left ambiguous in the letter of intent

become contested points in the purchase agreement when the buyer has already invested significant due diligence costs and the seller is eager to close. Representations and warranties in the purchase agreement survive the closing and can generate post-closing indemnification claims that reduce net investor proceeds. Negotiate these provisions carefully before signing the purchase agreement, not after.

- Investor consent for disposition must be obtained before the purchase agreement is executed, not after. A disposition completed without the required consent is an operating agreement breach and potentially a securities law violation. The consent solicitation should include the estimated waterfall distribution, the tax implications of the sale, and any post-closing indemnification exposure so that investors can make an informed decision.
- Depreciation recapture is the tax consequence that investors consistently underestimate until it arrives at disposition. Section 1250 property recapture is taxed at up to 25 percent, higher than standard long term capital gains rates. Section 1245 property from cost segregation is recaptured at ordinary income rates up to 37 percent. Communicate the estimated recapture amounts to investors at least 90 days before the anticipated closing so they can plan with their own tax advisers.
- Passive losses suspended under the passive activity loss rules throughout the hold period are released at disposition and can offset gains from the sale. Investors with significant suspended passive losses should quantify the offset with their tax advisers before the closing so they understand their net after tax return.
- 1031 exchange eligibility requires that the entity holding title to the property be the party conducting the exchange. Individual investors in a traditional LLC or LP syndication do not hold title and cannot personally conduct a 1031 exchange at the fund level. The PPM should disclose this limitation clearly, and investors who want 1031 deferral at exit should evaluate DST (under Rev. Rul. 2004-86) or TIC (under Rev. Proc. 2002-22) alternative structures at the time of their initial investment decision.
- If a 1031 exchange is to be conducted at the fund level, the qualified intermediary must be engaged before the relinquished property closing, not after. The 45 day identification period and 180 day closing deadline are absolute. The IRS provides no extensions for missed deadlines except in federally declared disasters. The qualified intermediary must be a disinterested third party. The fund's own counsel, accountant, or broker cannot serve as qualified intermediary.
- Entity wind down after the property closing takes three to six months minimum, primarily because the final K-1s cannot be prepared until the fund's complete income, deductions, and gains are finalized. Investors should not expect the entity dissolution to be

simultaneous with their sale proceeds distribution, and the sponsor should communicate the anticipated wind down timeline clearly before and after the closing.

**CHAPTER THIRTY ONE**

# Distressed Situations and Problem Assets

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No sponsor begins a real estate investment expecting it to become distressed. Every investment is underwritten to succeed, every business plan is drafted to produce the projected returns, and every investor is given PPM risk factors that are treated, by both the investor and the sponsor, as disclosures of theoretical possibilities rather than likely outcomes. Distress, when it arrives, arrives uninvited, and it rarely announces itself clearly or all at once. It creeps in through a series of individually manageable variances that compound into a structural problem before the sponsor has recognized that the trajectory of isolated quarterly shortfalls has become the trajectory of an investment that will not survive on its current path.

The sponsors who navigate distress successfully are those who recognized it early, communicated about it honestly, and engaged the right professional team (legal, financial, and operational) before the situation became a crisis. The sponsors who navigate distress poorly are those who minimized it in their communications with investors and their lender, who believed that the next quarter would improve, who deferred the difficult conversations about additional capital needs or loan restructuring until the options had narrowed to the least favorable of the available alternatives.

Understanding how distress develops, what options are available at each stage, and what legal obligations attach to the sponsor's conduct throughout is not merely useful for managing a distressed investment. It is essential for managing any investment competently. The disciplines described in this chapter are the ones that prevent distress from escalating, which protect the sponsor's relationships with investors and lenders, and that determine whether a difficult situation resolves in a way that preserves the investment or ends in foreclosure and litigation. Sponsors who read this chapter hoping never to need it are sponsors who have understood the stakes correctly. Sponsors who need it and have not read it tend to learn its contents at far greater expense.

## Recognizing Early Warning Signs

The most costly feature of real estate investment distress is not its severity. It is how late it is typically recognized. Most problem assets become apparent in retrospect at least 12 to 18 months before the crisis event that brings them to the sponsor's full attention. The monthly financial package contained the signals. They were just not read with adequate specificity or urgency. The asset manager's budget versus actual narrative attributed the variances to

manageable short term conditions. The lender's covenant monitoring was in the background of the quarterly review, not the foreground. By the time the loan enters default or the operating account runs dry, the window for the best remediation options has often already closed.

The early warning signs of distress fall into three categories (financial, operational, and external), and an asset manager who reviews each category monthly, at the specific KPI level rather than in aggregate, catches developing problems at a point when they can be addressed with a meaningful range of options.

## Financial Warning Signs

Financial warning signs are the most objective and the most reliably measurable. They are also the ones most consistently rationalized as short term noise rather than structural signals. The financial metrics that most reliably precede a serious distress event include the following.

- **Debt service coverage ratio trending below 1.20x.** 1.20x is the standard covenant floor in most commercial real estate loans. A DSCR that has been declining for three consecutive quarters, even if it remains above the covenant minimum, is a trajectory that must be addressed before the minimum is breached. Lenders who are informed of a declining DSCR trend before the breach have meaningfully more flexibility to work with borrowers than those who discover a covenant violation from a quarterly report.
- **Operating deficit requiring repeated advances from reserves.** When the property's operations are not covering debt service and operating expenses and the sponsor is funding the gap from operating reserves, the reserves are being depleted at a rate that has a calculable endpoint. When the reserve balance divided by the monthly deficit reaches less than six months of runway, the situation requires immediate escalation.
- **Accounts receivable aging showing delinquency above 5 percent of scheduled rents.** Persistent delinquency accumulates at a rate that compounds. A tenant who is two months behind on rent is a collection problem. A tenant who is six months behind has effectively stopped paying rent, and the collection recovery analysis becomes a lease termination analysis.
- **Capital expenditure requirements emerging that exceed the remaining reserve balance and operating cash flow.** A significant unexpected capital need (HVAC system failure, roof replacement, major tenant improvement commitment) that the property cannot fund from operations and reserves without either a capital call from investors or a modification of the loan's reserve requirements.
- **Insurance renewal at materially higher premium.** A signal that the property's risk profile has deteriorated in the insurer's assessment, which often precedes lender revaluation of the same information.

## Operational Warning Signs

Operational warning signs are more qualitative but equally important. They often manifest before the financial statements reflect their full impact.

- **Occupancy declining for two or more consecutive quarters without an active lease up plan.** An active plan means one that is actually producing signed leases, not just activity. Declining occupancy with credible near term lease execution is a manageable condition. Declining occupancy with general activity but no signed leases is a deteriorating trend.
- **Anchor or major tenant signaling non-renewal.** Even before formal notice is given, lease renewal negotiations that are clearly stalled, or credible market intelligence that a major tenant is evaluating alternative space, require immediate business plan review. The NOI impact of an anchor tenant's departure reverberates through the entire property's performance.
- **Construction or renovation delays beyond 60 days.** A value add program whose renovation timeline has extended materially delays the rent premium achievement that the business plan depends on, extends the period of operating shortfall, and consumes contingency reserves that were meant to protect against exactly the conditions that are causing the delay.
- **Property management performance deteriorating.** Increasing maintenance response times, growing delinquency, unusual vendor invoice volume, or property manager personnel turnover in key positions are operational signals that the management relationship may need to be addressed before the financial consequences compound.
- **Key sponsor personnel departure.** The loss of the operating principal who has the lender relationship, the investor relationships, and the operational knowledge that the investment depends on is both an operational warning sign and, in many operating agreements, an event that triggers investor notification or consent rights.

## External Warning Signs

External warning signs arise from market and capital market conditions that are outside the sponsor's operational control but that directly affect the investment's trajectory.

- **Interest rate increases on floating rate debt.** Properties financed with floating rate debt that have experienced significant rate increases may have seen their debt service cost rise by 30 percent to 50 percent or more, compressing DSCR even if NOI is performing to underwriting. In the rate environment following 2022, this single factor pushed a generation of floating rate borrowers into technical default on DSCR covenants despite properties that were otherwise operationally sound.



- **Cap rate expansion in the property's market.** When comparable properties are trading at higher cap rates than the exit cap rate assumed in the underwriting, the property's mark to market value has declined. A refinancing or disposition at current market values may not produce proceeds sufficient to repay the existing debt, let alone return investor capital.
- **Major employer departure or economic contraction in the local market.** Particularly for office and retail properties, the departure of a major employer in the submarket affects tenant demand across all properties. Office and retail sponsors should monitor local employment announcements with the same attention residential sponsors give to unemployment data.
- **Lender communication changes in tone or frequency.** A commercial lender who begins asking more detailed questions about operating performance, who sends a compliance certification earlier than customary, or who requests an updated appraisal unexpectedly is sending a signal about its own assessment of the loan's risk profile. These communications are early warning signs in their own right.

## Communicating Problems to Investors: Legal Obligations and Best Practices

The disclosure obligation does not diminish because the news is bad. The antifraud provisions of Section 17(a) of the Securities Act and Rule 10b-5 under the Exchange Act apply to ongoing investor communications with the same force they apply to the original offering documents. A quarterly report that omits a material adverse development (a DSCR covenant breach, a lender default notice, a major tenant vacancy that materially impairs the investment's trajectory) is not merely a service failure. It is a potential securities fraud, and the legal exposure from the omission compounds with each subsequent period in which the information remains undisclosed.

Experienced securities counsel frequently observe that the legal exposure arising from sponsors' management of distressed assets comes not from the distress itself, since real estate investments fail for reasons that are often genuinely beyond the sponsor's control, but from what the sponsor communicated (or failed to communicate) about the distress while it was developing. Investors who are kept informed of problems, even significant ones, make informed decisions, adjust their expectations, and retain the agency that informed investment requires. Investors who discover problems from sources other than the sponsor, or who receive a sudden adverse disclosure after a series of reassuring quarterly reports, become the sponsor's most dangerous legal exposure.

### The Material Event Notice Obligation

Most operating agreements require the sponsor to provide a written notice to investors upon the occurrence of any material event affecting the investment. Material events in the distress context include receipt of a written notice of default from the lender; a DSCR covenant breach; the departure of a major tenant representing more than a defined percentage of the property's income; a casualty event whose insurance recovery is uncertain; a significant unplanned capital expenditure; a material operating deficit that is depleting reserves; and any other development that a reasonable investor would consider important in evaluating the current status of their investment.

The material event notice is not a quarterly report. It is a prompt disclosure, typically required within a short window (often five to fifteen business days) after the material event occurs. Waiting for the next quarterly report to disclose a lender default notice that arrived three weeks ago is not compliance with a material event notice requirement. The operating agreement's specific provision controls, and the sponsor must read it and follow it.

The substance of the material event notice matters as much as its timing. A notice that says 'we are-experiencing some challenges with our lender and are working to address them' is not adequate disclosure of a formal notice of default. The notice should describe what happened and when; the specific nature of the loan default or other material event; what the lender's rights and remedies are under the loan documents; what the sponsor is doing in response, with specific next steps and timelines; and the sponsor's honest assessment of the likely range of outcomes. Vague and reassuring language in a material event notice is itself an antifraud problem. It shapes investors' understanding of the situation in a way that minimizes a material risk they are entitled to understand clearly.

## The Disclosure Standard in Distress

Sponsors in distressed situations face a specific psychological temptation that the disclosure obligation directly counteracts: the belief that the situation will improve before the next disclosure is required and that disclosing the current problem will damage investor confidence and the sponsor's reputation unnecessarily. This belief is occasionally accurate. Problems do resolve. But it is more often a rationalization that delays disclosure beyond the point where investors retain meaningful agency.

The legal standard is not whether the sponsor believes the problem will resolve. The standard is whether the information is material to a reasonable investor's evaluation of their investment. A lender default notice is material regardless of whether the sponsor believes the default will be cured. A DSCR covenant breach is material regardless of whether the sponsor projects improvement in the next quarter. A major tenant departure is material regardless of whether the sponsor has identified replacement tenant prospects.

### **⚠ Delayed Disclosure of Material Adverse Events Is a Securities Violation, Not Just a Communication Mistake**

*Sponsors who delay disclosing material adverse events to investors, because they believe the situation will improve, because they fear damaging investor confidence, or because they are hoping to have a resolution to announce alongside the disclosure, are not making a communication judgment. They are making a legal decision with securities fraud consequences.*

*The antifraud provisions apply to omissions of material information in connection with the ongoing ownership of securities. An investor who is considering whether to seek to sell their interest, whether to consent to a capital call, or whether to take other action with respect to their investment is making those decisions based on the information the sponsor has provided. Material information that was withheld during that decision period is the core of a Rule 10b-5 omission claim.*

*Disclose material adverse events promptly, specifically, and completely, before investors discover them from other sources, and before they make decisions without material information they were entitled to have. Engage securities counsel before any significant adverse event communication is drafted.*

## **Options When an Asset Is Underperforming**

The range of options available to address an underperforming asset narrows as the distress deepens. A property that is 90 days behind its business plan projection has many options. A property that is in default on its loan, whose reserves are depleted, and whose major tenant has vacated has far fewer. The decisions made, and the options not pursued, during the early stages of underperformance determine what remains available at the later stages. This sequencing means that the most valuable thing a sponsor facing an underperforming asset can do is acknowledge the situation early and engage the full range of remediation options while they remain available.

### **Operational Turnarounds**

For properties whose underperformance is attributable to operational execution (inadequate property management, a leasing strategy that is not producing the required velocity, a renovation program running over budget or behind schedule), the first remediation option is an operational turnaround: intensifying the management attention, replacing underperforming service providers, or modifying the business plan to address the specific execution failures.

A property management replacement is the most common operational turnaround decision. It is also the one sponsors are most reluctant to make, because the disruption of a management transition is real and the uncertainty about whether a new manager will perform better creates hesitation. But a property management company that has had six months to demonstrate improvement and has not demonstrated it is not going to produce different results in the next six months. The operating agreement's termination provision, including its notice period and transition assistance obligations, determines how quickly the change can be made. This is one of the reasons that favorable termination provisions in the property management agreement, negotiated before engagement, are so consequential.

Leasing strategy modifications (adjusting asking rents to market, increasing the leasing commission to create broker incentive, approving concessions that were previously unavailable, or changing the property's positioning in the competitive market) can be implemented more quickly than a management change but require honest acknowledgment of why the current strategy is not working. A sponsor who has been presenting the leasing pipeline as healthy in quarterly reports and then acknowledges that the pipeline was not converting at the expected rate has created an internal contradiction that investors will notice. The adjustment to the leasing strategy should be accompanied by a candid explanation of why the prior strategy underperformed.

## Recapitalization and Additional Equity

When the operational issue is compounded by a capital deficiency (insufficient reserves to fund required capital expenditures, insufficient cash flow to meet debt service, or an unanticipated capital need that the property cannot self-fund), a capital call to existing investors or a recapitalization bringing in new equity is often the path that preserves the investment. Chapter 29 addressed the mechanics of recapitalization in detail. In the distress context, the additional dimension is timing. The value of additional equity as a remediation tool decreases as the distress deepens, because the new equity is increasingly subordinated to the problems that have developed rather than correcting them at an early stage.

A capital call to existing investors, requiring each investor to contribute additional capital proportionate to their ownership interest, is the most straightforward mechanism but the one most likely to generate investor resistance. An investor who committed \$200,000 to a real estate fund and is now being asked to contribute an additional \$40,000 to address an operating shortfall that the sponsor's quarterly reports described as manageable is not a cooperative investor. The investor's cooperation with the capital call depends almost entirely on whether they trust the sponsor's assessment that the additional capital will resolve the problem, and that trust is a function of the quality of communication throughout the hold period.

The operating agreement's provisions governing capital calls (whether additional contributions are mandatory or voluntary, what happens to an investor's interest if they decline to participate, whether the sponsor can dilute non participating investors) are the legal framework through which the capital call is structured. An operating agreement that makes additional contributions entirely voluntary, with no dilution mechanism for non-participation, may produce insufficient capital from the capital call when some investors decline. An operating agreement with a punitive dilution mechanism for non-participation may face legal challenge if the mechanism is exercised during a period of distress when investors are alleging the sponsor contributed to the underperformance.

### **Asset Disposition Below Underwriting**

In some distressed situations, the most value preserving outcome for investors is a sale of the asset below the original underwriting projection, recovering some capital rather than losing more through continued holding. This is one of the most difficult decisions a sponsor makes, because it requires acknowledging that the investment did not perform as projected and accepting a below underwriting return, which affects both the sponsor's track record and the investors' return.

The calculus for a disposition below underwriting turns on several variables: how much of investors' capital can be recovered at current market pricing versus the expected recovery if the property is held through an attempted turnaround; whether the property's trajectory is improving or declining; whether the lender will cooperate with a voluntary sale or is moving toward foreclosure, which produces a worse outcome for investors than a voluntary sale at a discount; and whether the legal exposure from continuing to manage the property while it continues to underperform exceeds the exposure of acknowledging the investment's failure and distributing remaining proceeds.

A disposition below underwriting requires investor consent under most operating agreements if the proceeds will be materially below the floor that investor approval was predicated on. The investor consent solicitation for a below underwriting disposition must include the sponsor's honest assessment of the alternative scenarios (including what continued holding is likely to produce and the possibility of foreclosure) so that investors can make an informed decision about whether to consent to the sale.

### **Lender Modification and Workout**

When the primary source of distress is the debt structure (a loan that is maturing in a market that cannot support refinancing at adequate terms, a floating rate that has increased beyond what the property's NOI can support, or covenants that have been breached), a lender modification or workout is often the mechanism that preserves the investment. The lender

workout process is addressed in detail in the following section. The strategic question here is which option to pursue and in what sequence.

The sequence matters because pursuing options in the wrong order can foreclose options that were available earlier. A sponsor who approaches a lender for a modification before-exploring recapitalization options has signaled weakness without first exhausting internal solutions. A sponsor who attempts an operational turnaround for two quarters while hoping the loan covenant issue resolves itself, and then approaches the lender with a modification request when the covenant has been in breach for six months, has lost credibility and negotiating leverage with the lender. The right sequence is generally to assess all options simultaneously, engage legal and financial counsel immediately, address the easiest to fix issues first, and present a credible and comprehensive plan to the lender rather than a series of incremental requests that each reveal more of the distress without offering a resolution.

## Loan Defaults, Workouts, and Modifications

A commercial real estate loan default is not a single event. It is a status that is entered when specified conditions in the loan documents are triggered and that carries with it a range of lender rights that are activated at the lender's election. Understanding which rights the lender has, when they can be exercised, and what the implications are for the sponsor and the investors requires a specific, careful reading of the loan documents, not a general understanding of how defaults work. Every loan is different, every lender is different, and the loan documents are the controlling source, not industry generalizations.

The most common categories of default events in commercial real estate loans are the following. Monetary defaults include missed debt service payments and failure to fund required reserve contributions. Financial covenant defaults include DSCR, occupancy, or LTV covenant breach. Technical defaults include failure to provide required reporting, unauthorized transfers of ownership interests, insurance lapses, and unpermitted liens. Springing recourse trigger events are the bad boy acts that convert a Non-Recourse loan to full recourse. Each category carries different lender rights, different cure periods, and different implications for the sponsor's legal exposure.

### Lender Negotiation Strategy

The borrower's negotiating position in a workout is determined primarily by two factors: the property's current and projected value relative to the outstanding loan balance, and the lender's alternatives if negotiation fails. A property whose current value meaningfully exceeds the loan balance, and whose operating performance can credibly be restored with modest additional time and capital, is a much stronger negotiating position than a property whose value has declined below the loan balance and whose operating performance is deteriorating. Understanding the

lender's realistic recovery under each scenario (cooperative workout versus contested foreclosure) is the foundation of the borrower's negotiating strategy.

The borrower's leverage in workout negotiations includes the time and cost of the foreclosure process (judicial foreclosure in most states takes 12 to 24 months and costs significant legal fees); the lender's own capital allocation constraints and the carrying cost of a non performing loan on its balance sheet; the likelihood that a cooperative sale or modification will produce a better net recovery than a contested foreclosure process; and, where a deficiency judgment is available, the practical ability to collect on it from the sponsor's personal assets.

The borrower's approach in workout negotiations should be transparent about the property's current condition and financial performance; realistic about what the property can support; specific about the modification terms being requested and the rationale for each; capable of demonstrating how the requested modification produces a better outcome for the lender than the alternatives; and willing to offer meaningful consideration for the modification (partial principal paydown, additional equity, modified covenants, partial recourse extension). Lenders are-experienced at identifying implausible projections and unwilling to agree to modifications that simply extend the duration of a problem without addressing its cause.

### **Pre Negotiation Agreements and the Workout Framework**

Before any substantive workout discussions begin, the lender will almost universally require the borrower and guarantors to execute a pre negotiation agreement, also called a pre negotiation letter agreement. The pre negotiation agreement establishes the framework for the discussions and provides critical protections for both parties.

The primary purpose of the pre negotiation agreement from the lender's perspective is to prevent the workout discussions from being used by the borrower to assert claims or defenses in subsequent litigation, specifically to prevent the borrower from arguing that during the workout negotiations the lender made promises about modifying the loan, forbearing from enforcement, or agreeing to specific terms that the lender did not intend to be binding. Without a pre negotiation agreement, every email, every term sheet, and every discussion in the negotiation can be used as evidence of an oral modification or a lender liability claim. With a pre negotiation agreement in place, communications during the negotiation are non-binding until a formal written workout agreement is executed by all parties.

The key provisions of a typical pre negotiation agreement include an acknowledgment that discussions are voluntary and non-binding until a formal written agreement is signed; a confirmation by the borrower of the current outstanding loan amount, the existence of the default, and the validity and enforceability of the loan documents; a waiver by the borrower of any existing claims or defenses against the lender arising prior to the pre negotiation



agreement; a confidentiality covenant with respect to discussions and communications during the negotiation; and an acknowledgment that the lender's participation in negotiations does not constitute a waiver of any rights or remedies available under the loan documents.

The pre negotiation agreement benefits the borrower as well as the lender. Without a pre negotiation agreement establishing the non-binding nature of discussions, borrowers are sometimes reluctant to share unfavorable property information or candid assessments of the investment's problems, for fear that those disclosures will be used against them in subsequent enforcement proceedings. The pre negotiation agreement creates a protected negotiating space that allows both parties to engage more productively.

### **Non-Recourse Carveout Traps in Default**

Most commercial real estate loans are structured as Non-Recourse. The lender agrees to look only to the property and the borrowing entity for repayment, without recourse to the sponsor's personal assets. This protection is the feature of commercial real estate lending that allows sponsors to invest in large properties without staking their personal balance sheet on the outcome. But Non-Recourse loans are never completely Non-Recourse. Every Non-Recourse loan contains carveout provisions, called bad boy carveouts, that convert the loan to full recourse, or that impose liability on the guarantor for specified losses, if certain acts or omissions occur.

The carveout acts that trigger personal liability fall into two categories. Losses carveouts make the sponsor and guarantor personally liable for the lender's actual losses attributable to the specified act. The lender recovers damages rather than the full loan amount. Full recourse carveouts convert the entire loan to full recourse, making the sponsor and guarantor personally liable for the complete outstanding principal balance. The distinction is economically enormous in a distressed situation.

The acts that most commonly trigger losses carveouts include the following.

- Misapplication of rental income or other property cash flows, meaning the use of property operating income for purposes other than property expenses and debt service, such as distributing operating cash flow to investors while the property is in default.
- Failure to maintain required insurance, meaning allowing property or liability insurance to lapse.
- Failure to pay property taxes, meaning allowing property taxes to become delinquent and creating a superior lien.
- Permitting waste, meaning allowing the physical condition of the property to deteriorate materially through neglect.



- Unauthorized subordinate financing, meaning incurring additional debt secured by the property without lender consent.

The acts that most commonly trigger full recourse carveouts include the following.

- Voluntary bankruptcy filing, meaning filing a bankruptcy petition by the borrower entity without lender consent.
- Intentional transfer of the property in violation of the loan documents, meaning conveying title without lender consent.
- Fraud or material misrepresentation to the lender, meaning providing false financial statements, false operating data, or other material misrepresentations.
- Criminal activity or illegal use of the property, meaning using the property for illegal purposes.

### **⚠ Distributing Cash to Investors While the Loan Is in Default Is a Non-Recourse Carveout Trigger**

*One of the most dangerous and most frequently triggered bad boy carveouts in commercial real estate loan documents is the misapplication of rental income or property cash flows. When a loan is in default, distributing operating cash flow from the property to investors, rather than applying it to debt service and operating expenses, constitutes misapplication of funds in most loan agreements.*

*Sponsors who continue to make investor distributions after receiving a notice of default, or who distribute reserves to investors in a distressed situation, expose themselves to personal liability for the lender's losses attributable to the misapplication. In some loan structures, this act converts the Non-Recourse loan to full recourse for the entire outstanding balance.*

*Before any cash distribution from a distressed property is made, whether to investors, to the property manager, or to any other party, the loan documents must be reviewed by counsel to confirm that the distribution does not trigger a carveout. The time to understand which distributions are safe and which are not is before, not after, the distribution is made.*

## **Deed in Lieu and Discounted Payoff Strategies**

When a workout that preserves the borrower's ownership is not achievable, because the property's value cannot support the existing debt, because the lender's patience has been exhausted, or because the economics of continuing to hold the investment no longer serve

investors' interests, the borrower and lender may negotiate one of two exit transactions that avoid the time, cost, and uncertainty of the formal foreclosure process.

**Deed in lieu of foreclosure.** The borrower voluntarily transfers title to the property to the lender in satisfaction of the loan, avoiding the formal foreclosure process. The lender receives the property immediately rather than after a potentially lengthy foreclosure proceeding. The borrower receives a release of personal liability under the loan documents, including any guaranty obligations, which is the primary economic benefit to the borrower from a deed in lieu relative to a foreclosure. The deed in lieu agreement must include a clear recitation that the lender accepts the property in full satisfaction of the loan and releases the borrower and guarantors from any deficiency claim. Without an explicit deficiency release, the borrower may not receive the personal liability protection the transaction was intended to provide.

**Discounted payoff.** Rather than accepting the property, the lender accepts a payoff of the loan at an amount less than the outstanding principal balance. The discount acknowledges the property's current market value relative to the loan balance and allows the lender to dispose of the problem loan more cleanly than a foreclosure would permit. For the borrower, the discounted payoff allows preservation of the entity structure (the property is sold and the loan is paid off at a discount), which may have tax and liability advantages relative to a deed in lieu or foreclosure. The discounted payoff requires the lender to write down the loan balance, which has its own accounting and regulatory implications for the lender, and therefore requires internal lender approval that may add time to the negotiation.

Both a deed in lieu and a discounted payoff produce significant tax consequences for the borrower and, through the partnership tax rules, for investors. Under the Supreme Court's decision in *Commissioner v. Tufts*, 461 U.S. 300 (1983), a foreclosure or deed in lieu involving a Non-Recourse loan is treated for tax purposes as a deemed sale of the property at a price equal to the outstanding Non-Recourse loan amount, regardless of the property's actual fair market value. If the loan amount exceeds the property's adjusted tax basis, the partnership recognizes a taxable gain (including depreciation recapture) even though no cash was received. This phantom income, allocated to investors through K-1s, is one of the most surprising and damaging tax consequences of distressed real estate and must be analyzed by the fund's tax counsel before a deed in lieu or discounted payoff agreement is finalized. In the recourse loan context the analysis differs (a portion of the discharge may be cancellation of indebtedness income rather than sale proceeds), and that analysis must be performed by tax counsel on the specific loan documents.

## Foreclosure and Its Impact on Investors

Foreclosure is the lender's legal remedy for recovering its collateral, the property, when the borrower fails to repay the loan in accordance with its terms. In a Non-Recourse structure, foreclosure terminates the borrower's ownership of the property, extinguishes the borrower's equity interest, and, provided no bad boy carveouts were triggered, satisfies the lender's claim without personal recourse to the sponsor or guarantors. For investors in a foreclosed real estate syndication, foreclosure means the loss of their invested equity: the lender takes the property, any equity value above the loan balance is consumed by legal costs and unpaid loan obligations, and investors receive nothing from the proceeds.

The foreclosure process varies significantly by state. In judicial foreclosure states, where the lender must file a lawsuit and obtain a court judgment before conducting the foreclosure sale, the process can take 12 to 24 months or longer, during which the borrower retains possession of the property and the lender continues to bear the administrative and legal costs of the process. In non judicial foreclosure states, where the loan documents contain a power of sale provision that allows the lender to conduct the sale without court involvement, the process can be completed in 90 to 180 days in many states. The difference in timeline affects the borrower's negotiating leverage and the lender's practical incentive to pursue an out of court resolution.

For investors, the tax consequences of foreclosure require specific attention. When a Non-Recourse loan is foreclosed, the partnership is treated under Tufts as having sold the property for the outstanding loan balance. To the extent this deemed sale price exceeds the partnership's adjusted basis in the property, the partnership recognizes taxable gain (potentially including depreciation recapture), and that gain is allocated to investors through their K-1s in accordance with the operating agreement's allocation provisions, even though no cash is distributed. An investor who has received years of depreciation allocations that reduced their outside basis in the partnership interest may find that the foreclosure produces taxable income at exactly the moment they have absorbed a total economic loss on their investment. Investors must be warned of this consequence well in advance of any foreclosure proceeding so that they can plan with their own tax advisers.

## Investor Litigation Risk in Distressed Situations

Distressed real estate investments produce investor litigation with regularity that is disproportionate to the frequency of distress relative to the total volume of private real estate investment. The disproportion reflects two realities. Investors who have lost capital are more motivated to seek recovery than investors who have simply earned less than projected, and the legal frameworks available to dissatisfied investors (securities fraud, breach of fiduciary duty, breach of contract) are accessible enough that the threshold for commencing litigation is lower than sponsors sometimes assume.

Understanding the primary legal theories that distressed situation investors pursue, and the specific facts that strengthen or weaken each theory, is the most effective tool a sponsor has for managing litigation risk throughout a distressed situation.

## **Securities Fraud Claims**

Section 10(b) of the Securities Exchange Act and Rule 10b-5 prohibit material misstatements and omissions in connection with the purchase or sale of securities. In the distressed investment context, securities fraud claims typically arise from one of three factual patterns: misrepresentations in the original offering materials about the investment's risk profile, the sponsor's track record, or the property's condition; material omissions in ongoing investor communications about developing problems; or affirmative misstatements in periodic reports that describe a worsening situation more favorably than the facts support.

The most legally exposed pattern is the one most commonly encountered: a series of quarterly reports during the distress period that acknowledge some challenges while consistently projecting near term improvement that does not materialize, followed by a sudden adverse disclosure of the full extent of the problem. Each intervening report that understated the severity of the situation is a potential misrepresentation. Each investor who took action, or failed to take action, based on those reports has a reliance argument for their securities fraud claim.

## **Breach of Fiduciary Duty and Breach of Contract Claims**

The manager or general partner of a real estate fund owes fiduciary duties to investors: duties of loyalty (not to prefer the sponsor's interests over investors') and care (to manage the investment with the competence and attention a reasonably prudent professional would provide). In a distressed situation, fiduciary duty claims typically focus on the sponsor's delay in disclosing problems while continuing to collect management fees; decisions that extended the hold period or deferred disposition in ways that served the sponsor's management fee income rather than investors' interests; capital calls structured in ways that diluted non participating investors disproportionately; and operational decisions made without the investor consent that the operating agreement required.

Breach of contract claims arise from violations of the specific operating agreement provisions: failing to provide required notices, making distributions without following the waterfall, failing to obtain required consents, or taking actions expressly prohibited by the operating agreement. These claims do not require proof of fraudulent intent. They require only proof that the contractual obligation existed and was not fulfilled.

## **Protecting Against Investor Litigation in Distress**

The sponsor's strongest protections against investor litigation in a distressed situation are also the behaviors that best serve investor interests, and they must be maintained simultaneously.

- Prompt, specific, and complete disclosure of material adverse developments, delivered before investors discover problems from other sources.
- Contemporaneous documentation of the sponsor's decision making process: the analysis performed, the alternatives considered, the conclusions reached, and the rationale for each major decision. Litigation years later focuses on what the sponsor knew and when they knew it. A documented decision making record is the sponsor's most effective evidence that decisions were made competently and in investors' interests.
- Compliance with every operating agreement provision throughout the distress period: material event notices, investor consent requirements for major decisions, reporting deadlines, and distribution limitations. The breach of an operating agreement provision during a period when investors are already dissatisfied with performance creates a separate legal claim that operates independently of the investment's outcome.
- Early engagement of securities and litigation counsel at the first sign of developing legal exposure: before investor communications are drafted, before workout negotiations with the lender begin, and before any decision is made that the sponsor is uncertain about. Legal advice provided before a crisis is prevention. Legal advice provided after a lawsuit is filed is damage control.
- Maintenance of directors and officers or errors and omissions insurance coverage throughout the investment's life, including during any extended wind down period. Investors who cannot recover from the investment itself may look to the sponsor's personal assets or insurance as the recovery source. Professional liability coverage is the first line of defense against personal exposure.

## Practical Takeaways

- Distress is almost always recognizable in advance of the crisis event that makes it undeniable. The monthly financial package contains the signals (declining DSCR, accumulating delinquency, depleting reserves, construction delays) if they are reviewed at the KPI level rather than in narrative summary. Recognizing developing distress 12 to 18 months before a crisis event preserves a range of remediation options that are unavailable at the crisis moment.
- The disclosure obligation does not diminish because the news is difficult. The antifraud provisions apply to ongoing investor communications with the same force they apply to original offering documents. Material adverse events (lender default notices, covenant

breaches, major tenant departures, significant operating deficits) must be disclosed promptly, specifically, and completely. A quarterly report that minimizes a material adverse development is a potential securities violation, not merely a communication judgment.

- Material event notices in the operating agreement are legal obligations with specified timelines, not a discretionary communication tool. Read the operating agreement's specific provision and comply with it precisely. The notice must be issued within the specified window after the triggering event, and the substance of the notice must be specific enough that investors receive accurate information about the nature of the event and the range of outcomes.
- The sequence in which options are pursued matters. The range of remediation options available narrows as distress deepens. Operational turnarounds, capital calls, and lender modifications are more effective earlier. Deferred engagement with the lender, hoping the situation will improve, typically produces worse outcomes than proactive communication at the first signs of trouble.
- A pre negotiation agreement is the required first step before any substantive workout discussion with the lender begins. The pre negotiation agreement establishes that discussions are non-binding until a formal written agreement is signed, prevents the borrower from using negotiations as the basis for lender liability claims, and creates a protected space for candid discussion of the property's condition. Both borrowers and lenders benefit from this framework. Engaging without one exposes both parties to claims based on the discussions themselves.
- Non-Recourse carveouts convert a Non-Recourse loan to full recourse, or impose personal liability for actual losses, when specific bad boy acts occur. The most dangerous carveout in a distress context is the misapplication of rental income or property cash flows, which many loan documents define as distributing property cash flow to investors while the loan is in default. Before any distribution from a distressed property is made, the loan documents must be reviewed by counsel. The time to understand which distributions are safe is before, not after, they are made.
- Foreclosure produces phantom income for investors (taxable gain recognized even when no cash is received) because under Tufts the partnership is treated as having sold the property for the outstanding Non-Recourse loan balance. An investor whose outside basis has been reduced by depreciation allocations will recognize their allocable share of the partnership's deemed sale gain through their K-1. This consequence must be communicated to investors well before any foreclosure proceeding reaches completion, giving them time to plan for the tax liability.

- Investor litigation risk in distressed situations tracks the quality of disclosure and the compliance with operating agreement obligations. Investors who receive honest, specific, and timely communication about developing problems, and who see that the sponsor complied with operating agreement requirements throughout, have less factual basis for securities fraud and fiduciary duty claims than those who received misleading communications and discovered operating agreement violations. The behaviors that best serve investor interests are also the behaviors that best protect against litigation.
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## CHAPTER THIRTY TWO

# Common Capital Raising Mistakes

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The capital raising phase of a private real estate syndication is where most sponsors first encounter the full weight of federal securities law, and where the most consequential legal mistakes are made. Real estate operators who understand acquisitions, underwriting, and property management have spent years developing skills that are genuinely valuable. Those skills do not transfer to securities compliance. Knowing how to model a value add renovation does not make a sponsor better at understanding what constitutes general solicitation under Rule 506(b). Knowing how to negotiate a purchase agreement does not tell a sponsor whether the person they want to pay for investor referrals needs to be registered as a broker dealer. The capital raising function sits at the intersection of real estate expertise and securities law, and sponsors who are highly competent on one side of that intersection are not automatically competent on the other.

What makes capital raising violations distinctively serious is that their consequences do not track their intent. A sponsor who pays a commission to an unregistered finder because they genuinely did not know this was illegal faces exactly the same investor rescission rights as one who knew and did it anyway. A sponsor who posts about a specific investment opportunity on social media because they thought Regulation D was only about registered investors has committed the same general solicitation violation as one who understood the rule and chose to ignore it. Securities law violations are strict liability in the sense that matters most to sponsors: the knowledge or good faith of the violator does not eliminate the legal consequence for the investors who were affected. The rescission right exists. The enforcement exposure-exists. The validity of the offering is impaired regardless of why.

This chapter covers eleven of the most consequential capital raising mistakes in private real estate syndications, organized across three categories: regulatory violations that expose the sponsor to SEC enforcement and investor rescission rights; documentation and process failures that undermine the offering's legal foundation; and investor management failures that are the most common proximate cause of investor litigation. The chapter describes each mistake with enough specificity that a sponsor can determine whether their current or prior offering has the problem and understand what the existence of the problem means for their legal exposure.

Several of these mistakes, once identified, require immediate legal attention, not because they can be retroactively eliminated, but because the steps taken in the period following discovery affect the scope of the exposure and the options that remain available. The sponsor who identifies a general solicitation violation and immediately engages securities counsel is in a meaningfully different position than the sponsor who identifies the same violation and continues



accepting subscriptions while hoping no one notices. The chapter proceeds from that understanding: recognition is necessary but not sufficient. What happens after recognition is what determines the outcome.

## Regulatory Mistakes

The regulatory mistakes in this section share a property that distinguishes them from the documentation and investor management mistakes that follow. They are not process failures that can be improved on the next deal. They are violations that occurred on a specific date, which created legal consequences on that date, and that persist regardless of what the sponsor does afterward. A sponsor who discovers they paid an unregistered finder cannot undo the rescission rights that were created when those investors were admitted. They can only assess the exposure, take steps to prevent it from growing, and engage counsel to evaluate remediation options. The operational question (how not to make this mistake again) matters, but it is secondary to the immediate question of what the existing violation has produced and what can still be done about it.

### Mistake 1: Unregistered Broker Dealer Activity, Paying Finders Illegally

The broker dealer registration requirement under Section 15(a) of the Securities Exchange Act applies to anyone who is engaged in the business of effecting transactions in securities for the account of others. In the context of a capital raise, the clearest application is the finder or referral arrangement. A person who introduces investors to the offering and receives transaction based compensation, typically a percentage of the capital raised from the investors they refer, is performing a broker dealer function. If they are not registered as a broker dealer or associated with a registered broker dealer, they are operating in violation of Section 15(a). The sponsor who pays them is facilitating that violation and is exposed to its consequences.

The problem is pervasive in private real estate syndications because the arrangement feels natural and low risk. A sponsor with a strong network knows other people with investor networks, and agreeing to pay 2 percent or 3 percent of capital raised by those introducers seems like a straightforward cost of capital arrangement. It is not. Transaction based compensation for introducing investors to a securities offering is the defining characteristic of broker dealer activity. The arrangement's informality, the sponsor's good intentions, and the absence of any formal broker dealer label on the finder's role do not change the legal analysis.

The consequences are not theoretical. Courts have consistently allowed investors introduced to an offering through an unregistered finder to seek rescission of their investments, meaning the investor gets their money back regardless of whether the investment itself performed well. A successful rescission claim from multiple investors can unravel an otherwise successful offering. The SEC and state securities regulators have brought enforcement actions against sponsors

who paid unlicensed finders and against the finders themselves, and have used those actions to generate investor notification obligations that effectively broadcast the violation to the entire investor base. Recent SEC enforcement actions in 2025 have reaffirmed the agency's focus on transaction based compensation as the hallmark of unregistered broker dealer activity, and the 2020 proposed finder exemption, which would have created a limited safe harbor, has not been adopted.

The analysis of whether a particular arrangement constitutes unregistered broker dealer activity turns on whether the compensation is transaction based, meaning whether the amount paid to the introducer is tied to the amount of capital the introducer's contacts invest. Fixed fees for introduction services, without any linkage to how much capital results, are analyzed differently. But in practice, most finder arrangements are transaction based, whether explicitly or implicitly, and the formal structure of the arrangement is less determinative than its economic substance.

### **Mistake 1: Unregistered Broker Dealer Activity**

#### **What it looks like.**

*A sponsor pays an individual 2 percent of the capital raised from investors that individual refers to the offering. The individual is not a registered broker dealer or associated person. The compensation is calculated based on the amount of capital the individual's contacts invest, not a flat fee for introductory services. In some arrangements, the transaction based nature of the compensation is not explicit. The parties simply understand that the introducer will receive a percentage of whatever is raised.*

#### **Why it happens.**

*Sponsors treat compensated introductions as informal business development arrangements rather than regulated securities activities. The friend of a friend network dynamic makes the arrangement feel personal rather than commercial. Sponsors who have used the same arrangement on prior deals without incident believe it has been validated by the absence of enforcement.*

#### **The legal consequence.**

*Section 15(a) violation for the finder; potential enforcement action against the sponsor for facilitating the unregistered broker dealer activity; investor rescission rights for every investor introduced through the arrangement, regardless of the investment's performance; and state securities law violations in addition to federal exposure. The rescission exposure applies to the full principal amount invested, not merely to the commission paid to the finder.*

#### **The fix.**

*Engage only registered broker dealers or their associated persons for compensated capital raising activity. Uncompensated introductions from members of the sponsor's personal network, where no transaction based compensation of any kind is paid, are permissible under most circumstances, but even these arrangements should be reviewed by securities counsel before implementation to confirm that no compensation arrangement, however informal, exists.*

## Mistake 2: General Solicitation Under Rule 506(b)

Rule 506(b) of Regulation D is the most commonly used securities exemption for private real estate syndications, and it contains a categorical prohibition on general solicitation and general advertising. A Rule 506(b) offering cannot be publicly marketed. It cannot be promoted on a publicly accessible website that describes the investment opportunity to anyone who visits it. It cannot be pitched at a publicly advertised conference where the audience has not been prescreened. It cannot be sent as a marketing email to a list of recipients who have no pre-existing substantive relationship with the sponsor.

The prohibition on general solicitation under Rule 506(b) is absolute in the sense that a single act of general solicitation contaminates the entire offering, not merely the investors reached through that act. The SEC has taken the position that once general solicitation has occurred in a purported Rule 506(b) offering, the exemption is unavailable for all investors admitted after that point, including investors with whom the sponsor had a pre-existing relationship. The contamination runs forward from the act of general solicitation, potentially invalidating every subscription accepted after it.

The most common form of general solicitation in today's capital raising environment is the social media post or the sponsor's website that describes a specific investment opportunity in terms that a general audience could understand and act upon. A LinkedIn post that says 'We are offering accredited investors the opportunity to invest in our new 250 unit multifamily acquisition in Austin, contact us for details' is general solicitation. A sponsor website that describes current investment opportunities, their projected returns, and a button to request an offering memorandum is general solicitation. The fact that the post was seen by only 50 people, or that the website gets modest traffic, does not change the analysis. The public availability of the communication, not its reach, is the determinative factor.

The distinction between a general solicitation and a permissible communication to potential investors with whom the sponsor has a pre-existing, substantive relationship is one that securities counsel needs to evaluate for each specific fact pattern. The SEC has provided guidance on what constitutes a pre-existing substantive relationship. It requires more than a

brief prior acquaintance, more than a recent connection on LinkedIn, and more than a general familiarity from industry events. A sponsor who is uncertain whether a proposed communication constitutes general solicitation has already identified the question that requires a legal opinion before the communication is sent.

## **Mistake 2: General Solicitation in a Rule 506(b) Offering**

### **What it looks like.**

*A sponsor posts about a specific offering opportunity on LinkedIn or Instagram, tagging it with details about the property, projected returns, and minimum investment. Or the sponsor's website has a Current Offerings page that describes available investments to anyone who visits the site. Or the sponsor sends a marketing email about the offering to a purchased or rented investor list, not to people with whom the sponsor has a pre-existing substantive relationship.*

### **Why it happens.**

*Sponsors who have learned that Rule 506(b) allows up to 35 non-accredited sophisticated investors and does not require advertising may not have internalized that it absolutely prohibits general solicitation. Sponsors whose prior informal capital raises involved emailing their broader network without incident may not understand that the SEC's standard for general solicitation is broader than they assumed.*

### **The legal consequence.**

*Loss of the Rule 506(b) exemption from the point of general solicitation forward; potential requirement to register the offering with the SEC under the Securities Act; investor rescission rights for all investors admitted during and after the period of general solicitation; and state securities law violations if the applicable state exemptions also prohibit general solicitation. The SEC has pursued enforcement actions against sponsors who conducted nominally private offerings through publicly accessible marketing.*

### **The fix.**

*If public marketing is part of the sponsor's capital raising strategy, structure the offering under Rule 506(c), which permits general solicitation but requires that every investor be an accredited investor verified through the specific documentary methods the rule prescribes, not merely self-certification. If using Rule 506(b), have securities counsel review every investor facing communication before it is sent or published, and confirm that a genuine pre-existing substantive relationship exists with every investor to whom the offering is presented.*

### Mistake 3: Failure to Verify Accredited Investor Status Under Rule 506(c)

The introduction of Rule 506(c) by the JOBS Act of 2012 created a permitted path for sponsors who want to publicly market their offerings: conduct a general solicitation, but admit only accredited investors, and take reasonable steps to verify that each investor actually qualifies as accredited. The verification requirement is the price of the marketing freedom that 506(c) provides. It is also the requirement that sponsors most commonly fail to satisfy.

Investor verification failures under Rule 506(c) take a specific and consistent form. The sponsor uses a subscription agreement or online portal that asks investors to check a box confirming they are accredited investors, and treats the checked box as satisfying the rule's verification requirement. It does not. The SEC has been explicit in its guidance on Rule 506(c). Self-certification, an investor's own statement that they are accredited, is categorically insufficient under 506(c) because it is not verification. Verification requires that the sponsor actually confirm the investor's qualification using one of the rule's specified methods.

The SEC's safe harbor verification methods under Rule 506(c) for income based accreditation are: review of IRS Form W-2s, Form 1099s, or Form 1040 for the two most recent years, along with a written representation from the investor that they reasonably expect to continue meeting the income threshold; or a written confirmation from a licensed attorney, certified public accountant, registered investment adviser, or registered broker dealer that they have taken reasonable steps to verify the investor's accredited status and have determined the investor qualifies. For net worth based accreditation, the methods include review of bank statements, brokerage account statements, and other documentation of assets and liabilities, with the investor excluding the net equity in their primary residence.

The consequence of inadequate verification under Rule 506(c) is that the offering does not actually satisfy the 506(c) exemption's conditions. The offering is treated as a general solicitation offering without a valid exemption from registration. Every investor admitted under that defective process is an investor in an unregistered securities offering. The rescission exposure that attaches to those investors, the full principal amount of their investments, is not reduced by the fact that the underlying property performed well.

#### **Mistake 3: Failure to Verify Accredited Investor Status Under Rule 506(c)**

##### **What it looks like.**

*A 506(c) offering whose subscription agreement contains an accredited investor questionnaire asking investors to self-certify their status by checking boxes and initialing a representation. No third party verification is conducted. No tax returns, bank statements, or attorney confirmations are collected. The subscription is accepted based entirely on the*

*investor's own statement. Or a sponsor uses a verification provider whose process relies on investor representations rather than documentary review of financial records.*

#### **Why it happens.**

*Sponsors who are accustomed to Rule 506(b) self-certification, which can, in some circumstances, support a reasonable basis for believing an investor qualifies, apply the same process to a 506(c) offering where a different legal standard applies. Sponsors who switch from 506(b) to 506(c) to enable public marketing may not adjust their investor onboarding process to match the new exemption's verification requirements.*

#### **The legal consequence.**

*Failure to satisfy the 506(c) exemption's conditions. The offering is treated as a general solicitation without a valid exemption. Investor rescission rights for all investors admitted through the defective verification process. SEC enforcement exposure. The verification failure may be discoverable years after the offering closes, when an investor seeks rescission or a regulatory examination occurs.*

#### **The fix.**

*Implement a verification process that satisfies one of Rule 506(c)'s specified safe harbor methods before the first investor is admitted. If using a third party verification provider, confirm in writing what specific documentary evidence the provider collects and reviews before issuing an accreditation confirmation, and have securities counsel confirm that the provider's process satisfies the applicable standard. Self-certification is not verification. A checkbox is not verification.*

## **Mistake 4: Selling to Non-accredited Investors Without Proper Disclosure**

Rule 506(b) permits a limited number of non-accredited investors, up to 35, provided that those investors are sophisticated, meaning they have sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of the investment. But admitting non-accredited investors under Rule 506(b) triggers a specific, additional disclosure obligation that many sponsors do not know about. Under Rule 502(b)(2) of Regulation D, the offering must provide non-accredited investors with audited financial statements and a disclosure document containing the specific information items required by the rule. For most real estate offerings, the disclosure tracks the requirements that would apply under Regulation A for offerings up to \$20 million, or under Part I of Form S-1 or Form S-11 for larger offerings.

The practical consequence of this requirement is that Rule 506(b) offerings that include non-accredited investors face significantly higher disclosure and documentation standards than

those limited to accredited investors. The audited financial statement requirement alone can make including non-accredited investors economically impractical for many early stage sponsors. Sponsors who admit non-accredited investors under the mistaken belief that the 506(b) exemption's non-accredited investor allowance means they can treat those investors identically to accredited investors are creating a disclosure deficiency that gives each non-accredited investor rescission rights.

A separate and increasingly common form of this mistake is the sponsor who believes they have complied with Rule 506(b) by admitting only accredited investors, but who, through inadequate investor qualification screening, has actually admitted investors who do not qualify as accredited. An investor who is admitted as accredited based on their own self-certification, but who in fact does not meet the income or net worth thresholds for accredited investor status, is a non-accredited investor. If the offering has already admitted 35 non-accredited investors, or admitted non-accredited investors without the required disclosure, the additionally admitted investor causes the offering to exceed the Rule 506(b) limit or to lack the required disclosure.

#### **Mistake 4: Selling to Non-accredited Investors Without Required Disclosure**

##### **What it looks like.**

*A 506(b) sponsor admits a non-accredited investor, a family friend or long term relationship who the sponsor wanted to include, without providing the audited financial statements and enhanced disclosure that Rule 506(b) requires for non-accredited investors. Or a sponsor admits investors they believe are accredited based on self-certification, some of whom do not actually satisfy the accredited investor definition.*

##### **Why it happens.**

*The 506(b) rule's allowance of up to 35 non-accredited investors is widely known. The enhanced disclosure requirement that applies to those investors is less widely understood. Sponsors who are eager to include a particular investor without meeting the verification threshold may admit them without researching the additional obligations their admission triggers.*

##### **The legal consequence.**

*Rescission rights for non-accredited investors who were not provided the required disclosure; potential loss of the Rule 506(b) exemption if more than 35 non-accredited investors are admitted; SEC enforcement exposure; and state securities law violations. The consequences extend to all investors in the offering if the exemption is lost, not merely to the non-accredited investors.*

##### **The fix.**



*Confirm each investor's accreditation status through a diligence process, not merely self-certification, before admission. If the offering will include non-accredited investors, have securities counsel review and confirm the required disclosure obligations before those investors are admitted. Consider whether the offering should be structured to restrict admission to accredited investors only, avoiding the enhanced disclosure and documentation requirements that non-accredited investor admission triggers.*

## Mistake 5: Missing Form D Filing Deadlines

Form D is the SEC filing that notifies the Commission when a company makes a securities offering relying on a Regulation D exemption. Under Rule 503, the issuer must file Form D with the SEC no later than 15 calendar days after the first sale of securities in the offering. A sale for this purpose occurs when the issuer accepts a binding commitment from an investor, typically when the subscription agreement is executed and the investor's capital commitment becomes binding, not necessarily when the funds actually arrive.

The Form D filing obligation is procedural, but its failure carries real consequences. A late or missing Form D filing is a violation of Regulation D that, in some circumstances, can affect the availability of the exemption itself. More practically, Form D filings are public records that state securities regulators use to monitor private offerings within their jurisdictions and to identify offerings that may require state level registration or notice filings. A missing Form D filing is one of the first things a regulatory examination will identify, and it creates an inference of broader compliance carelessness that affects the scope of the examination.

Form D filings must be amended when certain information changes: when the offering is still ongoing and the total offering amount has increased materially, when a new jurisdiction has been added, or when annual amendments are required for offerings that continue beyond one year. Sponsors who filed a Form D at the outset of an offering and then conducted additional closing rounds without amending the Form D to reflect the revised offering size and additional states have an ongoing compliance deficiency that accumulates with each additional closing.

## Mistake 5: Missing Form D Filing Deadlines

### What it looks like.

*A sponsor accepts the first investor's binding subscription on March 15 but does not file Form D until June. Or a sponsor files Form D at the first closing but does not amend it when additional closings significantly expand the offering size or add investors from new*



*states. Or a sponsor conducts multiple separate offerings over several years, filing Form D for the first but not for subsequent offerings that are treated as separate under Regulation D.*

#### **Why it happens.**

*Form D is not a substantive offering document. It does not protect investors or provide meaningful disclosure. Sponsors who are focused on the substance of the offering (the PPM, the subscription agreement, the investor communications) may not track the Form D deadline as carefully as the transactional milestones. Some sponsors are unaware of the 15 calendar day deadline or believe the filing can wait until the offering closes.*

#### **The legal consequence.**

*Violation of Rule 503 of Regulation D; state securities regulator scrutiny in any state where the late filing delayed or prevented a required state level notice filing; adverse inference of compliance carelessness in any subsequent regulatory examination; and in some states, loss of the state exemption that depends on timely Form D filing. The SEC has pursued enforcement actions for persistent or deliberate failure to file.*

#### **The fix.**

*Build the Form D filing deadline into the closing calendar as a milestone with a specific due date calculated from the first sale date. Assign responsibility for the filing to a specific person, typically securities counsel, with a calendar reminder. Plan Form D amendments for any subsequent closings that exceed the original offering size, add new states, or occur more than one year after the initial filing.*

## **Mistake 6: Failing to Make Required State Blue Sky Filings**

The federal Regulation D exemption preempts most state registration requirements for Rule 506 offerings, but it does not eliminate state securities law obligations entirely. Every state in which an investor resides requires a notice filing, sometimes called a Form D copy filing or a blue sky notice, when a Regulation D offering is sold to that state's residents. These notice filings are typically required at or shortly after the first sale to an investor in that state, and they involve payment of a state fee and sometimes submission of offering documents.

The consequence of missing a required state filing is not merely a technical violation. Several states, most notably New York, Texas, and California, treat the failure to make required notice filings as a basis for rescission by investors in those states. A California investor who subscribed to a Regulation D offering for which no California notice filing was made may have a statutory right to rescind their investment and recover their principal, regardless of the offering's

financial performance. Sponsors who conduct multi-state offerings without a systematic approach to tracking which states require filings, and meeting those filing deadlines, are creating rescission exposure that is distributed across their investor base.

The blue sky filing obligation does not end at the initial offering. Many states require annual renewal filings for offerings that remain open beyond the initial filing period. A sponsor who makes the required initial filing in a state but does not renew it while the offering remains open has allowed the state exemption to lapse, creating a period during which subsequent investors from that state were admitted without a valid state exemption.

### **Mistake 6: Failing to Make Required State Blue Sky Filings**

#### **What it looks like.**

*A sponsor closes a Regulation D offering with investors from 12 states but makes notice filings in only 6 of those states, the ones the sponsor or their counsel happened to know required filings, without systematically reviewing the filing requirements in each investor's state of residence. Or a sponsor makes initial blue sky filings but does not track renewal obligations, allowing filings in key states to lapse while the offering remains open.*

#### **Why it happens.**

*State blue sky filing requirements vary by state, change periodically, and are not a uniform national standard. Sponsors who are focused on the federal exemption may not investigate state level obligations systematically. Sponsors who have raised capital from investors in the same states for several prior offerings may not identify that a new investor from a state they have not previously encountered has different filing requirements.*

#### **The legal consequence.**

*Rescission rights for investors in states where required filings were not made. In some states this is a statutory remedy that does not require proof of investor harm. State enforcement action including potential bar on future offerings in the state, and personal liability for the manager in states whose securities laws impose personal liability for registration violations. The cumulative rescission exposure across multiple missing state filings can be material.*

#### **The fix.**

*Maintain a state by state filing tracker that is updated whenever a new investor from a new state is admitted. Have securities counsel, or a blue sky service familiar with all 50 states' requirements, review filing obligations for every state in which the offering is sold. Build annual renewal deadlines into the compliance calendar for any state that requires them. Do*

*not assume that a prior deal's filing program applies to a new offering without confirming current requirements.*

## Documentation and Process Mistakes

Documentation and process failures are different in character from regulatory violations. Most regulatory mistakes are binary. The general solicitation either occurred or it did not. The Form D was either filed on time or it was not. Documentation failures exist on a spectrum. A PPM can be slightly outdated or seriously outdated. A risk factor section can be partially adequate or entirely generic. A subscription agreement can be missing one state specific representation or can contain outdated accreditation definitions throughout. The spectrum does not eliminate the legal consequences of documentation failures, but it affects how those consequences are analyzed and what remediation is available. The goal of this section is to describe the failure modes precisely enough that a sponsor reviewing their own documents can identify where on that spectrum their offering sits.

### Mistake 7: Using Form Documents Without Customizing Them to the Deal

Private placement memoranda, operating agreements, and subscription agreements are available from a variety of sources: prior deals, online document services, template libraries provided by professionals outside the securities law field. Sponsors who use these documents without having them reviewed and customized by securities counsel for the specific offering are using documents that were written for a different deal. The risk disclosures reflect the risks of the deal the form was written for. The economic terms reflect the structure of the original deal. The representations reflect the circumstances of the original offering. None of that may be true of the current deal.

The most dangerous form of this mistake is not the sponsor who uses an outdated template and knows it. They at least have a reason to be cautious. It is the sponsor who uses a template from a prior, successful offering, assumes it applies equally to the current offering because the structure is similar, and does not identify the specific ways in which the current offering differs from the prior one. The differences can be consequential: a different property type with different risk factors, a different capital structure with different investor economics, a different target investor base with different disclosure-expectations.

Securities law requires that every PPM disclose the specific material risks of the specific investment being offered. An investor who makes a decision based on a PPM that describes the risks of a different investment, or that omits material risks of the actual investment because

those risks were not present in the deal the form was written for, has not received the disclosure the law requires. The antifraud provisions apply to the PPM as actually delivered, not to what the sponsor intended to disclose.

### **Mistake 7: Using Form Documents Without Customizing Them to the Deal**

#### **What it looks like.**

*A PPM for a multifamily value add acquisition whose risk factors section describes the risks of a ground up development project, because the PPM form was borrowed from a sponsor who does development. An operating agreement whose waterfall provisions describe a different economic structure than the sponsor communicated to investors during marketing. Subscription agreement representations that are not accurate for the specific offering's structure or exemption.*

#### **Why it happens.**

*Document preparation by securities counsel is a cost that sponsors whose deals are under financial pressure may try to minimize. Prior successful offerings create overconfidence that the documents that worked before will work again. Non attorney professionals who assist with offering preparation may provide documents that look complete but have not been reviewed for the specific offering's legal requirements.*

#### **The legal consequence.**

*Antifraud liability for material omissions or misstatements in offering documents that were not reviewed for the specific deal; investor rescission claims based on inaccurate risk factor disclosures; inconsistency between the PPM's economic terms description and the operating agreement's actual provisions; and regulatory exposure if the documents reflect securities exemptions or investor qualification standards that do not match the actual offering structure.*

#### **The fix.**

*Have securities counsel review and customize every offering document for the specific offering before any investor is given access to those documents. The PPM's risk factor section must reflect the specific risks of the specific property, structure, market, and sponsor. The economic terms must match both the PPM description and the operating agreement's actual provisions. Document review is not optional after the fact confirmation. It is a pre offering requirement.*

### **Mistake 8: Inadequate Risk Factor Disclosure in the PPM**

The private placement memorandum's risk factor section is the primary mechanism through which a sponsor satisfies the antifraud obligation to disclose all material risks associated with the investment. Risk factors that are too general ('real estate investing involves risks') do not satisfy the disclosure requirement. Risk factors that apply to real estate generally but do not identify the specific risks of the specific offering (the risks of the particular market, the particular property condition, the particular business plan, the particular sponsor) are better than nothing, but do not fully satisfy the specificity the law requires.

The PPM risk factor section should identify, with enough specificity that an investor can actually evaluate the risk, every material risk that could cause the investment to underperform or fail. For a value add multifamily offering in a specific submarket, those risks include the specific construction cost risk associated with the planned renovation scope; the specific lease up risk given current market vacancy rates and the projected rental rate premium; the specific refinancing risk if the business plan depends on a refinancing at a specific LTV; the specific interest rate risk if the property is financed with floating rate debt; and the specific execution risk associated with the sponsor's experience with this property type and market.

A risk factor that says 'construction costs may be higher than anticipated' does not identify whether the construction program at this particular property involves unusual conditions, older infrastructure, or a market with constrained contractor availability. A risk factor that says 'the real estate market may decline' does not identify the specific supply dynamics in the target submarket that may affect lease up velocity. Generic risk factors that could apply to any real estate investment are not adequate disclosure of the specific investment's specific risks.

### **Mistake 8: Inadequate Risk Factor Disclosure in the PPM**

#### **What it looks like.**

*A PPM whose risk factor section is three pages of generic real estate investment risks (interest rate risk, market risk, construction risk, regulatory risk) without any risk factor specific to the particular property, the particular renovation scope, the particular sponsor's track record gaps, or the particular market conditions. Or a PPM that describes risks generically but nowhere discloses that the sponsor has never managed a property of this size, in this market, with this type of financing structure.*

#### **Why it happens.**

*Risk factor sections are the most time consuming part of the PPM to write properly, because they require genuine analysis of what could go wrong with this specific deal. Generic risk factors are easier to produce and may satisfy the sponsor's impression of*

*what a risk factor section should look like without satisfying the legal standard of materiality and specificity.*

#### **The legal consequence.**

*Antifraud liability under Section 17(a) of the Securities Act and Rule 10b-5 under the Exchange Act for material omissions of specific risk information; investor rescission claims when risks that should have been disclosed materialize and investors can demonstrate they would have made different investment decisions with accurate disclosure; and regulatory enforcement for disclosure deficiencies in PPMs.*

#### **The fix.**

*Draft risk factors after a genuine analysis of what is specifically risky about this particular investment, not after reviewing what risk factors appeared in the prior deal's PPM. Risk factors should be organized by category and should include at least one risk specific to the property, at least one risk specific to the market, at least one risk specific to the business plan execution, at least one risk specific to the financing structure, and at least one risk specific to the sponsor's experience with this type of investment.*

## **Mistake 9: Failure to Update the PPM for Material Developments**

The PPM is not a static document that is prepared once and then delivered without revision to every investor who joins the offering. It is a disclosure document that must accurately reflect the offering's current terms, the property's current condition, and all material facts about the investment at the time each investor makes their subscription decision. A material development that occurs after the PPM is prepared (a change in the property's condition, a change in the financing terms, a significant development in the local market, a material change in the sponsor's financial condition or track record) must be disclosed to investors before they subscribe.

The obligation to update the PPM arises not from any specific provision that says update the PPM when facts change.' It arises from the underlying antifraud obligation. It is a violation of Section 17(a) and Rule 10b-5 to make a material omission in connection with the offer of a security, and an investor who subscribes based on a PPM that was accurate when written but is now materially inaccurate because of an undisclosed subsequent development has made their investment decision without material information.

The timing of the update obligation depends on when the material development occurs relative to the offering's closing schedule. A development that occurs during an offering with multiple planned closings must be disclosed before the next closing through a PPM amendment or

supplement. An investor who has already subscribed and has been given the updated information must have the opportunity to rescind their subscription before the closing if the updated information is material. A development that occurs after all subscriptions are closed but before the investment's closing date, such as a material change in the property's condition discovered during due diligence, must be disclosed before the investment closes.

### **Mistake 9: Failure to Update the PPM for Material Developments**

#### **What it looks like.**

*A PPM prepared in January that describes the property's projected NOI and the underwriting assumptions. By the time of the second closing in April, a major tenant in the property has vacated, reducing the in place NOI by 25 percent. The April investors receive the same January PPM without any disclosure of the tenant departure. Or a PPM that describes the financing as fixed rate debt when, by the time subscriptions are accepted, the sponsor has negotiated floating rate bridge debt with different risk characteristics.*

#### **Why it happens.**

*Sponsors who are focused on closing the offering on schedule may treat an interim development as something to manage operationally rather than as something that requires disclosure. The judgment that a development is not material enough to require a PPM update is frequently made by the sponsor without legal guidance, a judgment that the sponsor is not legally qualified to make unilaterally.*

#### **The legal consequence.**

*Antifraud liability for investors who subscribed after the material development without being informed of it; investor rescission claims from those investors; potential SEC enforcement for ongoing offering fraud; and the retroactive discovery by earlier investors, whose PPM was accurate, that later investors received less favorable terms or disclosed different information.*

#### **The fix.**

*Establish a process for reviewing the PPM's accuracy before each closing and before any new investor package is sent. If any material fact has changed since the PPM was prepared, have securities counsel prepare a supplement or amendment before any additional subscriptions are accepted. The judgment of whether a development is material enough to require disclosure should be made by securities counsel, not by the sponsor whose interests may be affected by the timing of disclosure.*



## Mistake 10: Subscription Agreement Deficiencies

The subscription agreement is the legal document through which each investor makes their investment, the document that records the investor's representations about their accreditation and sophistication, their acknowledgment of the risks disclosed in the PPM, their agreement to be bound by the operating agreement, and the terms of their capital commitment. A deficient subscription agreement is not merely incomplete documentation. It is a deficient legal record that affects the sponsor's ability to rely on investor representations and that may leave the sponsor without the defenses that a properly structured subscription agreement provides.

Common subscription agreement deficiencies include representations about accredited investor status that do not specifically reference the applicable definition and therefore do not clearly establish that the investor has read and applied the definition to their own circumstances; acknowledgments of risk that are so general as to be meaningless as a defense to an investor's later claim that they were not informed of the risks; missing representations about the investor's sophistication and ability to bear economic loss, which are required as a condition of relying on the investor's sophistication under Rule 506(b); and state specific representations that are required by certain states' blue sky laws but that a form subscription agreement prepared for general use does not contain.

A subscription agreement that does not specifically address the chosen securities exemption's conditions (accreditation under 506(b), accreditation plus verification under 506(c), or sophistication for the non-accredited investor allowance under 506(b)) is not a legally complete document for an offering relying on that exemption. The subscription process must be viewed not merely as the mechanism for collecting investor signatures and capital, but as the legal record that documents the basis for the offering's exemption from registration for each individual investor.

### Mistake 10: Subscription Agreement Deficiencies

#### What it looks like.

*A subscription agreement that asks investors to check a box confirming they are sophisticated investors without including the legal definition of that term or the specific factors that establish sophistication. Or a subscription agreement whose accredited investor representations refer to the investor's net worth without excluding the primary residence as required by the current definition. Or a form subscription agreement for a 506(c) offering that includes a self-certification of accreditation rather than a requirement to complete a third party verification process.*

#### Why it happens.



*Subscription agreements from prior offerings, modified slightly for the current deal, are used without verifying that the representations accurately reflect the current offering's exemption, investor base, and applicable legal requirements. Online form documents may reflect an outdated version of the accredited investor definition or omit state specific required representations.*

#### **The legal consequence.**

*Deficient investor representations that do not establish the factual basis for the exemption relied upon; investor claims that representations in the subscription agreement do not support the sponsor's reliance on the exemption; missing state required representations that affect the availability of the state exemption; and investor rescission claims when subscription agreement deficiencies are identified in regulatory examinations or investor disputes.*

#### **The fix.**

*Have securities counsel review and update the subscription agreement for each offering, confirming that the investor representations specifically address the applicable exemption's conditions, reference the current legal definitions, and include any state specific representations required for the states where investors will be admitted. Do not use a subscription agreement from a prior offering without confirming that the exemption, investor qualification standards, and applicable state requirements are identical to the prior offering.*

## **Investor Management Mistakes**

Regulatory violations and documentation failures create legal exposure that is often discovered through regulatory examinations, investor disputes, or the sponsor's own internal review. Investor management failures create something different. They create the conditions under which investors decide to pursue legal action when they would not otherwise have done so. Most investors in private real estate funds who experience a disappointing return do not sue. What they do, whether they pursue a claim, file a regulatory complaint, or simply walk away, tracks the quality of the relationship with the sponsor throughout the investment and the quality of the communications they received when things were not going as planned. This section is about the investor management failures that most reliably convert a disappointed investor into a litigating one.

### **Mistake 11: Over Promising Returns in Marketing Materials**

The SEC's marketing rule for investment advisers, Rule 206(4)-1, applies to registered investment advisers and imposes specific requirements on performance advertising, including prohibitions on presenting hypothetical or projected returns without adequate disclosures. Even for sponsors who are not registered investment advisers, the antifraud provisions of the Securities Act and the Exchange Act impose an independent obligation on all persons offering securities. Projections and return estimates presented to investors in connection with a securities offering must be accompanied by a reasonable basis for the projections and appropriate disclosure of the assumptions, limitations, and risks that affect them.

The most common form of return over promising is the marketing pitch that presents projected returns as likely outcomes rather than as best case estimates under a favorable set of assumptions. A sponsor who tells investors they can expect a 15 percent IRR, using language that conveys reasonable probability rather than projection, and who presents that estimate in marketing materials without a clear description of the assumptions underlying the projection and the risks that could cause underperformance has made a representation that the antifraud provisions govern. If the return does not materialize, investors who relied on the representation as an expectation rather than a projection have a basis for a claim.

Return projections in offering materials must be supported by a reasonable analytical basis, must be accompanied by the material assumptions on which the projection depends, and must be presented with language that clearly identifies them as projections under specific assumptions, not as expected or guaranteed outcomes. Projected returns that assume a specific exit cap rate, a specific occupancy level, a specific renovation timeline, and a specific interest rate environment must disclose each of those assumptions so that investors can evaluate the projection's sensitivity to changes in any of them.

### **Mistake 11: Over Promising Returns in Marketing Materials**

#### **What it looks like.**

*A sponsor's pitch deck that shows 15 to 18 percent IRR projected returns with an asterisk leading to a single line of small print disclaimer. Or an email to potential investors that says 'we are targeting returns of 2x equity multiple over a 5 year hold' without any description of the assumptions that drive the projection. Or a sponsor who verbally describes projected returns to investors in a way that conveys more certainty than the written PPM, which contains the actual disclosure, would support.*

#### **Why it happens.**

*Return projections are the most compelling element of an investment pitch. Sponsors who are competing for investor capital have an incentive to present their projected returns as*

*attractively as possible, and the line between targeting and expecting is easy to blur in a competitive capital raising environment. Verbal statements made in investor presentations are also harder to document and review than written materials.*

#### **The legal consequence.**

*Antifraud liability under Section 17(a) and Rule 10b-5 for material misrepresentations about projected returns; investor rescission claims from investors who can demonstrate reliance on the return projections; regulatory scrutiny of marketing materials that contain projections without adequate assumptions disclosure; and for registered investment advisers, violations of Rule 206(4)-1.*

#### **The fix.**

*Present all return projections as projections under specified assumptions, not as expectations. Describe every material assumption underlying the projection. Include scenario analysis showing returns under less favorable assumptions. Have securities counsel review all marketing materials, including pitch decks, email communications, and scripts for investor presentations, before they are used. Ensure that verbal statements made in investor presentations are consistent with the written PPM's projections and disclosures.*

## **A Pattern Worth Recognizing**

Setting these eleven mistakes side by side, the most striking thing is not how different they are but how similar their underlying causes turn out to be. Six of the eleven (unregistered broker dealer activity, general solicitation, inadequate verification, non-accredited investor disclosure failures, Form D deadline misses, and state blue sky gaps) are regulatory compliance failures that most sponsors would correctly identify as violations if asked about them in the abstract. The problem is not that sponsors do not know the rules. The problem is the distance between knowing a rule and operating a capital raising process that reliably satisfies it on every deal, for every investor, across every closing.

The documentation mistakes (form documents used without customization, risk factors written at a generic level, PPMs not updated for material developments, subscription agreements with deficiencies) reflect a different kind of failure: the compression of document preparation under time and cost pressure until the documents nominally exist but do not do the work they are supposed to do. A PPM that runs 50 pages and contains no risk factor specific to the sponsor's actual track record or the actual property's actual market has consumed the time required to produce a document while failing to produce the legal protection a document is supposed to

provide. A subscription agreement from a prior deal that no one reviewed for the current deal's different exemption has the same problem in a different form.

The investor management mistake (presenting return projections in terms that imply probability rather than projection) is the capital raising equivalent of the disclosure failures in the documentation category. The mechanism is different. The antifraud obligation is violated through oral presentations and marketing materials rather than through a written offering document. But the underlying failure is identical. The sponsor presented the investment in a way that created a reasonable investor expectation that the facts did not support. The consequences of that failure play out through investor litigation rather than through regulatory enforcement, but the antecedent cause is the same. What the sponsor said, and how they said it, determined what investors believed. What investors believed determined what they decided to do when the investment did not deliver.

| Mistake                                        | Root Cause and Prevention                                                                                                                                                                                                                                                                                                                                               |
|------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1. Unregistered broker dealer activity         | Root cause: sponsor treats compensated introductions as casual business development rather than regulated securities activity. Prevention: any person receiving transaction based compensation for introducing investors must be a registered broker dealer or associated person. All finder arrangements must be reviewed by securities counsel before implementation. |
| 2. General solicitation under 506(b)           | Root cause: sponsor posts about offerings on social media or operates a publicly accessible offering page without recognizing these as general solicitation. Prevention: if public marketing is required, use 506(c). If using 506(b), have every investor facing communication reviewed by securities counsel before it is sent or published.                          |
| 3. Inadequate verification under 506(c)        | Root cause: sponsor conflates 506(b) self-certification sufficiency with 506(c)'s documentary verification requirement. Prevention: confirm in writing that the verification provider's process satisfies Rule 506(c)'s safe harbor methods before the first investor is admitted.                                                                                      |
| 4. Non-accredited investors without disclosure | Root cause: sponsor knows that 506(b) permits up to 35 non-accredited investors but does not know the enhanced disclosure obligations their admission triggers. Prevention: confirm each investor's accreditation through a diligence process; have counsel review all non-accredited investor admission obligations before those investors are admitted.               |
| 5. Missing Form D filing deadlines             | Root cause: sponsor is focused on transactional milestones and does not track the 15 calendar day Form D filing deadline as a closing calendar item. Prevention: assign Form D filing responsibility to securities counsel with a calendar deadline; plan amendments for subsequent closings that expand the offering size or add new states.                           |
| 6. Missing state blue sky filings              | Root cause: sponsor is aware of the federal Regulation D exemption but does not systematically track state level notice filing requirements for each investor's state of residence. Prevention: maintain a state by state                                                                                                                                               |

| Mistake                                            | Root Cause and Prevention                                                                                                                                                                                                                                                                                                  |
|----------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                    | filing tracker; have securities counsel or a blue sky service review obligations for every state before admitting investors from that state.                                                                                                                                                                               |
| 7. Form documents without customization            | Root cause: prior successful offering documents are reused with minimal updates, without review for the specific deal's different terms, risks, and structure. Prevention: securities counsel must review and customize every offering document for the specific offering before any investor receives those documents.    |
| 8. Inadequate risk factor disclosure               | Root cause: risk factor sections drafted at a generic level that applies to any real estate investment, without analysis of the specific property's, market's, or sponsor's particular risk profile. Prevention: draft risk factors after genuine analysis of what is specifically risky about this particular investment. |
| 9. Failure to update PPM for material developments | Root cause: sponsor treats interim adverse developments as operational management issues rather than disclosure obligations. Prevention: review PPM accuracy before each closing; have securities counsel prepare supplements for any material development that occurs after the PPM is prepared.                          |
| 10. Subscription agreement deficiencies            | Root cause: subscription agreement from prior offering used without review of whether it accurately addresses the current offering's exemption, investor qualification standard, and applicable state requirements. Prevention: securities counsel must review and update the subscription agreement for each offering.    |
| 11. Over promising returns in marketing            | Root cause: competitive pressure to present projected returns attractively leads to language that conveys probability rather than projection. Prevention: every return projection must be presented with assumptions, scenario analysis, and consistent language between written and verbal presentations.                 |

## Practical Takeaways

- Transaction based compensation to any person who introduces investors to a securities offering triggers the broker dealer registration requirement under Section 15(a). The informality of the arrangement, the small size of the offering, and the prior relationship between the sponsor and the finder do not change the legal analysis. Every person receiving compensation tied to the amount of capital raised must be a registered broker dealer or associated person. Uncompensated introductions, where no compensation of any kind is tied to the amount invested, require separate review.
- Rule 506(b) prohibits general solicitation absolutely. A single act of general solicitation (a social media post describing the offering, a publicly accessible website page with offering terms, a marketing email to a list without pre-existing relationships) contaminates the entire Rule 506(b) offering from that point forward. Sponsors who want

to market publicly must use Rule 506(c), which permits general solicitation but requires documentary verification of every investor's accredited status.

- Self-certification is not verification under Rule 506(c). The rule requires that the issuer take reasonable steps to verify accredited investor status, steps that, under the SEC's safe harbor, involve documentary review of financial records or written confirmation from a licensed professional. A checkbox on a subscription agreement, however prominently worded, is not verification. A verification provider whose process is based on investor representations rather than document review has not satisfied the 506(c) standard.
- Form D must be filed within 15 calendar days of the first sale of securities in the offering. The filing deadline runs from the date the first binding subscription agreement is signed, not the date funds arrive and not the date of the first closing. Build the Form D deadline into the closing calendar with a specific responsible party and a calendar reminder.
- State blue sky notice filing requirements are not uniform across all 50 states and are not satisfied by the federal Form D alone. Every state in which an investor resides may require a separate filing, often with a fee and sometimes with submission of offering materials. Several states impose investor rescission rights for failure to make required notice filings. Maintain a state by state filing tracker and review obligations for each new state before investors from that state are admitted.
- Form documents from prior offerings are not automatically suitable for current offerings. The PPM's risk factors must reflect the specific risks of this specific investment. The subscription agreement's representations must accurately address this offering's exemption and investor qualification standard. The operating agreement's economic terms must match what was communicated to investors. Have securities counsel review and customize every offering document for each specific offering.
- The obligation to disclose material developments does not end when the PPM is finalized. Every material development that occurs during the offering period (a change in the property's condition, financing terms, market conditions, or the sponsor's circumstances) must be disclosed to investors before they subscribe. The antifraud provisions require that every investor make their investment decision with current, accurate, complete information.
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## CHAPTER THIRTY THREE

# Common Structuring Mistakes

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Every attorney who practices in the private securities space has seen the same structuring mistakes appear in different offerings, in different years, with different sponsors, but with a regularity that suggests these failures are not accidents. They are patterns. The pattern of a real estate operator who understands assets and markets but consistently underestimates the precision required in legal documentation. The pattern of a first time syndicator who used a form operating agreement from the internet and does not realize what it does not contain. The pattern of a repeat sponsor who has done five deals and now believes the sixth is close enough to the fifth that the documents can simply be updated rather than rethought.

Structuring mistakes in private real estate offerings are-expensive in two distinct ways. Some are-expensive at the moment they are discovered: the waterfall calculation that cannot be performed because the distributable cash definition is circular, the investor exit that cannot be processed because the transfer restriction provision has no workable mechanism for approval, the capital call that investors legally cannot be required to fund because the operating agreement made additional contributions voluntary without specifying a consequence for non-participation. Others are-expensive only years later, at exactly the moment when something consequential turns on getting the answer right: the clawback provision that does not deliver the protection investors were promised, the FIRPTA withholding that was never collected because nobody read the foreign investor provisions carefully, the carried interest structure that fails to qualify for capital gains treatment because a threshold document requirement was overlooked.

This chapter works through fourteen of the most consequential structuring mistakes in private real estate syndications and funds, organized by category: entity structure, economic terms, governing document architecture, and tax structure. Each mistake is described with enough analytical depth that a sponsor reading this chapter can recognize whether their current structure has the problem and understand why it matters enough to fix before the first investor subscribes, before the first distribution is made, or before the event that would expose the flaw actually occurs.

Most of these mistakes are preventable. None of them is inevitable. All of them are, without exception, less expensive to avoid than to discover.

## Entity Structure Mistakes

Entity structure mistakes are the category most likely to create liability exposure that the sponsor did not anticipate and cannot contain after the fact. The choice of entity, the separation

between entities, and the jurisdiction in which those entities are formed are not administrative decisions. They are the legal architecture on which every other aspect of the investment rests. Getting the architecture wrong does not produce an immediate visible failure. It produces a structural vulnerability that becomes apparent at the worst possible moment, when an investor is seeking recovery or a lender is asserting remedies that the sponsor believed were limited by the Non-Recourse loan documents.

### **Mistake 1: Inadequate Separation Between the Sponsor Entity and the Operating Entity**

The standard private real estate syndication structure uses a special purpose entity, typically a Delaware LLC, to own each property, with the sponsor's management company serving as the manager of that entity. The purpose of this separation is both legal and practical. The property owning entity is isolated from the sponsor's other liabilities and business activities, and investors' claims arising from the property investment are theoretically limited to the assets of the property owning entity rather than extending to the sponsor's other properties, other funds, or personal assets.

The most common form of inadequate entity separation is the sponsor who operates the property owning entity and the sponsor entity as if they are the same business: commingling funds between the two entities, using the property entity's bank account for sponsor level expenses, having the property entity enter into contracts that are obligations of the sponsor, or failing to maintain separate books, records, and bank accounts for each entity. When a court is asked to determine whether the property entity's separate liability shield should be respected, the facts it looks to are—exactly these operational separations or their absence.

Veil piercing claims are more common in distressed real estate situations than sponsors expect. An investor or lender who cannot recover from the property entity may assert that the entity was not operated as a genuinely separate legal person, and therefore that the sponsor should be personally liable for the entity's obligations. Courts in most jurisdictions apply a multi factor test that includes whether the entity maintained separate books and records, whether the entities' funds were commingled, whether the entity observed corporate formalities, whether the entity was adequately capitalized for its purposes, and whether the entity was used as a fraud or to defeat a legal obligation. A sponsor who operated the entities as a single business fails most or all of these factors.

#### **Mistake 1: Inadequate Separation Between the Sponsor Entity and the Operating Entity**

**What it looks like.**



*A sponsor uses the property owning LLC's operating account to pay sponsor level expenses. Property management agreements are entered into by the sponsor entity rather than the property LLC. Financial reporting does not distinguish between entity level and fund level expenses. A single bank account serves multiple purposes without allocation methodology.*

#### **Why it happens.**

*Sponsors in the early stages of their investment businesses often treat entity separation as a formality rather than a substantive protection. The practical convenience of operating from a single account and a single set of books feels harmless because the business is small and the entities are all ultimately owned by the same principals.*

#### **The legal consequence.**

*Loss of the liability shield through veil piercing, making the sponsor personally liable for the property entity's obligations; potential breach of the fiduciary duty owed to investors whose capital is at risk from the sponsor's commingled operations; and potential securities fraud exposure if the commingling was not disclosed in the PPM.*

#### **The fix.**

*Each property owning entity must have its own bank account, its own books and records, its own set of governing documents, and its own contractual relationships with vendors and service providers. No funds move between entities without a documented, arm's length basis. The sponsor entity's expenses are paid from the sponsor entity's accounts, not from property entity cash flows except through specifically documented management fees.*

## **Mistake 2: Failure to Use a Separate SPV for Each Asset in a Multi Asset Fund**

In a multi asset fund (a fund that acquires multiple properties during its investment period) the failure to house each property in its own special purpose vehicle is a structural mistake that creates liability cross contamination between assets, complicates lender financing, creates obstacles to individual asset disposition, and exposes the entire fund to the liabilities of each individual property.

The proper structure for a multi asset fund uses a master fund LLC at the top of the structure, with each property owned by a separate LLC that is wholly owned by the master fund. This structure achieves several things simultaneously. The liability of each property is contained within its own SPV, so that a construction accident, environmental liability, or tenant claim at one property does not have direct recourse against the other properties. Lenders can take a

mortgage on the specific SPV entity that owns their collateral without encumbering the fund's other assets. Individual assets can be sold by transferring the SPV, which may be more tax efficient than an asset sale and avoids the need to assign all the property specific contracts to a new owner. And the fund can bring in additional equity investors or preferred equity at the individual SPV level without affecting the master fund structure.

Sponsors who acquire multiple properties in a single LLC, placing Property A, Property B, and Property C all in the same entity, have created a structure that is fundamentally difficult to unwind. Separating properties into individual SPVs after acquisition requires property transfers that trigger recording fees and transfer taxes, lender consents for any security interest changes, and in some cases creates income tax recognition events. The cost of the restructuring routinely exceeds the cost of getting the structure right before the first property was acquired.

## **Mistake 2: Failure to Use a Separate SPV for Each Asset in a Multi Asset Fund**

### **What it looks like.**

*A multi property fund that holds three or four properties all in the same LLC, with a single operating agreement governing all properties and a single bank account through which all property level cash flows and expenses are processed. Or a fund whose offering documents contemplate a multi asset strategy but whose entity structure was only designed for the first acquisition.*

### **Why it happens.**

*Sponsors believe a single entity structure is simpler to administer and less expensive to form. The cross contamination consequences are invisible until a property specific liability event occurs. Some sponsors intend to create SPVs eventually but defer the formation and then never complete it.*

### **The legal consequence.**

*Liability at one property reaching the fund's other assets; lender financing complications when a senior lender cannot obtain a clean first mortgage on a specific property; individual property disposition complications when the asset and its liabilities cannot be separated from the fund entity; potential investor claims when the multi asset structure-exposes their capital to risks they were not disclosed.*

### **The fix.**

*Establish the master fund and SPV structure before the first property is acquired. Each property acquisition is made through a newly formed LLC wholly owned by the master*

*fund. The entity formation cost is modest relative to the restructuring cost if the structure is incorrect and relative to the liability exposure the correct structure prevents.*

### **Mistake 3: Jurisdiction Selection Errors**

Delaware is the default jurisdiction for private real estate fund formation for well established reasons. Delaware LLC law is sophisticated, flexible, and extensively interpreted by its Court of Chancery, which has more-experience with private fund disputes than any other state court in the country. Delaware LLCs offer maximum flexibility in structuring the relationship between managers and members, can be formed quickly, have low annual maintenance fees, and are accepted by institutional investors who are accustomed to reviewing Delaware governing documents.

Jurisdiction selection errors take two forms. The first is forming the fund entity in the state where the property is located rather than in Delaware, driven by a desire to avoid the administrative step of registering a foreign LLC to do business in the property state. This tradeoff is almost never favorable. The cost of registering a Delaware LLC in the property state is modest, and the benefits of Delaware law for the fund's governance structure, particularly the flexibility in structuring manager authority, investor rights, and fiduciary duty standards, are substantial. A California LLC formed to own a California multifamily property is governed by California LLC law, which is less favorable to sponsors than Delaware law on numerous dimensions relevant to fund governance.

The second jurisdiction error is forming the operating entity in a jurisdiction that creates unintended tax consequences. An operating entity formed as a corporation rather than a pass through entity, whether because the sponsor did not consider the tax consequences or because a non-attorney assisted with the formation, creates an entity level tax on investment income that eliminates the pass through tax efficiency that makes real estate investment through a fund structure attractive to investors. Similarly, forming the sponsor's management company in a jurisdiction that subjects it to franchise taxes or other state level impositions that reduce the effective economics of the management fee is an oversight that accumulates a real cost over time.

### **Mistake 3: Jurisdiction Selection Errors**

**What it looks like.**

*A multi asset fund formed as a Texas LLC because all of the target properties are in Texas and the sponsor wanted to avoid the foreign LLC registration step. Or a fund formed as a corporation by a non-attorney service that did not understand the tax implications. Or a sponsor management entity formed in a high tax state when Delaware or Wyoming would have been preferable.*

#### **Why it happens.**

*Sponsors who form entities without attorney involvement make formation decisions based on convenience and cost rather than legal and tax analysis. Online formation services present formation in any state as equivalent choices when they are not.*

#### **The legal consequence.**

*Application of less favorable state law to fund governance disputes; potential loss of pass through tax treatment if the entity type is incorrect; unnecessary state level tax burdens; and increased friction with institutional investors who are accustomed to reviewing Delaware governing documents and less familiar with other states' LLC statutes.*

#### **The fix.**

*Form all fund entities as Delaware LLCs unless there is a specific reason to do otherwise that has been analyzed by competent legal counsel. Register the Delaware LLC as a foreign entity in each state where it conducts business or owns real property. Have a tax adviser confirm the entity type before formation, not after the first investor is admitted.*

## **Economic Terms Mistakes**

Economic terms mistakes are the category where investors are most likely to notice a problem, and where the sponsor's credibility suffers most when the problem is discovered. When the waterfall cannot be calculated because the distributable cash definition is circular, when the preferred return has been accruing in a way the operating agreement did not intend, or when the clawback provision turns out to deliver something entirely different from what investors were told, the error is visible in the numbers that investors care most about. These mistakes also tend to be discovered at the worst possible moment: when a distribution is being calculated, when a disposition proceeds, or when an investor is questioning why their account balance does not match their expectations.

### **Mistake 4: Waterfall Mechanics That Are Ambiguous or Internally Inconsistent**

The distribution waterfall is the operating agreement's most economically significant provision, the mathematical framework that determines who receives what from each distribution event, in what order, and on what terms. It is also the provision most likely to contain ambiguities that do not surface until a distribution is actually being calculated, at which point two reasonable people reading the same document can arrive at materially different answers.

Common forms of waterfall ambiguity include a distributable cash definition that uses undefined terms, requires calculations that are not specified, or is circular in its reference to other provisions; a preferred return accrual provision that does not specify whether the accrual is simple or compounding, whether it is calculated on contributed capital or unreturned capital, and whether operating distributions reduce the accrual balance or are applied in a different sequence; a GP catch up provision that does not specify whether it applies to above capital distributions only or to all distributions; and a promote tier that uses an IRR hurdle without specifying the calculation methodology (XIRR, net of fees, gross of what costs).

The consequence of these ambiguities is not merely administrative inconvenience. Each ambiguity is a potential investor dispute. The operating agreement's waterfall provisions are the definitive statement of what investors are entitled to receive, and sponsors who calculate distributions in a way that is inconsistent with a reasonable reading of the operating agreement's language expose themselves to breach of contract claims from investors whose distributions were underpaid. The fund administrator who produces the distribution calculation and the securities counsel who reviewed the operating agreement both become relevant parties in that dispute.

#### **Mistake 4: Waterfall Mechanics That Are Ambiguous or Internally Inconsistent**

##### **What it looks like.**

*An operating agreement that defines distributable cash as net operating income minus debt service minus reserves as determined by the Manager without specifying how each of those deductions is calculated. A preferred return provision that specifies an 8 percent rate but does not say whether it is simple or compounding, whether it accrues on contributed or unreturned capital, or how operating distributions interact with the accrual.*

##### **Why it happens.**

*Sponsors or document preparers who understand the general concept of a waterfall but have not worked through the mathematical consequences of specific language. Form operating agreements that contain internal inconsistencies from multiple revision cycles.*

*Legal document preparation without securities counsel who specifically reviews the economic term precision.*

**The legal consequence.**

*Investor disputes about the correct calculation of distributions; potential breach of contract claims if calculations are performed in a way that underpays investors relative to a reasonable reading of the operating agreement; fund administrator liability exposure when distributing based on a calculation that is later disputed; and difficulty attracting future investors if prior investors were improperly paid.*

**The fix.**

*Have every economic provision in the operating agreement reviewed by securities counsel who specifically works through the mathematical implications of the language. Run a model distribution calculation using the operating agreement's actual language before the offering launches, confirming that the document produces the distribution the sponsor intends for every tier. The model calculation should be reviewed alongside the operating agreement, not separately.*

## **Mistake 5: Preferred Return Accrual Errors**

The preferred return is the feature most commonly described to investors during the capital raise, and the feature whose mechanics are most often imprecisely documented in the operating agreement. Investors understand that they have been promised an 8 percent preferred return, or 7 percent, or 6 percent, whatever the specific rate, but the specifics of how that return accrues, on what base, and how it interacts with operating distributions are details that live in the operating agreement's definitions and that sponsors frequently handle inconsistently between the oral description, the PPM, and the governing document.

Three preferred return accrual errors appear with particular frequency. The first is the simple versus compounding ambiguity. An 8 percent preferred return on a \$1 million investment accrues at \$80,000 per year under a simple calculation, but at \$80,000 in Year 1, \$86,400 in Year 2, and \$93,312 in Year 3 under a compounding calculation, a meaningful difference over a five year hold period that investors and sponsors may have different expectations about if the operating agreement is silent.

The second is the accrual basis ambiguity. When a return of capital is distributed from a refinancing event, does the preferred return going forward accrue on the investor's original contributed capital, or on their unreturned capital balance? An investor who contributed \$500,000 and received \$200,000 as a return of capital from a refinancing has unreturned capital

of \$300,000. The difference between an 8 percent preferred return on \$500,000 (\$40,000 per year) versus \$300,000 (\$24,000 per year) compounds materially over the remaining hold period.

The third is the treatment of operating distributions against the preferred return accrual. Do quarterly operating distributions satisfy the preferred return as they are made, reducing the accrual balance? Or do they flow as a separate distribution category, leaving the full preferred return accrual intact for calculation at a capital event? Each approach is conceptually defensible, but an operating agreement that does not specify which applies will produce different distribution calculations depending on who is running the numbers.

### **Mistake 5: Preferred Return Accrual Errors**

#### **What it looks like.**

*An operating agreement that states an 8 percent preferred return without specifying whether it is simple or compounding, whether it accrues on contributed or unreturned capital, and how operating distributions are applied. Or marketing materials that describe a preferred return in terms that the operating agreement does not actually deliver because of an undefined or inconsistent definitional choice.*

#### **Why it happens.**

*Sponsors describe the preferred return to investors in terms of its rate but do not work through the definitional choices that determine how the rate is applied. The drafting decisions are then made by counsel in a vacuum, sometimes inconsistently with what investors were told.*

#### **The legal consequence.**

*Investor disputes about the correct accrual calculation; breach of contract claims if the operating agreement's preferred return provisions do not match what investors were told; difficulty raising future capital when prior investors discover that the preferred return they received was less favorable than what was represented.*

#### **The fix.**

*Specify in the operating agreement: the preferred return rate; whether it is simple or compounding (with the compounding frequency, if applicable); whether it accrues on contributed capital or unreturned capital; and how operating distributions interact with the accrual. Reconcile the operating agreement's preferred return mechanics against the PPM's description and the marketing materials, and ensure that all three communicate the same calculation.*



## Mistake 6: Clawback Provisions That Do Not Work as Intended

Clawback provisions appear in many real estate fund operating agreements as a mechanism to ensure that the sponsor's promote distributions over the fund's life are consistent with the fund's overall performance. The concept is that if early distributions resulted in the sponsor receiving promote payments that exceed what the waterfall would entitle them to based on the fund's ultimate aggregate performance, the excess is returned to investors. The concept is sound. The drafting frequently is not.

The most common clawback failure mode is the provision that requires the sponsor to return previously received promote distributions without addressing the tax consequences of those distributions. A sponsor who received \$500,000 of promote distributions in Year 2 paid federal and state income tax on that distribution at receipt. A clawback provision that requires the sponsor to return the full \$500,000 in Year 5 is requiring the sponsor to return a Pre-tax amount that they no longer have access to as a Pre-tax amount. Whether the clawback is calculated on a Pre-tax or after tax basis materially affects whether the clawback is economically feasible and whether the sponsor has the resources to fund it.

The second clawback failure mode is an inconsistency between the waterfall provisions and the clawback calculation methodology. If the waterfall uses an IRR calculation to determine the promote trigger but the clawback uses a cash on cash calculation to determine whether excess promote was received, the two calculations may reach different conclusions about whether the clawback obligation has been triggered, creating a dispute about which calculation governs at exactly the moment when the economic stakes are highest.

### Mistake 6: Clawback Provisions That Do Not Work as Intended

#### What it looks like.

*A clawback provision that requires return of the gross Pre-tax promote distribution without acknowledging the tax paid on receipt. A clawback calculated under a different methodology than the waterfall that generated the distributions. A clawback obligation without any security or escrow mechanism ensuring the sponsor can actually fund the obligation when it arises.*

#### Why it happens.

*Clawback provisions are frequently drafted as concepts rather than as self-executing calculations. Sponsors and counsel understand the general intent but have not worked through the mathematics of how the clawback would actually be calculated and funded in a real scenario where early distributions exceeded the fund's ultimate performance.*



**The legal consequence.**

*A clawback that fails to deliver the intended protection when invoked, creating investor claims; an unenforceably large clawback obligation that exceeds the sponsor's actual net economic benefit, creating the reverse problem; and disputes about calculation methodology that require litigation to resolve when the amounts are material.*

**The fix.**

*Draft the clawback provision as a specific mathematical calculation. Define the comparison methodology, the tax gross up (or lack thereof), the calculation timing, and the funding mechanism. Consider requiring the sponsor to maintain an escrow of a portion of promote distributions during the fund's life as a funded clawback reserve. Have securities counsel run a model clawback calculation under a realistic scenario where early promote distributions were later offset by fund level losses, and confirm the provision produces the intended result.*

## **Mistake 7: Fee Provisions That Create Conflicts Without Adequate Disclosure**

The sponsor's fee structure (acquisition fees, asset management fees, property management fees, construction management fees, disposition fees, and any other compensation the sponsor or its affiliates receive from the fund) is one of the most scrutinized sections of the PPM by sophisticated investors and one of the most common sources of investor disputes when the fees are disclosed inadequately or when fees are charged that the offering documents do not clearly authorize.

The most common fee conflict problem is the affiliated service provider arrangement that is not disclosed with sufficient specificity. A sponsor whose affiliate provides property management services, construction management, or disposition brokerage to fund properties is receiving additional compensation from the fund beyond the asset management fee, compensation that reduces the returns distributed to investors. This arrangement is permissible if it is properly disclosed and if the fees charged are at market rates, but it is a potential securities violation if the affiliated nature of the relationship and the fees charged are not disclosed clearly in the PPM.

A second common problem is the fee offset provision that is described in the PPM but not implemented in practice. Many institutional investors negotiate for provisions that reduce the asset management fee by a portion of any other fees received by the sponsor from the fund, recognizing that the management fee and the acquisition fee together represent the total

compensation for the sponsor's services, not separately justified categories of payment. A PPM that describes a fee offset that the fund administrator is not instructed to implement produces investor distributions that are less than what the operating agreement requires, a breach of contract and a potential securities violation.

### **Mistake 7: Fee Provisions That Create Undisclosed Conflicts of Interest**

#### **What it looks like.**

*A PPM that discloses an asset management fee but does not clearly disclose that an affiliate of the sponsor will also receive a property management fee and a construction management fee from each property. A fee offset provision in the operating agreement that the fund administrator is not implementing because no one communicated the implementation requirement. Acquisition fees charged at rates above those disclosed in the PPM.*

#### **Why it happens.**

*Sponsors develop their fee structures organically as their platforms grow, adding affiliated service providers without fully updating the offering documents to disclose the evolving conflict landscape. Fee offset provisions are frequently negotiated into operating agreements during the fund formation process and then not implemented operationally.*

#### **The legal consequence.**

*Securities fraud exposure for failure to disclose material conflicts of interest in the offering documents; breach of contract claims for operating agreement provisions not implemented as written; and investor rescission claims based on the materiality of the undisclosed compensation to investors who would have evaluated the investment differently had the full fee structure been disclosed.*

#### **The fix.**

*Disclose every fee and every form of compensation received by the sponsor or any affiliate from any fund related activity, with specific dollar amounts or percentage ranges, in the PPM. Confirm that the operating agreement's fee offset provisions are actually being implemented by the fund administrator. Have securities counsel review the PPM's fee disclosure section against the actual fee arrangements in place before the offering launches.*

## **Governing Document Mistakes**

Governing document mistakes (problems with the operating agreement's authority provisions, investor protection mechanisms, transfer restriction framework, and dissolution procedures) tend to be invisible for long periods and then catastrophically visible when a specific circumstance arises that the document was not designed to address. A manager authority provision that is too broad creates the conditions for a fiduciary duty claim when the sponsor makes a controversial decision without investor consent. One that is too narrow paralyzes the fund's management when a decision is needed quickly. Transfer restriction provisions that are unworkable in practice create trapped investors who cannot exit and frustrated sponsors who cannot implement legitimate transfers. These failures are all preventable with careful document drafting and all expensive when discovered in the middle of an event that requires the provisions to actually function.

### **Mistake 8: Manager Authority Provisions That Are Too Broad or Too Narrow**

The manager authority provision of the operating agreement defines the boundary between decisions the manager can make without investor consent and decisions that require investor approval. Drawing that boundary in the wrong place, or drawing it imprecisely, creates one of two problems. A provision that is too broad gives the manager unchecked authority to make decisions that investors would reasonably expect to participate in, which is both an investor relations problem and a potential fiduciary duty breach if the manager exercises that authority in ways that serve the sponsor's interests at investors' expense. A provision that is too narrow requires investor consent for routine operational decisions, creating paralysis when decisions need to be made quickly and creating administrative friction that imposes real costs on the fund.

The major decisions that most private real estate fund operating agreements require investor consent for include the sale or disposition of the property, material modifications to the business plan, incurrence of debt above a defined threshold, bringing in new equity investors or modifying the capital structure, and amendments to the operating agreement. These items are generally appropriate for investor consent requirements because they are the decisions that most directly affect investors' returns and their rights under the governing documents.

The operational decisions that should generally be within the manager's discretionary authority include entering into leases within defined size and term parameters, hiring and firing property managers, approving capital expenditures within the approved annual budget, making operating distributions in accordance with the waterfall, and making ordinary course operational decisions for the property. Requiring investor consent for these routine decisions converts the manager from an active asset manager into an administrator waiting for investor approval, and creates liability exposure when the fund cannot act quickly in a situation that requires an immediate decision.

## **Mistake 8: Manager Authority Provisions That Are Too Broad or Too Narrow**

### **What it looks like.**

*An operating agreement that grants the manager full and complete authority to manage the business and affairs of the company in all respects, including but not limited to the power to sell the property at any time on any terms the manager deems appropriate, with no major decision consent requirements. Or an operating agreement that requires investor consent for any lease, any capital expenditure above \$5,000, or any modification of any agreement with any service provider.*

### **Why it happens.**

*Form operating agreements that have not been specifically calibrated to the investment strategy and property type. Sponsors who favor breadth over precision in manager authority provisions to avoid having to obtain investor consents. Sponsors who over protect investors in response to prior investor complaints without understanding the operational consequences.*

### **The legal consequence.**

*Overly broad authority: fiduciary duty claims when the manager makes consequential decisions without investor input; difficulty raising future capital from investors who recognize that the document gives the manager unchecked authority. Overly narrow authority: administrative paralysis; claims that the manager breached the operating agreement by acting without required consent; and investor frustration when ordinary course decisions are delayed by the consent process.*

### **The fix.**

*Have securities counsel draft a specific major decisions list calibrated to the investment strategy, the property type, and the investor base. The major decisions list should require investor consent for the decisions that investors reasonably expect to participate in, while leaving the manager with clear discretionary authority over operational and management decisions that require prompt action.*

## **Mistake 9: Inadequate Investor Protection Provisions**

Investors in private real estate funds give up direct control of their capital in exchange for a legal framework that protects their economic interests, ensures that the sponsor complies with its obligations, and provides them with remedies when it does not. The operating agreement provisions that deliver these protections (reporting obligations, manager removal rights, indemnification limits, anti dilution provisions, and key man provisions) are the investor

protections that institutional investors review most carefully during due diligence and that become most consequential when the investment encounters problems.

Reporting obligation provisions are among the most commonly deficient. An operating agreement that requires quarterly reporting at such times as the manager deems appropriate and annual financial statements within a reasonable time after year end has provided investors with an unenforceable obligation and no practical remedy when the sponsor misses reporting deadlines. Reporting provisions should specify the required reports, the content of each, the delivery deadline, and the consequence (including investor remedies) for failure to deliver. Investors who cannot rely on receiving timely, complete, accurate financial information cannot evaluate their investment or identify developing problems before they become crises.

Manager removal provisions are the most significant investor protection in the fund's governing documents, because they are the mechanism through which investors can address a sponsor who is failing in their management obligations. A removal provision that requires unanimous investor consent to remove the manager is, in practical terms, no removal right at all. A single dissenting investor can block removal regardless of how the remaining investors have voted. Most well drafted operating agreements provide for removal of the manager for cause by a defined supermajority of investors (often 60 percent to 75 percent of membership interests), with cause defined to include specific categories of misconduct, material breach of the operating agreement, and fraud.

### **Mistake 9: Inadequate Investor Protection Provisions**

#### **What it looks like.**

*An operating agreement with no specific reporting obligations, or reporting obligations whose deadlines are defined as reasonable without a specific date. A manager removal provision requiring unanimous consent. An indemnification provision with no cap and no exclusion for gross negligence, fraud, or willful misconduct. No key man provision for a fund whose value depends entirely on the involvement of a specific individual.*

#### **Why it happens.**

*Form operating agreements designed to minimize sponsor obligations rather than to balance sponsor authority with investor protections. Sponsors who negotiate aggressively against investor protection provisions without understanding that inadequate protections reduce their ability to raise capital from investors who have seen these provisions negotiated properly.*

#### **The legal consequence.**

*Investor claims based on the sponsor's failure to deliver protections the operating agreement purported to provide; difficulty raising capital from institutional investors who identify inadequate investor protection provisions in due diligence; and limited investor remedies when a material problem occurs that the operating agreement's protections were intended to address.*

**The fix.**

*Ensure that reporting obligations specify content, delivery dates, and investor remedies for non-delivery. Manager removal for cause should require a defined supermajority (not unanimity) with a specific definition of cause. Indemnification should be capped and should exclude conduct below the required standard of care. Have securities counsel review the governing documents against institutional investor due diligence standards before the offering launches.*

## **Mistake 10: Transfer Restriction Provisions That Are Unworkable in Practice**

Membership interests in a private real estate fund are restricted securities. They cannot be freely transferred without either registration under the Securities Act or satisfaction of an applicable exemption from registration. The operating agreement's transfer restriction provisions implement this legal requirement and establish the operational process through which legitimate transfers are reviewed, approved, and documented. An operating agreement with poorly drafted transfer restrictions creates two categories of problem. It permits transfers that should be restricted (creating securities law violations), or it blocks transfers that should be permissible (creating investor relations problems and potential legal claims from trapped investors).

The most common operational failure is a transfer restriction provision that specifies the categories of required approval (manager consent, securities counsel opinion, lender consent where required) but does not specify the timeline within which the manager must respond to a transfer request. An investor who submits a transfer request and waits indefinitely for a manager response has been deprived of whatever limited liquidity the operating agreement was intended to provide. Courts in several jurisdictions have found that unreasonable delay in responding to a transfer request can constitute an implied refusal, with consequences depending on whether the refusal was permissible under the operating agreement.

A separate common problem is the transfer restriction that ignores the lender's transfer restriction provisions in the loan documents. As discussed in Chapter 29, most commercial real estate loans restrict changes in ownership of the borrower entity. An operating agreement that permits certain transfers without addressing whether those transfers require lender consent

under the loan documents creates a mechanism through which investors can trigger a loan default without understanding that they have done so.

### **Mistake 10: Transfer Restriction Provisions That Are Unworkable in Practice**

#### **What it looks like.**

*A transfer restriction provision that requires manager consent, a securities law opinion, and satisfaction of unspecified other conditions the manager may impose, but specifies no timeline for the manager's response. An operating agreement that lists permitted transfers without cross referencing the lender's transfer restriction provisions in the loan documents. Transfer restriction provisions that refer to undefined terms or that create an approval process that is more burdensome in practice than investors were led to expect.*

#### **Why it happens.**

*Transfer restriction provisions are frequently copied from form documents without calibrating them to the specific operating agreement's structure, the specific lender's loan documents, or the specific investor communication about what transfer rights investors have been told they hold.*

#### **The legal consequence.**

*Delayed or impossible transfers that create investor claims; loan defaults triggered by transfers that were permitted under the operating agreement but not under the loan documents; securities law violations from transfers made without proper exemptions; and investor litigation when trapped investors cannot access whatever limited liquidity the operating agreement was intended to provide.*

#### **The fix.**

*Specify the manager's response timeline for transfer requests (typically 30 to 45 days), the complete list of required approvals including lender consent, and the process for obtaining a securities law opinion. Cross reference the loan documents' transfer restriction provisions explicitly. Have the transfer restriction provision reviewed alongside the loan agreement before the operating agreement is finalized.*

### **Mistake 11: Dissolution Provisions That Do Not Address Common Scenarios**

The operating agreement's dissolution provisions establish the circumstances under which the fund may be dissolved, the process through which dissolution is conducted, and the order in which assets are distributed upon winding up. These provisions are among the most neglected



in typical fund operating agreements. They are rarely reviewed during the offering period, receive little investor attention during fund formation, and become critically important only when a dissolution event actually occurs. At that point, their inadequacy creates significant legal and operational complications.

The most common omission is the failure to address what happens when the fund's primary asset is lost through foreclosure, is destroyed, or is condemned through eminent domain. A dissolution provision that contemplates only a voluntary sale of the property has not anticipated the most consequential involuntary disposition scenarios. When the property is foreclosed, the fund's operating agreement should specify what happens to the entity, whether it continues in existence for winddown purposes, who manages the wind down, how expenses during wind down are funded, and how any residual assets (tax refunds, insurance proceeds, reserve releases) are distributed.

A second common deficiency is the absence of a mechanism for addressing a deadlock between the manager and investors on a dissolution triggering question. Most operating agreements give the manager the authority to decide whether to pursue an operational turnaround or voluntarily dissolve, but some give investors the right to force dissolution under specified conditions. When these provisions do not mesh (when both sides believe they have authority over the dissolution decision) the result is a governance impasse that may require court intervention to resolve.

### **Mistake 11: Dissolution Provisions That Do Not Address Common Scenarios**

#### **What it looks like.**

*A dissolution provision that contemplates only the voluntary sale of the property and distribution of proceeds, with no provisions for involuntary disposition through foreclosure, condemnation, or casualty. No specification of who manages the entity during wind down, how wind down expenses are funded, or who has authority to file tax returns and dissolution documents during the winding up period.*

#### **Why it happens.**

*Dissolution provisions are drafted during the fund formation process when dissolution seems remote and speculative. Sponsors and counsel focus on the investment's operation rather than on its conclusion, and the dissolution provisions receive the least attention of any section in the operating agreement.*

#### **The legal consequence.**

*Governance vacuum when a dissolution event occurs without adequate provisions governing how it should be managed; disputes about authority during wind down; inability*



*to make required distributions from residual assets because the distribution sequence for wind down is not specified; and potential state law dissolution proceedings that produce a less favorable outcome than a properly governed voluntary wind down.*

**The fix.**

*Draft dissolution provisions that specifically address voluntary sale, foreclosure, condemnation, and material casualty as distinct triggering scenarios. Specify who manages the wind down, how wind down expenses are funded, the priority of payments during wind down, and who is authorized to execute the legal steps required to dissolve the entity in the formation jurisdiction and any state where it is registered.*

## Tax Structure Mistakes

Tax structure mistakes are in a category of their own because their consequences arrive on a specific, immovable timetable. A waterfall error might be discovered at the first distribution and corrected before significant harm results. A tax structure error is discovered on the date of a taxable event (the disposition, the foreclosure, the carried interest payment) and by that point the error has already produced its consequence. The tax cannot be undone retroactively. The only question is who bears the cost of the mistaken structure. The answer, in almost every case, is investors.

### Mistake 12: Failure to Plan for Depreciation Recapture at Disposition

Chapter 30 addressed depreciation recapture in the context of the disposition process. It bears specific treatment here as a structuring mistake because the issue is not merely one of disclosure at disposition. It is a structuring failure that occurs at fund formation, when the depreciation allocation methodology, the cost segregation strategy, and the investor communication framework are established.

The recapture mechanics are straightforward in principle. Section 1250 property depreciation (building structure, straight line) is recaptured at a maximum federal rate of 25 percent when the property is sold. Section 1245 property depreciation accelerated through cost segregation (the personal property and land improvement components reclassified to 5 year, 7 year, and 15 year depreciable life) is recaptured at ordinary income rates up to 37 percent. A fund that pursues an aggressive cost segregation strategy, allocating large first year bonus depreciation deductions to investors, delivers a genuine current year tax benefit that investors value, and creates a future ordinary income recapture obligation at disposition that many of those same investors did not model when they committed capital.

The structuring failure occurs when the offering documents describe the depreciation benefits in detail but do not describe the recapture consequences with equal specificity. A PPM that prominently describes the fund's cost segregation strategy and the resulting depreciation allocations, but that addresses recapture only in a general risk factor disclosure, has created a foreseeable investor expectation problem. Investors who made investment decisions in part because of the depreciation benefit will discover at disposition that a substantial portion of their gain is taxed at ordinary income rates, rates up to 37 percent rather than the 20 percent capital gains rate they may have anticipated.

## **Mistake 12: Failure to Plan for Depreciation Recapture at Disposition**

### **What it looks like.**

*A PPM that describes the fund's cost segregation strategy and projects large first year depreciation allocations without a corresponding, specific description of the Section 1245 recapture that will be triggered at disposition. Investors who received K-1s showing significant bonus depreciation allocations in Years 1 and 2 discover at disposition that a portion of their gain is taxed at ordinary income rates rather than capital gains rates.*

### **Why it happens.**

*Depreciation benefits are a marketing feature. Recapture is a disincentive. Sponsors and their tax advisers are motivated to highlight the former and may treat the latter as a standard risk factor rather than a specific, quantifiable obligation that investors should model when evaluating the investment's net after tax return.*

### **The legal consequence.**

*Investor claims that the offering documents were misleading about the tax consequences of the investment; investor relations damage when tax bills at disposition exceed expectations by a material amount; and potential securities fraud exposure if the omission of specific recapture information is deemed material to a reasonable investor's investment decision.*

### **The fix.**

*Disclose depreciation recapture consequences with the same specificity as depreciation benefits. If the fund pursues a cost segregation strategy, the PPM should specifically describe the Section 1245 recapture consequence for those components (including the applicable rate, ordinary income up to 37 percent) alongside the description of the accelerated depreciation benefit. Communicate estimated recapture amounts to investors at least 90 days before the anticipated disposition closing.*

## Mistake 13: Inadequate FIRPTA and Section 1446 Provisions for Foreign Investors

Two separate but related federal withholding regimes apply to foreign investors in U.S. real estate funds, and the operating agreement that does not address both creates compliance problems and personal liability exposure for the sponsor. The Foreign Investment in Real Property Tax Act (FIRPTA), implemented through Section 1445 of the Internal Revenue Code, imposes a withholding obligation when a foreign person disposes of an interest in U.S. real property. The Section 1446 withholding regime, implemented through Sections 1446(a) and 1446(f), addresses partnership level withholding on income and on transfers of partnership interests.

Under Section 1446(a), a partnership that has effectively connected taxable income allocable to foreign partners must withhold on that income at specified rates. The current withholding rates are 21 percent for corporate foreign partners (the corporate tax rate under Section 11(b)) and 37 percent for non-corporate foreign partners (the highest individual rate under Section 1). Section 1446(a) withholding applies to periodic income allocations throughout the hold period, not only at disposition. Under Section 1446(f), added by the Tax Cuts and Jobs Act of 2017 effective for transfers occurring on or after January 1, 2018, a transferee of a partnership interest must withhold 10 percent of the amount realized on the disposition of an interest in a partnership engaged in a U.S. trade or business, unless an exception applies.

The most common FIRPTA structuring failure is the operating agreement that does not address withholding at all, that treats all investors identically in the distribution provisions without acknowledging that foreign investors are subject to withholding requirements that reduce their net distributions and that impose withholding obligations on the fund as the responsible withholding agent. The practical consequence is that distributions are made to foreign investors without the required withholding, creating a fund level liability for the unwithheld amounts plus interest and penalties.

A second common failure is the operating agreement drafted before the significant Section 1446(f) withholding rule changes that does not address transfer level withholding obligations on secondary market transfers of fund interests. An operating agreement that does not provide the fund with adequate mechanisms to comply with these obligations exposes the fund and its manager to liability for unwithheld amounts.

### **Mistake 13: Inadequate FIRPTA and Section 1446 Provisions for Foreign Investors**

**What it looks like.**

*An operating agreement that makes distributions to all investors without reference to FIRPTA, Section 1446(a), or Section 1446(f) withholding requirements. A fund that has admitted foreign investors but whose fund administrator has not been instructed to calculate and remit the required withholding. A fund that collects W-9s from domestic investors but has not collected W-8BEN or W-8BEN-E forms from foreign investors before making distributions.*

#### **Why it happens.**

*Many real estate fund operating agreements are drafted for a domestic investor base without anticipating that foreign investors will be admitted. When foreign investors subsequently commit capital, the withholding obligations are not incorporated into the fund's distribution and tax administration processes because the operating agreement does not require them.*

#### **The legal consequence.**

*Fund level liability for unwithheld FIRPTA, Section 1446(a), and Section 1446(f) amounts; IRS penalties and interest; potential personal liability for the manager for failure to comply with withholding obligations; and investor disputes when foreign investors receive distributions that are then subject to IRS collection of amounts that the fund failed to withhold.*

#### **The fix.**

*If the fund may admit foreign investors, even as a possibility, the operating agreement should specifically address the fund's FIRPTA and Section 1446 withholding obligations, the process for collecting required W-8 documentation, the mechanism for calculating and remitting withholding (including the differential between corporate and non-corporate foreign partner rates), and the right to reduce distributions to foreign investors by the withheld amounts. Have a tax adviser who is familiar with international tax review the withholding provisions before the offering launches.*

## **Mistake 14: Carried Interest Structure That Does Not Qualify for Capital Gains Treatment**

The carried interest (the sponsor's promoted interest, the economic mechanism through which the sponsor receives a disproportionate share of the fund's profits above the preferred return hurdle) is intended to be taxed at capital gains rates when the fund realizes capital gains on the disposition of its real estate assets. This favorable tax treatment is one of the economic features that makes the sponsor's promote meaningful relative to its ordinary income alternative. But capital gains treatment for carried interest is not automatic. It depends on satisfying specific

requirements that are easy to overlook and that, if not satisfied, result in the promote being taxed at ordinary income rates currently as high as 37 percent.

Section 1061 of the Internal Revenue Code, enacted as part of the Tax Cuts and Jobs Act of 2017, imposes a three year holding period requirement on capital gains allocated to applicable partnership interest holders in certain investment partnerships. The general rule requires that the assets generating the capital gain be held for more than three years for the gain allocated to the carried interest to qualify for long term capital gains rates. Assets held for more than one year but less than three years produce gain that is recharacterized as short term capital gain for carried interest holders, taxed at ordinary income rates, even if the same gain would be long term for investors who hold a direct interest in the partnership rather than a promoted interest.

Section 1061 contains an important exception that is highly relevant for real estate funds and that is frequently overlooked. Gains characterized as Section 1231 gains, which is the typical characterization of gains on the disposition of real property used in a trade or business, are excluded from Section 1061's three year holding period requirement. Most operating real estate held for rental purposes generates Section 1231 gain on sale, and most real estate fund promotes are therefore outside the scope of Section 1061. The Treasury regulations finalized in 2021 (TD 9945) confirm this exclusion, along with separate exclusions for qualified dividend income and capital gain dividends from REITs.

The exception is not unlimited. Section 1061 still applies to gain that is true long term capital gain rather than Section 1231 gain, including gain on the sale of raw land held purely for appreciation without active rental or development use, and gain on the sale of partnership interests in real estate funds where the partnership interest itself (rather than the underlying property) is the asset disposed of. Funds that include strategies producing pure capital gain rather than Section 1231 gain, and funds whose carried interest holders may dispose of their interests before satisfying the three year holding period, need to address Section 1061 specifically in their structuring analysis.

#### **Mistake 14: Carried Interest Structure That Does Not Qualify for Capital Gains Treatment**

##### **What it looks like.**

*A fund that includes strategies producing pure capital gain (raw land appreciation, partnership interest sales) without considering the Section 1061 three year holding period. A fund whose carried interest is held through an entity structure that compromises capital gains treatment. PPM language about carried interest tax treatment that does not specifically address Section 1061 and its real estate exception.*

**Why it happens.**

*Sponsors and their tax advisers who are familiar with the pre 2017 carried interest rules may not have fully internalized the Section 1061 holding period requirement or its real estate exception. Sponsors may overestimate the protection of the Section 1231 exception when their strategy produces gain that is not Section 1231 in character.*

**The legal consequence.**

*Carried interest gain recharacterized as short term capital gain and taxed at ordinary income rates up to 37 percent rather than long term capital gains rates, a meaningful reduction in the sponsor's net economic benefit from the promote. Retroactive tax liability if the structure was implemented on the assumption of capital gains treatment that does not apply. Potential disclosure issues if the PPM represented the tax treatment of the carried interest without specifically addressing Section 1061 and the Section 1231 exception.*

**The fix.**

*Have a tax adviser who is specifically familiar with Section 1061 and the Treasury Regulations finalized in 2021 review the fund's carry structure before the offering launches. Evaluate whether the fund's investment strategy and expected gain characterization will fall within the Section 1231 exception or will require satisfaction of the three year holding period. Where the strategy may produce gain outside the Section 1231 exception, ensure that the investment strategy and disposition timeline are compatible with the three year requirement.*

## A Pattern Worth Recognizing

Reviewing these fourteen mistakes together, a pattern becomes visible, and it is a different pattern than the one that most sponsors expect to see. These are not the mistakes of careless people who do not care about getting the structure right. They are the mistakes of competent real estate operators who underestimate the precision that legal documentation requires, experienced real estate investors who delegate structuring decisions to counsel without providing adequate context about the investment strategy, and capable sponsors who form their entities and draft their documents at the start of their investment careers and then use those same documents, with minor updates, for every subsequent transaction.

The entity structure mistakes are almost entirely the result of underestimating the legal significance of decisions that feel administrative. Forming entities in the right jurisdiction, maintaining genuine separation between them, and creating an SPV for each asset are not complicated tasks. They are tasks that feel like overhead and that are deferred or simplified by

sponsors under time pressure. The deferral is almost always more-expensive than the proper structure would have been.

The economic terms mistakes reflect a different gap: the gap between understanding the concept and specifying the mathematics. Every sponsor who has raised capital understands that their offering has a preferred return and a promote. Very few have worked through the precise mathematical implications of every definitional choice (compounding versus simple, contributed versus unreturned capital basis, operating distribution treatment) with the result that the operating agreement specifies the general concept without resolving the specific calculations. Those calculations become consequential at every distribution event.

The governing document mistakes reflect a pattern of delegation without review. Operating agreements are complex documents. Sponsors who rely entirely on counsel to draft governing documents without specifically reviewing the major decisions list, the investor protection provisions, the transfer restriction mechanics, and the dissolution provisions are delegating decisions that have material consequences without providing the business judgment that makes those decisions correct for the specific fund and investor base.

The tax structure mistakes reflect a timing problem. Tax counsel is engaged at the beginning of the fund's life, the structure is designed, and then the tax consequences of specific scenarios (the depreciation recapture at disposition, the FIRPTA obligations when foreign investors are later admitted, the carried interest holding period and Section 1231 character analysis) are not revisited until the scenario actually arises. By that point, restructuring is not available. The question is only who bears the tax cost of the initial structure.

The thread connecting all fourteen mistakes is the gap between knowing what the document should accomplish and ensuring that it actually accomplishes it. Counsel's role in a private real estate offering is not simply to produce a legally sufficient document. It is to ensure that the document's specific provisions accomplish what the sponsor intends, reflect what was represented to investors, comply with the applicable securities and tax rules, and function correctly when the circumstances that trigger each provision actually occur.

| Mistake                                     | Category         | Root Cause                                                            | Prevention                                                                    |
|---------------------------------------------|------------------|-----------------------------------------------------------------------|-------------------------------------------------------------------------------|
| 1. Sponsor and operating entity commingling | Entity structure | Treating entity separation as administrative rather than substantive. | Separate bank accounts, books, and contracts for each entity; no commingling. |
| 2. No SPV per asset in multi asset fund     | Entity structure | Cost savings prioritized over structural protection.                  | Form the master fund and SPV structure before the first acquisition.          |



| Mistake                                           | Category            | Root Cause                                                                       | Prevention                                                                                        |
|---------------------------------------------------|---------------------|----------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------|
| 3. Wrong formation jurisdiction                   | Entity structure    | Formation decisions made for convenience without legal analysis.                 | Delaware LLC for all fund entities; tax adviser confirms entity type before formation.            |
| 4. Ambiguous waterfall mechanics                  | Economic terms      | Conceptual drafting without mathematical specificity.                            | Model distribution calculation using actual operating agreement language before launch.           |
| 5. Preferred return accrual errors                | Economic terms      | Sponsors review headline rate without reviewing definitional choices.            | Specify the rate, simple versus compounding, accrual basis, and operating distribution treatment. |
| 6. Clawback provisions that do not work           | Economic terms      | Clawback drafted as concept, not self-executing calculation.                     | Draft as a specific calculation; model under realistic scenarios; consider funded escrow.         |
| 7. Undisclosed affiliated fee conflicts           | Economic terms      | Fee structure evolves without offering document updates.                         | Disclose every affiliate compensation source with specificity in the PPM.                         |
| 8. Manager authority too broad or narrow          | Governing documents | Form documents not calibrated to the specific fund and investor base.            | Specific major decisions list calibrated to investment strategy and investor sophistication.      |
| 9. Inadequate investor protections                | Governing documents | Sponsor favorable form documents; protections negotiated out.                    | Reporting deadlines specified; removal by supermajority for cause; indemnification capped.        |
| 10. Unworkable transfer restrictions              | Governing documents | Transfer provisions not cross referenced to loan documents.                      | Manager response timeline specified; loan document transfer restrictions cross referenced.        |
| 11. Inadequate dissolution provisions             | Governing documents | Dissolution is remote at formation; provisions receive little attention.         | Specifically address foreclosure, condemnation, and casualty dissolution scenarios.               |
| 12. No depreciation recapture planning            | Tax structure       | Benefits marketed; recapture treated as generic risk factor.                     | Disclose Section 1245 recapture rate and consequence with same specificity as benefit.            |
| 13. Inadequate FIRPTA and Section 1446 provisions | Tax structure       | Domestic investor form documents; foreign investor admission unanticipated.      | Address Section 1445, 1446(a), and 1446(f) withholding before any foreign investor is admitted.   |
| 14. Carry that misses capital gains treatment     | Tax structure       | Pre TCJA carry structure applied without Section 1231 and Section 1061 analysis. | Section 1061 analysis before launch; confirm Section 1231 character or hold period compatibility. |



## Practical Takeaways

- Entity separation is not an administrative formality. It is the liability protection that the entire structure depends on. Each property owning entity must have its own bank account, its own books, and its own contractual relationships. A sponsor who operates multiple entities as a single business has provided future plaintiffs with the factual basis for a veil piercing claim.
- Multi asset funds require a master fund and SPV structure established before the first property is acquired. The cost of entity formation is modest. The cost of restructuring an incorrectly formed multi property fund after the fact is not. The cross contamination of liability between properties held in the same entity is the most preventable and most expensive entity structure mistake in real estate fund practice.
- Delaware is the default formation jurisdiction for private real estate fund entities, not because it is the most convenient, but because its LLC statute is the most sophisticated and its courts are the most experienced with private fund disputes. Formation in the property's state to avoid foreign registration fees is a tradeoff that is almost never favorable when the legal consequences are considered fully.
- Waterfall provisions must be drafted as specific mathematical specifications, not as general descriptions of the intended economics. Every definition referenced in the waterfall (distributable cash, unreturned capital, preferred return, catch up, promote) must be defined with enough precision that a distribution calculation can be performed mechanically without judgment calls. Run a model calculation using the actual operating agreement language before the offering launches.
- The preferred return is a commitment to investors, every dimension of which must be specified: the rate, whether it is simple or compounding, the base on which it accrues, how it is affected by return of capital events, and how operating distributions interact with the accrual. Sponsors who describe a preferred return to investors during the capital raise and then discover that the operating agreement's mechanics produce a different result than what was represented face both breach of contract and securities law exposure.
- Clawback provisions must be drafted as self-executing calculations, not as general commitments to return excess promote if something goes wrong. The clawback calculation methodology must be consistent with the waterfall that generated the distributions. Tax gross up considerations must be addressed. The funding mechanism must be specified, and a funded escrow should be seriously considered for any fund where early period promote distributions might exceed the ultimate waterfall entitlement.

- Every fee received by the sponsor or its affiliates from fund related activities (acquisition fees, asset management fees, property management fees, construction management fees, disposition fees) must be specifically disclosed in the PPM. Affiliated service provider relationships are material conflicts of interest subject to the antifraud provisions. Fee offset provisions agreed to in the operating agreement must be operationally implemented by the fund administrator, not merely documented.
- The operating agreement's major decisions list should be specifically calibrated to the investment strategy and investor base, not copied from a form that was designed for a different type of fund. Major decisions requiring investor consent are the governance mechanism through which investors maintain meaningful input on consequential decisions. The list should include exactly the decisions that investors reasonably expect to participate in.
- FIRPTA and Section 1446 withholding obligations apply to every fund that has admitted, or might admit, foreign investors. The operating agreement should address these obligations before any foreign investor is admitted, including the W-8 collection process, the differential between the 21 percent corporate foreign partner rate and the 37 percent non-corporate foreign partner rate under Section 1446(a), the 10 percent withholding under Section 1446(f) on partnership interest transfers, and the right to reduce foreign investor distributions by withheld amounts. The time to build this compliance into the fund's administration is at formation, not at the first distribution to a foreign investor.
- Section 1061 carried interest analysis for real estate funds turns on whether the fund's gain at disposition is Section 1231 gain (which is excluded from the three year holding period requirement) or true capital gain (which is subject to the three year rule). Most operating real estate held for rental purposes produces Section 1231 gain and is therefore outside Section 1061's scope. Funds that include strategies producing non Section 1231 gain (raw land appreciation, partnership interest sales) need a Section 1061 analysis before the offering launches.

## CHAPTER THIRTY FOUR

# When You Should (and Should Not) Syndicate or Form a Fund

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The decision to syndicate, to raise capital from outside investors and accept the legal, operational, and fiduciary obligations that come with it, is one of the most consequential decisions a real estate operator makes. It is not primarily a financial decision, though the financial analysis matters. It is a business decision about what kind of real estate business the sponsor wants to run and whether the infrastructure required to run that business correctly is in place or can realistically be built. Sponsors who treat syndication as a financing tool, a way to use other people's money to do more deals, without fully reckoning with what that choice demands operationally and legally, tend to discover the full weight of what they signed up for at exactly the wrong moment: when a deal encounters problems, when an investor asks a question the sponsor does not have a good answer to, or when a regulatory filing that was supposed to happen quietly becomes the subject of an enforcement inquiry.

The preceding chapters of this handbook have described, in considerable detail, how private real estate syndications and funds work: the legal structure, the securities law framework, the offering documents, the investor economics, the ongoing compliance obligations, and the management of the investment through its full lifecycle. This chapter steps back from that operational depth to address a prior question. Not how to syndicate, but whether to syndicate. Whether this particular deal, with this particular capital structure, at this particular stage of the sponsor's career, warrants bringing in outside investors and accepting the legal, operational, and relationship obligations that doing so creates.

That question deserves an honest answer. Syndication is the right vehicle for sponsors who have the deal quality, the track record, the infrastructure, and the commitment to investor relationships that the structure requires. It is the wrong vehicle for sponsors who are drawn to it primarily because they need more capital than they have, or because they have seen others do it successfully and assume the path is simpler than it is. The cost of choosing the wrong vehicle (both the financial cost of building infrastructure that the deal cannot support and the legal cost of conducting an offering that was not ready to be conducted) is high enough that the prior question deserves as much attention as the operational ones that follow it.

This chapter addresses four dimensions of that question: when syndication and fund formation make strategic sense; when they do not; how the joint venture structure provides an alternative worth serious consideration; and the specific cost benefit analysis that every sponsor contemplating a first or next syndication should work through before committing to the structure.

## **When Syndication and Fund Formation Make Strategic Sense**

Syndication is not the right answer to the question ‘how do I acquire more real estate?’ It is the right answer to a different question: ‘I have identified a real estate investment opportunity that requires more capital than I can provide, that I have the competence and infrastructure to manage for the benefit of outside investors, and that generates sufficient returns to support both investor economics and meaningful sponsor compensation.’ That is a more demanding question, and a sponsor who can answer it affirmatively has identified the conditions under which syndication actually makes sense.

### **When the Deal Requires More Capital Than the Sponsor Can Provide**

The most fundamental condition for a syndication is a capital need that the sponsor cannot meet independently. A real estate operator who has sufficient capital to fund a deal entirely from their own resources, or from a small number of institutional relationships that do not implicate the securities laws, generally should not syndicate that deal. The regulatory overhead, the ongoing investor relations obligations, and the legal compliance costs of a securities offering are real costs that reduce the economics of any deal to which they are applied. They are justified when the capital need genuinely requires them, not when they are incurred as a matter of preference for leverage.

The capital threshold below which syndication is difficult to justify economically is not fixed. It depends on the deal size, the offering costs, and the sponsor’s infrastructure. But as a practical matter, most experienced securities counsel will note that a deal requiring less than \$1 million in equity from outside investors is difficult to justify as a Regulation D syndication when the offering costs alone can represent 3 percent to 5 percent of that equity raise. At that scale, the economics of bringing in outside capital through a securities offering frequently do not justify the legal and administrative costs, the investor relations obligations that follow, and the fiduciary duties that attach.

For deals that genuinely require significant outside capital (multifamily acquisitions, commercial redevelopments, portfolio acquisitions that require \$3 million or more in equity) the cost benefit calculation shifts. The offering costs represent a smaller percentage of the capital raised, the management fee and promoted interest generate meaningful sponsor economics, and the access to a broader investor base provides genuine diversification of the sponsor’s capital sources. At that scale, syndication is not a workaround. It is the appropriate tool.

### **When the Sponsor Has a Repeatable Deal Sourcing Advantage**

A single successful syndication that cannot be repeated is a transaction, not a business. The case for building the legal and operational infrastructure of a private real estate fund platform (entity structures, form documents, investor onboarding processes, fund administration relationships, compliance calendars) is strongest when the sponsor has a deal sourcing advantage that produces a repeatable pipeline of suitable investment opportunities. A sponsor who has demonstrated the ability to consistently identify and acquire deals at favorable terms, in a market and asset class they understand deeply, is a sponsor for whom the infrastructure investment pays off across multiple offerings rather than being amortized across a single transaction.

Repeatable deal sourcing advantage takes different forms. A regional operator who has spent fifteen years building relationships with owners of mid-size multifamily properties in a specific market has an off market deal access that is genuinely difficult to replicate. A developer with deep relationships in a specific municipality, an understanding of the entitlement process, and a track record of navigating that process successfully has an advantage that produces a differentiated pipeline. A commercial real estate operator whose property management platform controls expenses better than market competitors, and who can therefore underwrite at assumptions that are genuinely achievable, has an execution advantage that most capital providers cannot replicate independently.

What does not constitute a repeatable deal sourcing advantage: access to the MLS; a general familiarity with real estate investing; a recent track record that was produced in an unusually favorable market environment without being tested in a more challenging one; or a network of real estate contacts that is broad but not deep. Investors who commit capital to a fund do so on the belief that the sponsor will continue to deploy that capital into suitable investments throughout the fund's life. That belief requires something more than aspiration. It requires a demonstrated and sustainable deal sourcing capability.

### **When the Sponsor Has the Infrastructure to Manage Investor Relationships**

Investor relations is an ongoing operational function, not a one-time transaction. The sponsor who raises capital from outside investors has accepted an obligation that runs from the first closing through the final distribution: quarterly reporting, annual financial statements, K-1 preparation and delivery, investor inquiries, material event notifications, and the human relationship management that keeps investors who are satisfied with their investment experience interested in committing capital to the next one. That function requires time, personnel, systems, and a genuine commitment to keeping investors informed and feeling respected as partners in the investment.

Sponsors who underestimate the investor relations burden routinely discover it at a stage when the underestimation has already caused damage. The investor who has not received a quarterly

report in two quarters and who sends an email asking what is happening with their investment is not a difficult investor. They are an investor whose reasonable expectation of communication has not been met. The sponsor who responds defensively, or who treats the inquiry as an imposition on their time, has misunderstood the bargain they agreed to when they accepted outside capital. The investor's interest in information is not a request for a favor. It is the exercise of a right that the operating agreement explicitly provides.

The infrastructure question is practical. Does the sponsor have, or can they build, the capacity to report accurately and on schedule, to communicate proactively when material developments occur, and to manage investor relationships at the scale they are contemplating? For a sponsor raising capital from 20 investors in a single syndication, this may be manageable with a disciplined personal process and good fund administration support. For a sponsor managing a multi asset fund with 100 investors across multiple entities and multiple closings, it requires dedicated personnel and purpose built systems. The infrastructure must be present before the capital is raised, not assembled in response to investor complaints after it has been.

### **When the Returns Are Sufficient to Support Investor Economics and Sponsor Compensation**

The economics of a private real estate syndication must work for both parties. Investors must receive returns that are competitive with alternative investments of comparable risk, and the sponsor must receive compensation that is meaningful relative to the time, capital, and legal risk they commit to the offering. When a deal's economics cannot satisfy both conditions simultaneously, it should not be syndicated. A deal whose returns are sufficient to generate a competitive preferred return for investors but whose projected profit above the preferred return is too thin to produce meaningful sponsor promote economics is not a good syndication candidate. The sponsor would capture more of the deal's economics by investing their own capital rather than sharing them with outside investors while bearing all of the management and compliance obligations.

The return test is straightforward to articulate but genuinely difficult to apply in practice, because it requires honest assumptions about exit pricing in an uncertain market. A deal that pencils attractively at a 5.5 percent exit cap rate in a market where current trading is at 5.25 percent has a different risk profile than one that pencils attractively at 5.5 percent in a market where current trading is at 6.5 percent. The spread between the underwriting assumption and the current market condition is a measure of how much execution the deal requires, and the thinner that spread, the less margin for error on every subsequent assumption.

As a general benchmark, a private real estate syndication that cannot project a minimum 1.5x equity multiple and a 12 percent to 15 percent IRR to investors, before the sponsor's promoted interest, under reasonable assumptions is a deal whose returns are marginal for the syndication

structure. That does not mean every deal that meets those benchmarks should be syndicated, but it provides a floor below which the investor value proposition is difficult to sustain. Investors in private real estate accept illiquidity, concentration, and execution risk. The returns must compensate them for all three.

## **When You Should Not Syndicate**

The counterpart to the affirmative case for syndication is equally important and, in practice, more difficult for sponsors to apply honestly. The conditions that counsel against syndication are real, and they apply more frequently than the volume of private real estate offerings in any given year would suggest. Sponsors who identify with one or more of the conditions below are not disqualified from ultimately becoming successful syndicators, but they are not yet in the position where syndication is the right choice for them or their investors.

### **When the Sponsor Does Not Have the Legal and Compliance Infrastructure**

Conducting a securities offering without appropriate legal counsel and compliance infrastructure is not merely inadvisable. It is illegal. The preceding chapters of this handbook describe, in detail, the securities law requirements that apply to private real estate offerings: Regulation D exemption requirements, Form D filing obligations, state blue sky notice filing requirements, accredited investor qualification and verification standards, PPM disclosure obligations, and the antifraud framework that applies to all investor facing communications. A sponsor who proceeds with a capital raise without securities counsel and without a compliance process that implements these requirements is conducting an unregistered securities offering with rescission exposure attaching to every investor.

The absence of legal and compliance infrastructure is the single most common reason a sponsor should not syndicate at a particular moment. It is not a permanent condition. The infrastructure can be built. But it cannot be assembled retroactively after investors have already committed capital. The sequence must be: build the legal structure and compliance program, then offer securities to investors. The reverse sequence (raise the capital first and sort out the legal requirements later) has generated enforcement actions, investor rescission claims, and personal liability for sponsors at every scale and in every market cycle.

The cost of building appropriate legal and compliance infrastructure before the first offering is real. Securities counsel fees for a first syndication, including entity formation, PPM preparation, operating agreement drafting, subscription agreement preparation, and state blue sky filing program, typically range from \$15,000 to \$35,000 for a straightforward single asset deal and can exceed \$50,000 for a more complex first fund structure. Those costs must be accounted for in the deal economics before the offering is conducted. A sponsor who cannot structure a deal

that supports the legal and compliance costs of a proper offering should not conduct the offering.

## **When the Deal Economics Do Not Support Investor Returns and Sponsor Fees**

A deal that works for the sponsor but not for investors is not a deal that should be syndicated. The test here is not whether the deal produces investor returns in the most optimistic scenario. It is whether the deal produces competitive investor returns under realistic, conservatively underwritten assumptions and whether there is sufficient projected profit above the preferred return to generate meaningful sponsor compensation. If the deal cannot satisfy both conditions, structuring it as a syndication creates a misalignment between the sponsor's incentives (to close the deal and collect fees) and investors' interests (to earn competitive returns).

The specific failure modes to evaluate before conducting a syndication include the following.

- The deal requires a projected exit cap rate materially below current market trading to produce investor returns, meaning the deal only works under a market appreciation scenario, not under value add execution alone.
- The sponsor's fee stack is so large relative to projected investor returns that investors are bearing the execution risk but the sponsor is capturing a disproportionate share of the upside before the preferred return is satisfied.
- The deal requires a specific refinancing event at a specific LTV to return investor capital during the hold period, and current lending conditions make that refinancing scenario unlikely.
- The projected return assumes a hold period and disposition timing that requires perfect market conditions at a specific future date, with no margin for the market to be at a different point in its cycle when the exit is needed.

None of these conditions is an automatic disqualifier. Many successful syndications involve one or more of them. The question is whether the disclosure of these conditions in the PPM, combined with the projected returns under conservative assumptions, produces an offering that a sophisticated investor would reasonably evaluate as competitively attractive. If the honest answer is no, the offering is not ready to be conducted.

## **When the Sponsor Is Not Prepared for the Investor Relations Obligations**

The investor relations obligations of a private real estate syndication run for the entire duration of the investment, from the first closing through the final distribution. They are not optional, and they are not something that can be addressed when the sponsor has bandwidth. The operating agreement's reporting obligations are legally binding commitments. The antifraud provisions'



ongoing disclosure requirements apply continuously. The K-1 delivery obligations have statutory deadlines. A sponsor who is not genuinely prepared to meet these obligations on a sustained basis, who envisions the syndication as a financing mechanism rather than a long term operating relationship with their investor base, is not prepared to syndicate.

The practical question to ask before raising capital from outside investors. Am I willing to send quarterly reports on this investment for the next five to seven years, including reports during quarters when the investment is performing below plan? Am I willing to call investors when a material adverse event occurs (a lender default notice, a major tenant vacancy, a capital shortfall) before I have a solution in hand? Am I willing to account in detail for every dollar that passes through the investment's accounts, and to explain every deviation from the underwriting projections in writing?

These questions are not rhetorical. They describe the actual obligations that the operating agreement and the securities laws impose. Sponsors who are not genuinely willing to fulfill them consistently over the investment's life should not raise capital from outside investors. The alternative is not necessarily to avoid real estate investment. It may be to pursue a structure (a joint venture with a small number of active partners, or a family office relationship that is not a public offering) that does not carry the same ongoing obligations.

### **When the Deal Is Too Small to Justify the Cost of a Syndication**

The economics of a private real estate offering have a minimum scale below which they do not work. A \$2 million multifamily acquisition that requires \$600,000 of outside equity cannot bear the offering costs, compliance obligations, and ongoing fund administration expenses of a Regulation D syndication without materially impairing investor returns. The offering legal costs alone may represent 5 percent or more of the equity raise. Add the fund administrator's annual fee, the accountant's K-1 preparation cost, the state blue sky filing fees, and the annual Form D amendment, and the all in overhead of a properly conducted offering consumes a share of investor returns that a deal of that scale cannot absorb.

The minimum deal size that can support a properly conducted private real estate syndication (one with qualified securities counsel, a properly prepared PPM, a fund administrator, and an audited annual financial statement) is generally in the range of \$5 million to \$8 million in total capitalization, with outside equity of at least \$2 million to \$3 million. Below those thresholds, the overhead costs represent too large a share of the projected investor returns to produce an offering that is economically compelling. Sponsors who want to invest below those thresholds should consider the joint venture alternative, a private loan from a single sophisticated investor, or equity from their own balance sheet.

### **⚠ The Premature Syndication Is the Most Common First Time Sponsor Mistake**

*The most common mistake made by first time real estate syndicators is not a legal error or a documentation failure. It is the decision to syndicate before the conditions for a successful syndication are in place. A sponsor who conducts their first offering before they have securities counsel, before they have built the investor relations capacity to communicate with investors over a multi-year hold period, or before they have a deal that can produce competitive investor returns under conservative assumptions, has created a situation where investor disappointment is more likely than investor satisfaction.*

*The legal, regulatory, and investor relations consequences of a poorly executed first syndication follow a sponsor into subsequent offerings. Investors who had a poor experience rarely reinvest. Regulatory issues identified in a first offering create background that affects future regulatory interactions. The reputational cost of an unsuccessful first offering, in a capital raising world where reputation is the primary currency, is difficult to reverse.*

*The right question to ask before a first offering is not ‘Can I syndicate this deal?’ but ‘Is this deal, at this stage of my platform’s development, the right vehicle for me and for the investors I am asking to trust me with their capital?’ Those are meaningfully different questions.*

## **Joint Ventures as an Alternative to Syndication**

The joint venture is the most important and most underutilized alternative to syndication for sponsors who need capital partners but who are not yet ready for, or whose deal economics do not support, a full Regulation D securities offering. Understanding when a joint venture is the right structure, and what distinguishes it legally from a syndication, is essential for sponsors who are building their real estate investment business incrementally.

### **What a Joint Venture Is and Is Not**

A joint venture is a business arrangement between two or more parties who each have an active, defined role in the management and operation of the investment. Each party contributes capital, expertise, or both. Decisions are made jointly or by a designated managing partner, but the key legal characteristic is that no party is a passive investor. Every participant in the venture has a genuine management role and exercises it actively. This is the feature that distinguishes a joint venture from a syndication at the securities law level.

The landmark test for whether an arrangement is a securities offering (the Howey Test, established by the Supreme Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946)) turns on whether investors are relying on the efforts of others for their expected profit. In a properly structured joint venture between a small number of active, sophisticated participants who each exercise genuine management authority, the Howey Test may not be satisfied, meaning the arrangement is not a securities offering and does not require registration or a Regulation D exemption. In a syndication, where passive investors contribute capital and rely entirely on the sponsor's efforts for their expected return, the Howey Test is satisfied and securities law applies in full.

The critical qualifier is properly structured. A transaction that is called a joint venture but that involves a capital partner who has no genuine management role, who is expected to take no active part in the investment's management, and whose expected return depends entirely on the operating partner's efforts is a syndication in substance regardless of what the parties call it. Courts and regulators apply the Howey Test to the economic substance of the arrangement, not to its label. The line between joint venture and syndication is not determined by the documents. It is determined by the actual role of the parties.

### **When the Joint Venture Structure Is Appropriate**

The joint venture is the right structure when a small number of parties, typically two to five, are each contributing something material to the deal. The operating partner brings deal sourcing, management expertise, and execution capability. The capital partner or partners bring equity capital and, in many cases, additional market knowledge, relationships, or complementary expertise. Both sides are active participants in the major decisions affecting the investment. Both sides are sophisticated enough to understand and evaluate the investment independently.

Joint ventures work particularly well in several contexts. A sponsor who is acquiring their first larger deal and needs a capital partner willing to participate as an active co investor, rather than a passive outside investor, can structure that relationship as a joint venture without incurring the legal and compliance costs of a securities offering. A developer who has a long term relationship with a single family office that commits capital on a deal by deal basis in exchange for co management rights is often operating in joint venture territory rather than syndication territory. A real estate operator who partners with a private equity firm as the operating member in a joint venture, with the private equity firm serving as the capital member and exercising specific consent rights over major decisions, is in a joint venture structure that both parties contribute to actively.

The joint venture is also appropriate for deals that are below the minimum scale that can support a full syndication. A \$3 million commercial acquisition that requires \$900,000 of outside equity can be structured as a joint venture with one or two capital partners who are active

participants, without incurring the costs of a Regulation D offering. The legal costs of a joint venture operating agreement, even a carefully drafted one, are meaningfully lower than the costs of a full PPM, subscription agreement, and Regulation D compliance program.

## The Legal Boundary Between Joint Venture and Syndication

The boundary between joint venture and syndication is one of the most consequential legal determinations that a real estate sponsor makes, because structuring a securities offering as a joint venture does not make it a joint venture. It makes it an unregistered securities offering with all of the consequences that status carries. Sponsors who structure investor arrangements as joint ventures to avoid the costs of securities compliance, while the investors in those arrangements are functionally passive, are exposed to the same enforcement risks and investor rescission rights as sponsors who conduct explicit unregistered offerings.

The factors that courts and regulators evaluate in determining whether an arrangement is a joint venture or a securities offering include whether the investor has a genuinely active role in management decisions affecting the investment; whether the investor has the sophistication and experience to evaluate and exercise that role; whether the investor actually participates in management, or whether the joint venture agreement's management provisions exist on paper but not in practice; and whether the investor is relying entirely on the operator's efforts for the expected return. Each of these factors must be genuinely, not nominally, satisfied for the joint venture characterization to hold.

Before structuring any two party or small group investment arrangement as a joint venture, the operating partner must have securities counsel evaluate whether the arrangement satisfies the Howey Test as a non-security. That evaluation is not a formality. It is a specific legal analysis that turns on the facts of the particular arrangement. A joint venture agreement that includes participation rights, voting rights, and management consent provisions, but whose capital partner has no realistic ability to exercise those rights because the operating partner is geographically distant and information is not shared in a way that allows the capital partner to form independent judgments, may not withstand the Howey Test analysis.

## The Cost Benefit Analysis: Syndication Infrastructure Costs

Any sponsor who is evaluating whether to conduct a private real estate syndication needs to work through the full cost benefit analysis before making the decision. The costs are real, they are largely fixed (meaning they apply to small deals and large deals with only modest variation), and they are incurred before the deal closes, before the sponsor knows whether the investment will perform as projected. The benefits (access to more capital, a growing investor base, and the economic leverage of the promote) are real but contingent on execution. The analysis requires honest accounting of both sides.

## Legal and Document Preparation Costs

Legal costs for a first private real estate syndication typically include entity formation for the fund entity and any SPV holding entities; preparation of the private placement memorandum; drafting the operating agreement and, for most syndications, a separate subscription agreement; review and markup of the purchase agreement from the securities law perspective; state blue sky notice filing preparation and fees; and preparation of the Form D. For a standard first syndication, this work typically runs between \$15,000 and \$35,000 in legal fees, depending on the complexity of the deal, the number of entities, and the counsel's experience with private real estate offerings.

Fund structures, where the sponsor is raising a pool of capital to deploy across multiple properties over an investment period, rather than raising capital for a specific identified acquisition, involve additional complexity and higher initial legal costs. A real estate fund with a defined investment period, multiple asset classes, and an institutional grade operating agreement typically involves legal costs of \$40,000 to \$75,000 or more at inception, before any deal specific legal work is performed. Those costs must be absorbed either as fund organization expenses or as sponsor costs, and they represent a meaningful economic commitment to the fund formation decision.

Ongoing legal costs, including annual compliance work, state blue sky renewals, operating agreement amendments, and deal specific work for each acquisition and disposition, run \$5,000 to \$15,000 per year for an active sponsor with a single fund, and scale upward with the number of funds, the number of investors, and the complexity of each deal. These ongoing costs are typically charged to the fund as operating expenses, but they reduce the net returns to investors and must be disclosed in the PPM.

## Accounting and Fund Administration Costs

Fund administration (the maintenance of capital accounts, waterfall calculations, financial statement preparation, investor distribution processing, and investor reporting) is an ongoing operational cost that begins at the first closing and runs through the fund's dissolution. For sponsors who self-administer, the cost is primarily time and the risk of calculation errors whose consequences can be expensive to correct. For sponsors who engage a third party fund administrator, which is increasingly the expected standard for funds with institutional investor participation, the cost depends on the fund's complexity and the administrator's pricing model.

Third party fund administration fees for a typical private real estate fund range from \$10,000 to \$30,000 per year for a single asset fund with 20 to 50 investors, and can exceed \$50,000 per year for a multi asset fund with more complex waterfall mechanics and a larger investor base. These fees cover capital account maintenance, waterfall calculations, investor reporting

preparation, and distribution processing. They do not typically cover K-1 preparation, which is a separate tax adviser function.

K-1 preparation and delivery is one of the most time sensitive and investor visible accounting obligations in a private real estate fund. A tax adviser experienced in real estate fund partnerships charges \$500 to \$2,000 per K-1 for a single asset fund, depending on the complexity of the depreciation allocations and any special items. For a fund with 30 investors and a cost segregation study, the K-1 preparation cost alone can exceed \$40,000 annually. That cost, too, must be built into the fund economics and disclosed to investors as a fund expense.

Audited financial statements, required by most institutional investors and by the Investment Advisers Act's custody rule for registered advisers, add \$10,000 to \$25,000 per year for a single asset fund, depending on the property's complexity and the auditor's experience with real estate fund accounting. Sponsors whose investor base includes institutional capital should assume audited statements are required from the first year.

## Compliance and Regulatory Filing Costs

Regulatory compliance costs in a private real estate fund include both the initial offering compliance costs (which are included in the legal cost estimates above) and the ongoing compliance costs that persist for the life of the fund. The ongoing compliance calendar typically includes annual Form D amendments while the offering remains open; state blue sky renewal filings in every state where investors reside (which in a geographically diverse offering can involve ten or more annual filings at costs of \$200 to \$1,500 each); and for registered investment advisers, the annual Form ADV amendment, updating required disclosures and the firm's brochure.

For exempt reporting advisers (sponsors who manage funds above the threshold requiring reporting but who are not fully registered) the annual Form ADV filing and updating obligation involves legal time that typically runs \$3,000 to \$7,000 per year. For fully registered investment advisers, the compliance program costs (including the annual compliance review, compliance manual updates, and any state level investment adviser registration and renewal fees) add \$15,000 to \$40,000 annually in compliance counsel costs, independent of any deal specific work.

The compliance cost that most sponsors underestimate is the cost of the compliance calendar maintenance itself: tracking what needs to be filed, in which jurisdiction, by which deadline, and confirming that it has been done. A missed Form D amendment or an expired state blue sky filing is not merely an administrative failure. It is a legal violation that creates investor rescission rights in the states where the filing lapsed. Building the compliance calendar into a system that

is actively monitored, with assigned responsibility and automated reminders, is a practical requirement that has its own cost in either internal time or external adviser fees.

## Ongoing Investor Relations and Reporting Costs

Investor relations is the most time intensive ongoing cost of a private real estate syndication, and it is also the cost that is most consistently underestimated by sponsors who focus their pre offering analysis on the financial and legal costs. A sponsor managing a 30 investor fund through a five year hold period will spend meaningful time, often measured in hours per week rather than hours per month, on investor communications: answering investor inquiries, preparing and reviewing quarterly reports, managing the distribution calculation and notification process, and handling the investor specific questions that arise whenever a material development occurs.

The specific investor relations workload scales with the number of investors, the complexity of the fund's financial performance, and, critically, the quality of the investor communications during the holding period. A fund that produces accurate, timely, and well written quarterly reports and that communicates proactively about material developments requires less reactive investor relations time than one whose investor base has been left to wonder about developments they should have been informed of promptly. Proactive communication is not only a legal obligation. It is an operating efficiency.

The technology costs of investor relations (investor portal, document delivery system, and investor database management) run from near zero for sponsors using basic commercial tools to \$10,000 to \$30,000 per year for purpose built fund management software platforms. These costs are justified as the fund grows and the investor base expands. They are difficult to justify for a single asset syndication with twenty investors.

## Practical Takeaways

- Syndication is not a financing tool. It is a long term operating commitment that requires legal infrastructure, investor relations capacity, and deal economics sufficient to produce competitive investor returns and meaningful sponsor compensation simultaneously. Sponsors who approach syndication as a way to access more capital for deals they could not otherwise afford, without reckoning with the full scope of what the structure demands, tend to discover that scope at the worst possible moment.
- The four conditions that must be present before syndication makes strategic sense are: a genuine capital need that the sponsor cannot meet independently; a repeatable deal sourcing advantage that produces a sustainable pipeline; the infrastructure to manage investor relationships over a multiyear hold period; and deal economics that support



competitive investor returns under conservative assumptions. The absence of any one of these conditions is a reason to pause and address it before proceeding.

- The single most common reason a first time sponsor should not syndicate is the absence of legal and compliance infrastructure. Securities counsel must be engaged before the offering launches, not during it and not after. The legal costs of a properly conducted first syndication range from \$15,000 to \$35,000 in initial offering work. Those costs are a floor, not a ceiling, and they must be built into the deal economics before the offering is conducted.
- A deal whose total capitalization is below \$5 million to \$8 million, or whose outside equity raise is below \$2 million to \$3 million, is difficult to structure as a Regulation D syndication whose infrastructure costs are economically supportable. Below those thresholds, the offering costs represent too large a share of the capital raised and the projected returns to produce an offering that is compelling to investors. The joint venture structure deserves serious consideration at smaller scales.
- The joint venture is a genuine and underutilized alternative to syndication for deals involving a small number of active, sophisticated capital partners. The key legal distinction is that joint venture participants must each have a genuine, active management role in the investment, not merely formal rights described in an operating agreement. A capital partner with nominal management rights who exercises no active management function is a passive investor, and the arrangement is a securities offering regardless of its label. Securities counsel must evaluate the Howey Test analysis before any arrangement is characterized as a joint venture rather than a syndication.
- The full five year cost of running a properly structured single asset syndication (legal, fund administration, K-1 preparation, audit, compliance, and investor relations) ranges in the low to mid hundreds of thousands of dollars for a representative \$5 million acquisition with a \$2 million equity raise. On a representative midpoint that cost is in the range of 15 percent to 25 percent of the equity raised over the five year hold. That cost must be absorbed by the sponsor's management fee and promote economics, not by investor returns. Sponsors who have not worked through this calculation before structuring their offering are underestimating the cost of doing it right.
- The investor relations burden runs from the first closing through the final distribution. It includes quarterly reporting, annual financial statements, K-1 preparation and delivery, material event notifications, and ongoing investor inquiries. Sponsors who are not genuinely willing to sustain this level of communication over a multi-year hold period, including during periods when the investment is performing below plan, are not prepared to raise outside capital.



- Infrastructure costs scale more slowly than deal size. A \$10 million equity raise involves roughly the same offering costs as a \$2 million raise, meaning the percentage of capital consumed by infrastructure drops materially as the offering size increases. This is one of the most compelling arguments for ensuring that a sponsor's first syndication is large enough that the economics genuinely work. Doing a small deal to test the waters on syndication frequently produces a situation where the infrastructure costs impair investor returns, the investor experience is consequently less positive, and the track record the sponsor builds is built on an economically marginal offering.

## CHAPTER THIRTY FIVE

# Building a Real Estate Syndication and Fund Platform

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There is a meaningful difference between completing a real estate syndication and building a real estate syndication platform. The former is a transaction. The latter is a business. Sponsors who have completed one, two, or three successful offerings have proven that they can identify deals, build the legal structure, raise capital, and manage the investment through its lifecycle. What they have not yet proven is that they can do it repeatedly, at scale, with the same quality of execution on the fifteenth offering as on the first. The platform (the systems, the legal infrastructure, the technology, the investor network, and the compliance program) is what makes that repeatability possible.

Sponsors who plateau at \$20 million to \$50 million in assets under management often attribute their inability to grow past that point to deal flow, or to capital, or to market conditions. Those factors matter, but they are rarely the primary constraint. The primary constraint is operational. A sponsor whose deal sourcing process is entirely relationship dependent and non-systematized, whose offering documents are rebuilt from scratch for every transaction, whose investor communications run through personal email without a CRM, and whose compliance calendar exists only in their own memory has built a business that depends entirely on their personal bandwidth. That business does not scale because they cannot scale.

This chapter addresses the systems, infrastructure, and strategic decisions that transform a series of successful syndications into a durable investment business. It covers the repeatable investment program that gives a platform its identity; the legal infrastructure that allows each new offering to be executed with professional quality and appropriate customization rather than built from a blank page; the technology stack that makes investor relationships manageable at scale; the investor network strategies that shift the capital raising function from a crisis driven scramble into an ongoing relationship program; the transition from deal by deal syndications to fund structures; and the compliance infrastructure that allows a growing platform to stay ahead of its regulatory obligations rather than perpetually catching up to them.

## Designing a Repeatable Investment Program

A platform's investment program is its operating identity, the answer to the question that every investor and every potential investor will ask at some point: what do you do, why are you the best person to do it in the markets you target, and how does your approach generate superior risk adjusted returns over time? A sponsor who has a crisp, honest, differentiated answer to that

question has the foundation of a platform. One who describes a broad appetite for any value add deal in any market where the numbers work has described an undifferentiated offering that will struggle to build a loyal investor base.

## Defining Your Investment Thesis and Target Asset Class

The investment thesis is the platform's first and most consequential design decision. It defines the property type the sponsor will pursue, the geographic markets they will operate in, the investment strategy they will apply (core, core plus, value add, opportunistic, development, or some combination), and the differentiated capability that the sponsor believes gives them an advantage in executing that strategy. A well designed investment thesis is narrow enough to be meaningful and broad enough to generate a sustainable deal pipeline.

Narrowness produces credibility. A sponsor who has completed fifteen multifamily value add acquisitions in three Sunbelt metros, who has built a renovation management team, property management relationships, and underwriting database specific to that product type and geography, has a story that a sophisticated investor can evaluate and believe. A sponsor who describes themselves as targeting opportunistic real estate across asset classes and markets has described a scope so broad that it conveys no specific expertise and provides no basis for evaluating their competitive advantage.

The investment thesis should answer four specific questions. First, what asset class and subtype is the focus (multifamily, industrial, retail, office, a specific niche like medical office, self-storage, or manufactured housing) and why does the sponsor have superior access to and knowledge of that specific segment? Second, which geographic markets or market types (specific MSAs, or a market type category like secondary Sunbelt markets or supply constrained coastal urban centers) and why does the sponsor have competitive advantages in those markets specifically? Third, which investment strategy (value add renovation, lease up execution, distressed acquisition, ground up development) and why does the sponsor's team have the operational capabilities to execute that strategy consistently? Fourth, what is the differentiated deal sourcing approach (broker relationships, direct to owner marketing, auction platform expertise, off market network) that generates deal flow at better pricing or in less competitive conditions than the sponsor's peers?

The geographic concentration question deserves particular attention. Sponsors who operate in many markets simultaneously spread their local knowledge across too many jurisdictions to maintain genuine advantage in any of them. A sponsor with deep submarket knowledge (who knows which specific corridors in a specific city are supply constrained, which specific submarkets have demographic tailwinds, which specific landlords own aging assets with capital needs) has an informational edge that translates into better deal sourcing, better underwriting

accuracy, and better property level execution. That edge is built in a small number of markets over a long period. It is not transferable to new markets by reading market reports.

## Building Systems for Deal Sourcing and Underwriting

Deal sourcing is where most real estate platforms are most fragile. The sponsor's personal relationships generate deal flow in the early years. As the platform grows and the sponsor's attention divides between more investor relationships, more asset management obligations, and more operational complexity, the personal relationship model produces less deal flow per unit of sponsor time, exactly the period when the platform needs more deal flow, not less.

Systematizing deal sourcing means building a process that generates deal flow reliably regardless of how much of the sponsor's personal bandwidth is available on any given day.

A systematic deal sourcing program for a private real estate fund platform includes several components. The broker relationship program (a tracked, maintained set of relationships with the specific brokers who represent properties in the target asset class and market, cultivated through consistent communication, deal feedback, and market intelligence sharing) produces the early looks at listed deals and the first calls on off market opportunities that turn listed deal access into off market access over time. The direct to owner program (systematic outreach to owners of target properties through direct mail, cold calling, or targeted marketing campaigns) produces deal flow that is entirely independent of broker relationships and that frequently surfaces the most motivated sellers. The data driven pipeline (a systematic process of identifying target properties based on defined acquisition criteria, tracking their ownership, and reaching out when conditions suggest motivation) combines technology with direct outreach in a way that scales independent of personal relationships.

The underwriting infrastructure is equally important. A standardized underwriting model that produces consistent outputs across deals, a market data repository that tracks rent comparables, sales comparables, and operating metrics in the target markets, and a defined review process for evaluating each deal against the platform's acquisition criteria all contribute to underwriting decisions that are both faster and more reliable than ad hoc analysis on each opportunity. Platforms that have systematized these processes can evaluate dozens of opportunities per quarter and identify the few that warrant deeper diligence, while platforms that underwrite each deal as a custom exercise are limited to the number of deals the sponsor can personally analyze.

Systematizing deal sourcing and underwriting (building processes that operate consistently whether or not the sponsor is personally available) reduces the platform's dependence on the sponsor's personal bandwidth and produces more reliable deal flow as the platform grows. The investment in systematization is not overhead. It is the operating leverage that makes growth possible.

## Establishing Consistent Offering Structures and Documentation

One of the most significant operational advantages a scaled platform has over a one off syndicator is the ability to launch a new offering efficiently because the structures and documents already exist in developed, tested form. The sponsor who builds a new LLC structure, negotiates a new operating agreement from scratch, and drafts a new PPM for every offering is not building a platform. They are doing a transaction over and over. Each transaction is completed at something approaching full transaction cost, and the learning from each does not materially reduce the cost or improve the quality of the next.

A platform's offering structure program should achieve the opposite. Each new offering launches faster, at lower cost, and with higher quality than the prior one, because the structure has been refined, the documents have been tested and updated based on investor and regulatory feedback, and the execution process has been mapped and assigned. The specific elements of a consistent offering structure program are addressed in detail in the following section on legal infrastructure.

## Legal Infrastructure for a Multi Offering Platform

The legal infrastructure of a multi offering platform is distinct from the legal work required to complete a single transaction. A single transaction legal engagement produces a set of documents for a specific deal, used once. A platform's legal infrastructure produces document frameworks that are used repeatedly, adapted efficiently for each new offering, and updated systematically as the law, market practice, or the sponsor's business model evolves. The difference is not merely a cost efficiency question, though it is that too. It is a quality and consistency question. Investors in a sponsor's fourth offering deserve documents that are at least as carefully considered as those in the first, and they deserve an operating agreement whose economic provisions are actually consistent with what the sponsor communicated in marketing.

## Master Operating Agreement Templates

The master operating agreement template is the foundational document of the platform's legal infrastructure. It establishes the standard economic structure (the waterfall, the preferred return mechanics, the promote tier structure, the catch up provision, the clawback mechanism) that the sponsor applies consistently across offerings, with deal specific modifications where the specific deal warrants them. It also establishes the standard governance framework (the manager authority provisions, the major decisions list, the investor protection provisions, the reporting obligations) that applies across the platform.

Building a master operating agreement template is not simply selecting a form and committing to use it. It is the result of a deliberate design process in which the sponsor, working with securities counsel who understands both the legal requirements and the economic intent, works through every significant provision and makes a considered decision about the standard position. The preferred return accrual methodology (simple or compounding, contributed capital or unreturned capital basis) should be selected based on what the sponsor believes is fair and competitive for their investor base, and the standard position should be applied consistently. The major decisions list should be calibrated to the sponsor's investment strategy and operational style. The investor protection provisions should reflect what the sponsor is genuinely willing to commit to, not what was carried over from a form document that was never carefully reviewed.

The master template should be reviewed and updated by securities counsel at least annually, and whenever applicable law or regulatory guidance changes; the sponsor's business model or typical deal structure changes materially; investor feedback or market practice in the sponsor's peer group suggests that the standard provisions are out of alignment with expectations; or the sponsor completes a deal whose legal or operational experience reveals gaps in the template that should be addressed prospectively. A document that was carefully designed in Year 1 but has not been reviewed since is not a platform asset. It is an aging form document with an accumulating gap between its provisions and the sponsor's current business.

### **Form PPM with Deal Specific Customization**

The private placement memorandum performs two functions simultaneously. It satisfies the antifraud disclosure obligation by providing investors with material information about the investment, and it serves as the primary marketing document through which investors evaluate whether to commit capital. A well designed form PPM that can be efficiently customized for each new deal serves both functions well for every offering. A form that was written for one specific deal, used for the next five offerings with minimal review, satisfies neither function adequately. The risk factors describe a different deal, the financial projections reflect a different market, and the sponsor description does not account for the track record built since the original form was prepared.

The form PPM structure should be organized to distinguish clearly between the sections that remain largely constant across offerings and the sections that must be customized for each deal. Sections that are largely constant (the securities law disclosure sections, the risk factor categories though not all individual risk factors, the sponsor description framework, the investor qualification and subscription process) can be maintained as a stable template that requires only periodic review. Sections that must be substantively customized for every deal (the property description, the specific risk factors for this asset type and market, the financial

projections and their specific assumptions, the use of proceeds, the disclosure of the specific property's condition and history) must receive genuine deal specific analysis and drafting, not merely replacement of property names and numbers.

A well-organized PPM template reduces the time required to produce a high quality offering document from several weeks to several days, because the structural work has been done and the legal framework is established. It does not, and must not, reduce the analytical rigor of the deal specific sections. The risk factor section for a multifamily value add offering in Dallas must describe the specific risks of this specific Dallas property's renovation program, the specific submarket's supply pipeline, and the specific financing structure's interest rate exposure, not the generic risk factors that would apply to any multifamily investment anywhere. That analysis requires genuine work on every deal, regardless of how good the template is.

### **Subscription Agreement and Investor Onboarding Process**

The subscription agreement and the investor onboarding process that surrounds it are simultaneously a legal compliance function and an investor experience function. As a compliance function, they must collect the information and representations required to satisfy the applicable Regulation D exemption, make the required state level investor disclosure, document the investor's qualification and accreditation, and establish the legal record of the investor's commitment. As an investor experience function, they determine the investor's first operational experience with the sponsor: whether the process is organized and professional or confusing and manual, whether the sponsor's team is responsive and helpful or reactive and difficult to reach.

The subscription agreement template should be maintained as a separate document from the operating agreement and reviewed annually alongside it. Each state in which the platform has significant investor concentration should be evaluated for state specific disclosure or representation requirements that must be incorporated into the subscription agreement. The 506(b) and 506(c) versions of the subscription agreement should be maintained as distinct templates, because the investor representation and verification requirements differ materially between the two exemptions.

Sponsors using Rule 506(c) should be aware of the SEC Division of Corporation Finance no action letter issued on March 12, 2025, which provides a bright line safe harbor for the 506(c) verification requirement. Under that guidance, an issuer may rely on minimum investment amounts (generally \$200,000 for natural persons and \$1 million for legal entities) combined with specified investor representations as a reasonable step to verify accredited investor status, without requiring the more intrusive documentary review (tax returns, brokerage statements) that has historically deterred sponsors from using Rule 506(c). The no action letter does not change the underlying verification requirement, but it provides a meaningfully easier path to

compliance for platforms whose minimum investments meet the thresholds. The 506(c) verification, once performed for an investor, may be relied upon for that investor's subsequent investments in the platform for up to five years under the SEC's safe harbor for reasonable reliance on prior verification.

The investor onboarding process (the sequence of steps from the investor's expression of interest through their execution of the subscription agreement, completion of accreditation verification, delivery of subscription funds, and receipt of their welcome communication and portal access) should be mapped as a defined workflow with specific responsible parties, specific timelines, and specific escalation points for issues that arise. An investor who completes their subscription agreement but does not receive instructions for funding, or who wires funds but does not receive a confirmation, or who is admitted to the fund but does not receive K-1 access, is an investor whose first direct experience of the sponsor's operational quality is negative. That experience shapes their willingness to reinvest and to refer others.

## Technology Infrastructure

The technology infrastructure of a real estate syndication platform serves a specific function that is distinct from the legal infrastructure. It makes the human relationships (with investors, with brokers, with service providers) manageable at a scale where they could not be managed manually. A sponsor with 50 investors in a single deal can maintain adequate investor communications through personal email and a shared drive. A sponsor with 200 investors across five deals cannot. The technology is not a substitute for the relationship quality that makes those investors committed partners in the platform. It is the operational medium through which that relationship quality is delivered at a scale where personal attention to every investor, every week, is not humanly possible.

## CRM and Investor Relationship Management

The investor CRM (the system that tracks the sponsor's relationships with current and prospective investors) is the operational foundation of the investor relations function. A well configured CRM records every interaction with every investor: emails, phone calls, meetings, distribution notices, quarterly report deliveries, investment inquiries, and subscription transactions. It tracks each investor's investment history across offerings, their communication preferences, their expressed interests and investment goals, their accreditation status and expiration dates, and their relationship network (who introduced them to the sponsor and who they have referred). That accumulated information is the raw material of a genuine, personalized investor relationship at scale.



The CRM selection decision involves a real tradeoff. General purpose CRM platforms (Salesforce, HubSpot, and their peers) offer broad functionality, integration with a wide range of third party tools, and the ability to build highly customized workflows. They are expensive to implement effectively, require significant configuration to serve the specific needs of a real estate fund platform, and produce the best results only when the configuration is done by someone who understands both the CRM and the real estate fund business. Purpose built real estate fund CRM platforms (Juniper Square, InvestNext, Cash Flow Portal, Dynamo Software, and others) offer functionality designed specifically for the private real estate fund business, including deal management, investor onboarding, distribution tracking, and investor portal integration. They are typically faster to implement, require less customization, and are better suited to a growing platform's needs than a general purpose CRM with a real estate overlay.

Whatever platform is selected, the CRM is only as valuable as the discipline with which it is used. A CRM that is populated with investor contact information but that is not updated after each investor interaction, that does not track accreditation expiration dates, and that does not record the outcome of each investor call is less useful than a well maintained spreadsheet. The CRM's value compounds over time as interactions accumulate. A relationship that has been tracked through three deals, multiple quarterly reports, and several years of consistent communication is a relationship whose history is searchable and whose context is available to any member of the sponsor's team who interacts with that investor. That institutional memory is a platform asset that personal email cannot create.

### **Investor Portal and Document Delivery**

The investor portal is the primary interface through which investors experience the platform's operational quality on an ongoing basis. It is where they access quarterly reports and annual financial statements, download their K-1s, review the performance of each investment, receive distribution notices and confirmations, and track the cumulative performance of their relationship with the sponsor. The quality of the investor portal (its clarity, reliability, accessibility, and the completeness of the information it contains) is not a nice to have feature of a sophisticated platform. It is increasingly the standard that institutional quality investors expect and that separates platforms that attract the next tier of capital from those that remain limited to their existing investor base.

A well configured investor portal provides a dashboard showing each investor's current investments, their total capital committed, distributions received to date, and current unrealized value based on the sponsor's latest marks; deal specific pages for each investment showing the property details, the financial statements, the quarterly reports, and all material transaction documents; a document library where subscription agreements, operating agreements, K-1s, and other investor specific documents are stored and searchable; a distribution history showing

each distribution by date, amount, and investment; and a communication center where the sponsor can send targeted messages to specific investor segments or to the full investor base.

The document delivery function of the investor portal replaces the email attachment process that many sponsors use for report delivery, a process that creates version control problems, is difficult to audit, and produces no confirmation that the investor has received or reviewed the communication. Documents delivered through the portal are time stamped, access logged, and available to the investor at any time from any device. The operational discipline of delivering all investor communications through the portal also creates the compliance record that, in an SEC examination or an investor dispute, demonstrates that the sponsor met their reporting obligations on schedule.

## Fund Administration Software

Fund administration software (the system that maintains capital accounts, calculates waterfall distributions, produces financial statements, and manages the distribution payment process) is distinct from both the CRM and the investor portal, though all three may be provided by a single integrated platform. The fund administration system is the financial engine of the platform. It is the source of record for every investor's capital account balance, every distribution paid, and every income and loss allocation made across the fund's life.

The choice between managing fund administration internally with purpose built software and outsourcing it to a third party fund administrator is addressed in Chapter 28. For a growing platform, the relevant question is how the technology choice integrates with the rest of the platform's infrastructure. A fund administration platform that feeds data directly into the investor portal (so that investors see current capital account balances and distribution history without manual data transfer between systems) is meaningfully better for the investor experience than one that requires manual exports and uploads. A fund administration platform that produces financial statements in a format that flows easily into the annual audit process reduces the cost and timeline of the audit. These integration considerations should inform both the platform selection and the vendor relationship negotiations.

## Building Your Investor Network

Capital is the raw material of a private real estate fund platform, and the investor network is the primary mechanism through which that capital is sourced. Most sponsors who have successfully raised capital for one or two deals have done so primarily from their personal network: people they knew from prior careers, prior transactions, or social and professional relationships. That network has real value and should not be taken for granted, but it has a natural ceiling. The people who know you well enough to invest with you before you have a substantial track record

are a finite group, and once they have committed their available capital to your prior deals, the next round of capital must come from somewhere else.

Building an investor network beyond the personal relationship base is the growth constraint that most mid-sized syndication platforms encounter first. Sponsors who plateau at \$20 million to \$50 million in assets under management often do so because they have deployed all of the capital available from their personal network without building the systems and reputation that would attract investors they do not already know.

## Strategies for Growing an Accredited Investor Database

Growing the investor database from the personal network to a broader community of accredited investors requires a marketing program that builds the sponsor's reputation in the accredited investor community over time, not a campaign to sell a specific deal, but a consistent program that positions the sponsor as a credible, informed, professional operator whose analysis and perspective are worth following. That positioning is the prerequisite for the investment conversation. The deal specific pitch comes later, and to an audience that has already formed a favorable impression of the sponsor through months or years of educational content.

The most effective investor database growth strategies for private real estate sponsors in the current environment operate through several channels simultaneously. Educational content (detailed market analysis, deal case studies from prior investments, commentary on market conditions and their implications for the sponsor's target asset class) demonstrates expertise in a format that prospective investors can evaluate without any commitment. Published consistently through a newsletter, a podcast, or a maintained website, educational content builds an audience of investors who have self-selected based on interest in the asset class and the sponsor's specific market focus.

Conference and event participation (speaking at real estate investment conferences, hosting investor education webinars, or appearing on podcasts that reach accredited investor audiences) provides introductions to investors who have not yet encountered the sponsor's work. These introductions do not produce immediate subscriptions. They produce relationships that, cultivated over months with consistent follow up and continued content, eventually produce investment conversations. The timeline from first contact to investment commitment for an investor who does not know the sponsor through a personal relationship is typically six to eighteen months, and sponsors who expect faster conversion from a conference appearance are typically disappointed.

Referral programs (structured programs through which existing investors refer qualified contacts to the sponsor, in exchange for economic recognition within the fund structure or other non-transaction based recognition) leverage the sponsor's existing investor base to reach the social

networks of people who are already invested and satisfied. Existing investors are the most credible advocates for the sponsor's capabilities and operating style. A satisfied investor who refers a colleague has provided something that no amount of marketing content can replicate: a personal endorsement from someone the prospect trusts. Referral programs must be designed carefully to ensure they do not create unregistered broker dealer arrangements. The referral economic recognition must be structured in a way that does not constitute transaction based compensation for introducing investors, as discussed in Chapter 32.

Track record transparency is the foundation on which sophisticated investors evaluate whether to commit to a new relationship with a sponsor they do not personally know. Sponsors who systematically share full cycle performance data, including the deals that did not achieve their projections and how those situations were managed, differentiate themselves from sponsors who rely on curated highlights of their best performing investments. The willingness to share the complete record (and to discuss the lessons learned from underperforming deals) is one of the strongest signals a sponsor can send about the quality of their operating discipline and their commitment to investor partnership.

### **Managing Investor Communications at Scale**

Investor communications at scale require a different discipline than investor communications to a small group. When the investor base is 25 people across one deal, the sponsor can send a personal email to each investor, call the ones who have not opened it, and have a genuine sense of the state of every relationship. When the investor base is 200 people across six deals, personal email to each investor for each quarterly report is not operationally feasible, and the personal sense of every relationship's state is not maintainable through memory alone.

Managing investor communications at scale requires a system that enables personalized communication at high volume, where personalized means that each investor receives communication that acknowledges their specific investments, their specific returns, and their specific history with the platform, rather than a generic report that applies to all investors identically. The investor CRM and portal together provide this capability. The CRM tracks the context of each investor relationship, and the portal delivers deal specific content to each investor based on their investment holdings.

The communication calendar (the schedule of standard investor communications that goes out on a predictable schedule regardless of whether the sponsor remembers to initiate them) is the operational tool that makes consistent communication survivable in a growing organization. Quarterly report deadlines should be on the calendar before the quarter ends, with a defined workflow that produces the report from draft to delivery within the specified post quarter window. K-1 delivery deadlines should be on the calendar in January, with a backward planned workflow that identifies when the fund administrator's data must be delivered to the tax adviser and when

the tax adviser must deliver draft K-1s for review. Material event notifications should have a defined process for drafting, review, and delivery that does not depend on the sponsor remembering to initiate it.

Sponsors who build consistent, templated communication systems and deliver against their communication calendar reliably reduce routine investor inquiry volume meaningfully, freeing the sponsor's team for the personalized, substantive investor conversations that actually build relationships. The routine communications answer the routine questions before they are asked. The capacity freed by those routine communications is what allows the team to give genuine attention to the investor conversations that matter.

## Scaling from Syndications to Funds

The transition from deal by deal syndications to a fund structure is one of the most consequential strategic decisions a growing real estate investment platform makes. It is also one of the most frequently misunderstood, because the advantages of a fund structure are real and visible, and the disadvantages and requirements are less immediately obvious. Sponsors who transition to a fund structure before the conditions for a successful fund are in place often discover that the fund structure's demands exceed their current operational and investor relations capacity, and that the fund's performance suffers because the sponsor's attention is divided between fundraising obligations and asset management obligations in a way that a deal by deal structure did not require.

### When to Transition from Deal by Deal to Fund Structure

The fund structure becomes superior to the deal by deal structure when three conditions converge. The sponsor has a deep enough deal pipeline that they can credibly commit to deploying a defined amount of capital across multiple investments during a specified investment period. The investor base is large enough and sufficiently committed to the sponsor's platform that a blind pool raise (asking investors to commit capital before specific investments are identified) is feasible. And the sponsor's operational infrastructure (the fund administration, investor reporting, compliance, and team capacity) can handle the additional complexity of managing a multi asset fund rather than a series of single asset syndications.

Deal by deal syndications offer investors the ability to evaluate each specific investment before committing capital. That transparency is appealing to investor bases that are not yet deeply committed to the sponsor's judgment, and it reduces the sponsor's fundraising friction on each deal because investors are deciding on a known asset. Fund structures offer a different value proposition: speed of deployment (capital is available when a deal is found, eliminating the capital raising delay that can cause good deals to be lost), operational efficiency (one fundraise,

one set of fund level documents, one consolidated reporting structure), and diversification (investors' capital is spread across multiple assets rather than concentrated in a single property).

The minimum operational conditions for a fund structure include an investment track record of at least three to five completed deals, with at least one full cycle realized exit that demonstrates the sponsor's ability to achieve the projected returns through disposition; an investor base that has demonstrated a willingness to commit follow on capital to the sponsor, indicating that the blind pool concept is feasible for the specific investor community; and a team of at least two investment professionals who can manage the acquisitions pipeline while the sponsor is engaged in fundraising. Fund formation requires significant sponsor time and attention during the fundraising period that a single person shop cannot simultaneously invest in acquisitions.

From a legal perspective, the transition to a fund structure involves document complexity that a deal by deal structure does not require. The fund level operating agreement must address the investment period, the deployment timeline, the portfolio composition parameters, the diversification requirements, the fund level fee structure, the waterfall mechanics at the fund level (which are more complex than at the individual deal level), and the provisions for managing the transition from the investment period to the holding period. That additional complexity is manageable with appropriate legal infrastructure, but it requires more time and legal cost than the documents for a single asset offering.

## Track Record Requirements for Fund Capital Raising

Track record is the primary currency of private real estate fund capital raising. Investors in a blind pool fund are committing capital to a manager, not to a specific property, and their evaluation of whether to make that commitment turns primarily on whether the manager's historical performance justifies the investment of trust. A strong track record does not guarantee future performance, and sophisticated investors understand that. But the absence of a verifiable track record, or the presence of one that cannot be independently confirmed, or one that shows only selected deals rather than all deals, is an effective barrier to capital formation with investors who do not have a prior personal relationship with the sponsor.

The dimensions of track record that matter to investors evaluating a fund commitment are more specific than sponsors sometimes appreciate. Total deals completed is the starting point, but it is only the context. What investors want to see is realized returns on completed investments, expressed as both IRR and equity multiple and compared to the projections in the original offering documents; the performance of investments that did not achieve their projections, and how the sponsor managed and communicated those situations; the consistency of the investment strategy across deals, confirming that the track record is relevant to the fund being offered rather than built in a different asset class or market; and the stability of the team,

confirming that the people who produced the track record are the people who will manage the fund.

Sponsors preparing to transition to a fund structure should develop a formal track record presentation that meets several standards simultaneously. It covers all deals in the sponsor's history, not a curated selection of the best performing ones (sophisticated investors and institutional investors specifically know to ask for the full record). It distinguishes between realized and unrealized returns, clearly identifying which deals have been sold and which remain held. It includes actual versus projected comparison for completed deals, showing how the investment performed relative to the underwriting. And it is prepared in a format that is auditable, meaning an independent party could verify the numbers against the fund's books and records.

### **Institutional LP Relationships: The Path from Retail to Institutional**

The term institutional LP covers a wide range of capital providers, from family offices, which may behave more like sophisticated individual investors, through registered investment advisers, multifamily offices, and smaller endowments and foundations, to true institutional investors like pension funds, large endowments, and sovereign wealth funds. Each tier of this spectrum has different capital sizes, different due diligence requirements, different governance expectations, and different relationships with the fund manager. The path from retail to institutional capital is not a single step. It is a progression through several distinct tiers, each of which requires the platform to meet a higher standard on the preceding tier's criteria before the next tier becomes accessible.

The practical progression for a growing real estate syndication platform typically moves through four stages. In the first stage, the investor base consists of high net worth individuals, many of whom know the sponsor personally, with minimum investments in the \$50,000 to \$100,000 range, investor relations managed primarily through personal communication, and reporting provided through email and basic investor portals. In the second stage, the platform has attracted larger family offices and registered investment advisers who are allocating on behalf of their clients, with minimum investments of \$100,000 to \$500,000, investor relations that are more formal and more demanding, reporting that requires specific format and timing standards, and audit expectations. In the third stage, smaller endowments, foundations, and institutional family offices, with minimum commitments of \$500,000 to \$2 million, formal due diligence processes that evaluate the entire platform rather than just specific deals, ERISA compliance analysis, and institutional grade legal documentation. In the fourth stage, pension funds, large endowments, and sovereign wealth funds, with minimum commitments typically above \$5 million, multi quarter due diligence processes, placement agent relationships, and operational



infrastructure requirements that most emerging managers cannot meet without significant investment.

The key insight for a growing platform is that the transition between stages is a platform readiness question as much as it is a capital raising question. Institutional investors do not evaluate the deal first and the manager second. They evaluate the manager first, and if the manager passes, they evaluate the deal. A platform that wants to attract family office and institutional capital must have the operational infrastructure, governance, and track record that meets those investors' standards before approaching them, not after their interest is expressed. Approaches to institutional investors before the platform is ready waste relationship capital that cannot be easily recovered.

## **Compliance Infrastructure for a Growing Platform**

Compliance obligations in a private real estate fund platform are not static. They accumulate as the platform grows. More offerings mean more Form D filings, more state blue sky renewals, and more investor specific documentation. More assets under management may trigger adviser registration thresholds that impose new obligations. More institutional investors mean more formal due diligence scrutiny of the compliance program itself. A compliance program that was adequate for a platform managing \$10 million across two offerings is not adequate for a platform managing \$100 million across eight offerings with investors in twenty states.

### **The Compliance Calendar as an Operational Tool**

The compliance calendar is the operational backbone of the compliance program, the document that translates the abstract compliance obligations into specific tasks, specific deadlines, and specific responsible parties. It should be maintained on a rolling twelve month basis, updated whenever a new offering is launched, a new state is added, or a regulatory change imposes new obligations, and reviewed quarterly to confirm that upcoming deadlines are on track.

A representative compliance calendar for a platform with multiple active Regulation D offerings includes Form D filing deadlines for each offering (within 15 calendar days of first sale); annual Form D amendment deadlines for each offering that remains open; state blue sky notice filing deadlines for each state in which investors are admitted; state blue sky renewal deadlines for each state where prior filings are still active; the re verification requirement for Rule 506(c) investors after the five year safe harbor period (where the SEC permits an issuer to rely on a previously verified investor's representation of continuing accredited status for up to five years before re verification is required); refreshed W-8BEN and W-8BEN-E forms for foreign investors (generally required by the end of the third calendar year following the year the form was signed, for FIRPTA and Section 1446 withholding purposes); annual compliance review of the PPM and



offering documents for each active offering; annual investment adviser registration renewal (if applicable); and the FINRA CRD system update requirements for any registered broker dealer or associated persons.

The compliance calendar should have a specific owner (typically the sponsor's compliance officer, outside securities counsel on retainer, or a compliance consultant) who is responsible for monitoring it, escalating upcoming deadlines, and confirming completion. A compliance calendar that is maintained in theory but that no one is actively monitoring is not a compliance program. It is documentation of obligations that may not be met.

## **Adviser Registration and Growing Platforms**

Investment adviser registration thresholds are directly relevant to growing real estate fund platforms. A sponsor who manages funds with aggregate regulatory assets under management below \$100 million is generally not required to register with the SEC as an investment adviser, though they may be required to register with one or more state securities regulators in their home state. Above \$100 million in regulatory assets under management, SEC registration is generally required, with certain exceptions for advisers who qualify for the Venture Capital Adviser Exemption or the Private Fund Adviser Exemption (the latter available to advisers who manage only private funds and have regulatory assets under management below \$150 million).

The transition from exempt reporting adviser status to full SEC registration imposes a meaningfully different compliance burden. A fully registered investment adviser must maintain a compliance program under Rule 206(4)-7 that includes written compliance policies and procedures covering all required areas (conflicts of interest, trading practices, portfolio management, marketing, investor communications, and recordkeeping); a designated Chief Compliance Officer who is responsible for administering the compliance program; an annual review of the adequacy of the compliance program; and the full annual Form ADV filing with the SEC, including the brochure and brochure supplement that must be provided to clients.

Sponsors who are approaching the \$100 million regulatory AUM threshold should be planning for the transition at least twelve months in advance, engaging compliance counsel to design the compliance program, identify the required policies and procedures, evaluate personnel needs, and prepare for the first SEC registration filing. The registration process itself takes 45 days after application is submitted to be effective, but the preparation work necessary to produce a defensible compliance program is substantially longer.

## **Building Compliance into the Platform Culture**

The most effective compliance programs are not programs that describe what the firm must do. They are programs that describe how the firm actually operates. A compliance program whose policies exist on paper but whose day to day operations deviate from those policies (because

the team has not been trained on the policies, because the policies are not integrated into the workflow, or because the policies are aspirational rather than descriptive of current practice) does not protect the platform in an examination. It creates additional exposure, because the examination will identify the gap between the written policies and the actual practice.

Building compliance into the platform culture means integrating compliance considerations into the decision making process at every level: in the investor communications review process, in the deal sourcing outreach program, in the marketing content review, in the investor onboarding workflow, and in the distribution and reporting processes. It means training every team member who interacts with investors or produces investor facing materials on the relevant compliance requirements for that role. It means establishing a culture in which a team member who identifies a potential compliance question raises it before acting, rather than after. These are not outcomes that a written policy produces automatically. They are outcomes that result from deliberate investment in compliance training, clear accountability structures, and leadership that treats compliance as a business priority rather than a regulatory imposition.

| Platform Stage                  | Investor Base                                                                    | AUM Range        | Legal Infrastructure Priority                                                          | Compliance Priority                                                                                    |
|---------------------------------|----------------------------------------------------------------------------------|------------------|----------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------|
| Stage 1. First 1 to 2 offerings | Personal network; high net worth individuals; \$25K to \$100K minimums           | \$5M to \$25M    | PPM and operating agreement per deal; Form D; blue sky filings; subscription agreement | Offering compliance; Form D calendar; state blue sky tracking                                          |
| Stage 2. Growing platform       | Broader high net worth; RIA referrals; family offices; \$100K to \$250K minimums | \$25M to \$100M  | Master operating agreement template; form PPM; investor portal; fund administration    | Investor accreditation tracking; annual document review; exempt reporting adviser filing if applicable |
| Stage 3. Maturing platform      | Family offices; smaller institutions; \$250K to \$1M minimums                    | \$100M to \$300M | Fund structure; institutional grade documentation; audited financials                  | Full SEC registration if above threshold; formal CCO role; annual compliance review                    |
| Stage 4. Institutional platform | Institutions; pension funds; endowments; \$1M+ minimums                          | \$300M+          | Co-investment rights; side letter program; managed accounts                            | Full registered investment adviser compliance program; ERISA analysis; placement agent compliance      |

## Practical Takeaways

- The distinction between completing syndications and building a syndication platform is the distinction between a transaction business and an operating business. A transaction business produces capital and returns one deal at a time. An operating business builds the systems, legal infrastructure, technology, investor network, and compliance program that allow the transaction business to grow without the sponsor's personal involvement being the primary constraint on every function.
- The investment thesis is the platform's first and most consequential design decision. It should be narrow enough to convey genuine competitive expertise and broad enough to generate a sustainable deal pipeline. Sponsors who define their thesis around specific asset types, specific geographic markets, and a specific differentiated execution capability, and who communicate that thesis consistently, build investor relationships based on genuine understanding of what the sponsor does and why they are positioned to do it well.
- Systematizing deal sourcing and underwriting reduces the platform's dependence on the sponsor's personal bandwidth and produces more reliable deal flow as the platform grows. The investment in systematization (building the broker relationship program, the direct to owner outreach process, the market data repository, and the standardized underwriting model) is operating leverage that compounds over time.
- The master operating agreement template and form PPM are the legal infrastructure tools that make each new offering faster, less expensive, and higher quality than the prior one. They require initial investment in design (working through every significant provision with securities counsel and making deliberate choices about the standard position) and ongoing investment in review and updating. They are not set once documents. They are living frameworks that should be reviewed annually and updated when law, market practice, or the sponsor's business model changes.
- Sponsors using Rule 506(c) should review the SEC Division of Corporation Finance no action letter issued on March 12, 2025, which provides a bright line safe harbor for the 506(c) verification requirement based on minimum investment amounts of \$200,000 for natural persons and \$1 million for legal entities, combined with specified investor representations. The 506(c) verification, once performed, may be relied upon for that investor's subsequent investments in the platform for up to five years under the SEC's safe harbor.
- The CRM, investor portal, and fund administration platform are the technology tools that make investor relationships manageable at a scale where personal attention to every investor on every communication cycle is not operationally feasible. Purpose built real estate fund platforms (Juniper Square, InvestNext, Dynamo Software, Cash Flow Portal,

and their peers) offer functionality designed specifically for the private real estate fund business that general purpose tools cannot match without significant customization.

- Growing the investor database beyond the personal network requires a marketing program built around track record transparency, educational content, and consistent positioning, not around individual deal promotion. Sponsors who systematically share full cycle performance data, including the deals that did not achieve their projections, differentiate themselves from the majority of the market and build the credibility that makes blind pool fund capital raising feasible.
- The transition from deal by deal syndications to a fund structure requires three converging conditions: a deal pipeline credible enough to support a defined investment period, an investor base willing to commit on a blind pool basis, and an operational infrastructure capable of managing the additional complexity of a multi asset fund. Sponsors who transition before all three conditions are present typically find that the fund structure's demands exceed their capacity during the fundraising and deployment period.
- Track record presentation for fund capital raising must cover all historical deals, not a curated selection; must distinguish realized from unrealized returns; must show actual versus projected comparisons for completed deals; and must be prepared in a format that can be independently verified. Institutional investors know to request the complete record, and selective track record presentation undermines credibility with exactly the investors whose capital the platform needs to access the next stage of growth.
- The compliance calendar is not a document to file and forget. It is an operational tool that must be actively monitored, with assigned responsibility and regular review. The compliance obligations of a growing platform accumulate with each new offering, each new state, each new investor, and each threshold crossing that triggers new regulatory requirements. Compliance counsel on retainer, responsible for monitoring the calendar and flagging upcoming obligations, is an operational cost that is substantially less expensive than the consequences of missed deadlines.
- Sponsors approaching the \$100 million regulatory assets under management threshold should begin preparing for SEC registration as an investment adviser at least twelve months in advance. The transition from exempt reporting adviser to fully registered investment adviser imposes a meaningfully different compliance burden, including the Rule 206(4)-7 compliance program, a designated Chief Compliance Officer, and the full Form ADV filing. The 45 day post application registration effective period is the floor on the timeline. The preparation work necessary to produce a defensible compliance program is substantially longer.

## CHAPTER THIRTY SIX

# When You Are Ready to Move Up Market: Institutional Capital

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The Institutional Limited Partners Association represents more than 7,000 professionals across 52 countries, drawn from over 600 member institutions that collectively manage approximately half of the world's institutional private market assets. Those professionals have spent decades defining, in precise and published detail, exactly what they expect from the general partners to whom they entrust capital. The ILPA Principles, the ILPA Model Limited Partnership Agreement, the ILPA Due Diligence Questionnaire, the ILPA Reporting Template, and the full suite of ILPA standards documents are not aspirational guidelines. They are the operational benchmarks against which institutional investors measure every fund and every manager they evaluate. A sponsor who arrives at an institutional capital conversation without having studied those documents has arrived unprepared.

This chapter is about that preparation. It addresses what institutional capital actually means in a real estate fund context, what institutional investors require before committing it, the specific ILPA framework that governs fund documentation and governance expectations, the ERISA plan asset rules that transform the legal landscape when retirement capital enters a fund, the due diligence process a sponsor should expect from a genuine institutional investor, and the placement agent relationships that help emerging managers bridge the gap between their current investor base and the institutional market.

Two things distinguish this chapter from a general description of institutional investing. First, the analysis is grounded in the actual documents that institutional investors use: the ILPA Model LPA, whose provisions on the Advisory Committee, key person events, clawback, and general partner removal define what institutional standard fund documents look like in practice, and the ILPA DDQ and Principles, which define what institutional due diligence actually evaluates. Second, the analysis is addressed specifically to the real estate fund sponsor at the threshold of the institutional market, one who has built a track record, assembled a team, and developed the conviction that institutional capital is the right next step, and who needs to understand, in concrete terms, what that step actually requires.

## What Institutional Capital Means

The term is used loosely, and the imprecision produces confusion in strategy and wasted effort in execution. Institutional capital is not a monolithic category. It encompasses a spectrum of capital sources that range from single family offices at one end to sovereign wealth funds at the

other, with meaningful differences in decision making processes, due diligence rigor, minimum commitment sizes, governance expectations, and legal and regulatory constraints at every point along that spectrum.

ILPA's own membership provides the clearest picture of who institutional investors actually are. It's over 600 member institutions, represented by more than 7,000 professionals, span foundations and endowments, public and corporate pension plans, insurance companies, sovereign wealth funds, fund of funds, and the larger multifamily offices and registered investment advisers that aggregate high net worth capital into pools large enough to behave like institutional allocators. These investors manage private market assets collectively representing roughly half of the global institutional private market, making ILPA's standards documents the closest thing to a universal language for institutional private equity and private real estate fund practice.

For a real estate fund sponsor assessing which tier of this spectrum is realistically accessible, the differences between tiers matter more than the aggregate description. Family offices with \$100 million or more under management allocate to real estate funds with minimum commitments often starting at \$500,000 to \$2 million, and their decision process can be relatively fast when the principal has conviction about the manager. Registered investment advisers and OCIO platforms that aggregate client capital are one step more formal: they have investment policy statements, committee approval requirements, and reporting obligations to their own clients that shape both what they can invest in and how they evaluate it. Foundations and endowments with \$100 million to \$500 million in total assets run structured processes that involve investment consultants and investment committees, with diligence timelines of six to eighteen months. Corporate and public pension funds subject to ERISA or state law fiduciary frameworks are the most demanding, with diligence processes that can span twelve to twenty four months, minimum commitments of \$5 million or more, and compliance requirements that impose obligations on the fund that do not apply when ERISA capital is absent.

Understanding which tier is accessible (not which tier is theoretically desirable) is the starting point for an institutional capital raising strategy with any realistic probability of success. Approaching pension funds with a three deal track record and self-administered fund documents is not an institutional capital strategy. It is an expenditure of relationship capital that cannot be recovered if the approach fails, because institutional investors do not typically re-engage managers who approach them prematurely.

## What Institutional LPs Require

ILPA's Principles, updated periodically and available publicly at [ilpa.org](http://ilpa.org), organize institutional LP requirements around three pillars: alignment of interest, governance, and transparency.

Those three pillars have been elaborated into specific standards that now appear in ILPA's Model LPA, its DDQ, its Reporting Template, and its suite of best practice guidance documents. Understanding what those documents require, not at a summary level but at the provision level, is the prerequisite for building an institutional grade fund platform.

## **Audited Track Record and Performance Attribution**

Track record is where institutional diligence begins, and the standard for what constitutes an adequate track record presentation is more demanding than most sponsors who have not previously pursued institutional capital appreciate. The ILPA DDQ, which covers 21 sections including strategy, track record, team, operations, compliance, ESG, and DEI, devotes significant attention to historical performance: not just headline IRR and equity multiple, but the consistency of the strategy that generated the track record, the role of specific key persons in each investment, the performance of investments that did not achieve projections, and the comparison of actual returns against original underwriting assumptions for every completed deal.

An institutional grade track record presentation has several characteristics that distinguish it from the marketing materials most sponsors use with retail investors. It covers all investments in the manager's history under the current strategy, not a selection of successful deals. It distinguishes realized returns (exits where the actual cash has been distributed) from unrealized returns, which are based on current marks and subject to revision. It presents actual versus projected returns for completed investments, showing whether the underwriting proved accurate or optimistic. It is organized in a format that an independent party could verify against the fund's books and records. And it covers performance across at least a portion of a market cycle, because performance during a favorable market tells institutional investors far less than performance during a period when the market challenged the investment thesis.

Performance attribution (the decomposition of total returns into their contributing sources) is a level of analytical detail that more sophisticated institutional investors will request and that distinguishes analytically rigorous managers from those who cannot explain where their returns actually came from. A manager who can describe not just their IRR but how much of it was generated by the renovation execution, how much by income growth, how much by exit cap rate compression, and how much by efficient debt structure has demonstrated the kind of investment discipline that institutional investors associate with repeatable outperformance.

## **Professional Grade Fund Documentation Aligned with ILPA Standards**

The ILPA Model LPA, published in October 2019 and available publicly at [ilpa.org](http://ilpa.org), is the most important reference document for understanding what institutional grade fund documents look like. It was developed by an international group of counsel working under ILPA's direction

specifically to address the persistent need for a standard starting point for fund formation, one that builds in the governance, transparency, and alignment of interest provisions that institutional LPs require, rather than treating those provisions as concessions negotiated out of a sponsor friendly base document.

Several features of the ILPA Model LPA have direct relevance to real estate fund sponsors building documents for the institutional market. The Model LPA's Advisory Committee provisions (Article 13) establish a committee structure with meaningful authority, not merely advisory status. The LPAC must approve conflicts of interest transactions, must be informed of all co-investment opportunities offered to any person, must receive annual disclosure of all fee income and management fee calculations, must be promptly notified of regulatory proceedings and any change of control, and must confirm independent valuations when requested. An institutional grade real estate fund operating agreement or LPA must contain provisions that replicate this level of LPAC authority, calibrated to the real estate context.

The Model LPA's general partner removal provisions (Article 10) establish both for cause and no fault removal mechanisms. Under the Model LPA, removal for cause requires only a majority in interest after court confirmation of removal conduct. Removal without cause requires 75 percent in interest and results in immediate termination of the management fee and, for removal without cause specifically, a reduced carried interest on prior investments. No fault removal at 75 percent in interest, without requiring proof of misconduct, is the institutional market standard that most emerging manager documents do not include. A sponsor whose fund documents lack a workable no fault removal right has, from an institutional investor's perspective, a document that falls materially short of market standard on governance.

The clawback provision (Section 14.7 of the Model LPA) is drafted as a specific, self-executing calculation with defined triggering events and defined funding mechanics, including a tax gross up that reduces the clawback obligation by taxes actually paid on the original promote distributions. The escrow mechanism (Section 14.7.2) provides an alternative structure in which a percentage of each promote distribution is placed into a separate escrow account until the LP preferred return has been satisfied, eliminating the funding risk that makes traditional clawbacks difficult to enforce. A real estate fund operating agreement that contains a clawback provision drafted at the conceptual level rather than as a specific calculation, without addressing the tax gross up and the funding mechanism, does not satisfy institutional market standard.

The fee offset provision (Section 8.4 of the Model LPA) requires that 100 percent of fee income (all directors' fees, transaction fees, monitoring fees, breakup fees, and other fees received by the GP or its affiliates from fund related activities) reduce the management fee dollar for dollar, carried forward if the fee income exceeds the current quarter's management fee. In the real estate context, this provision applies directly to the acquisition fees, construction management



fees, property management fees, and disposition fees that the sponsor or an affiliated entity may receive from the fund's properties. Institutional investors reviewing a real estate fund's documents will look for this provision, compare it against the fee disclosure in the PPM, and will negotiate specific fee offset terms through side letters if the base document is inadequate.

The reporting requirements (Section 15.2 of the Model LPA) specify quarterly unaudited financial reports within 45 days of quarter end and annual audited financial statements within 90 days of year end, with each report's required contents specified in detail, including each LP's closing capital account balance, all fund expenses since inception, the amount and cost of all debt (including subscription line disclosure showing IRR with and without the credit facility), and confirmation of management fee and carried interest accuracy. The Model LPA also requires consistency with the ILPA Reporting Template. Real estate fund managers whose quarterly reports do not contain the information the ILPA Reporting Template specifies are operating below the institutional reporting standard, and institutional investors will negotiate upgraded reporting obligations through side letters.

ILPA's guidance extends beyond the Model LPA to address several specific topics that institutional investors scrutinize in real estate fund due diligence. The Subscription Lines of Credit guidance addresses how credit facility usage must be disclosed, including the requirement to show IRR both with and without the credit facility, an issue that received significant LP attention when subscription lines became common. The NAV Based Facilities guidance establishes expectations for transparency around NAV facility usage. The Continuation Funds guidance addresses the conflicts and disclosure requirements when a GP restructures a maturing fund through a continuation vehicle. Each of these topics is directly relevant to real estate fund managers who use credit facilities or who anticipate structuring continuation vehicles at the end of a fund's life.

## Compliance Programs and Operational Infrastructure

Institutional investors evaluate compliance and operational infrastructure through a dedicated operational due diligence process that is separate from investment due diligence and that is conducted by a dedicated ODD team. The ODD evaluation is not a pro forma review. It is a structured assessment of whether the fund's infrastructure, governance, compliance program, and risk management framework are adequate to be trusted with institutional capital. A meaningful portion of institutional LPs have rejected managers over operational concerns independent of the investment strategy's merits, and institutional ODD scrutiny has continued to deepen in recent years.

The compliance infrastructure that institutional ODD teams expect to find includes a formal written compliance manual with specific policies covering conflicts of interest, marketing, investor communications, and recordkeeping; a designated Chief Compliance Officer with clear

authority and accountability who is meaningfully independent of the investment function; an annual compliance review that produces documented findings and remediation; a code of ethics with specific provisions covering personal trading and outside business activities; documented AML and KYC policies and investor onboarding procedures; and a cybersecurity program that includes annual penetration testing and a documented incident response plan. For registered investment advisers, each of these elements is required under Rule 206(4)-7 of the Investment Advisers Act. For exempt reporting advisers, the elements are not legally required but are operationally expected by institutional investors.

The ILPA Model LPA specifically addresses several compliance adjacent operational points. Section 2.5 distinguishes fund expenses from GP expenses, with the Model LPA specifically stating (Section 2.5.5) that the GP will not charge the fund for its own internal compliance costs under applicable securities rules, an important boundary between fund borne expenses and expenses that are properly the GP's responsibility. Section 9.5 addresses conflicts of interest disclosure, requiring the GP and fund manager to promptly disclose all actual or material potential conflicts to the Advisory Committee, and specifying that disclosure in the PPM as a risk factor does not by itself constitute a permissible conflict or eliminate the requirement for Advisory Committee consent.

## Key Person and Business Continuity Provisions

The ILPA Model LPA's key person provisions (Article 11) establish both the definition of a key person event and its consequences in specific terms. A key person event under the Model LPA is triggered by one of two conditions: a key person ceasing to devote the required time and attention to the fund, or a change of control of the GP or fund manager. When a key person event occurs, the commitment period is automatically and immediately suspended until a majority in interest approves a written remediation plan. If a majority in interest does not approve a remediation plan within 90 days of the suspension, the commitment period is automatically terminated.

The change of control definition in the Model LPA (included in the Definitions section) covers two conditions: the key persons ceasing to control the GP and fund manager, and the key persons together being legally and beneficially entitled to less than 75 percent of the carried interest. This carried interest transfer restriction, preventing key persons from transferring more than 25 percent of their carry without triggering a key person event, is a specific protection that prevents the economic alignment between key persons and fund performance from being diluted through carry transfers to other parties. Real estate fund documents that do not include a change of control definition addressing carry transfer are missing a protection that institutional investors will notice.

Business continuity (the practical plan for maintaining fund operations if a key person becomes unavailable) is the operational counterpart to the contractual key person provisions. Institutional ODD teams ask specific questions about the manager's succession plan for key investment and operational roles, the team's depth below the key person level, and the manager's documented business continuity plan including technology backup and disaster recovery. A small emerging manager with a single key investment professional and a two person team has structural vulnerabilities that cannot be fully addressed through contractual provisions alone, but institutional investors will want to see that the manager has recognized those vulnerabilities and documented a realistic plan for addressing them.

## **ERISA Plan Assets: A Critical Threshold**

The Employee Retirement Income Security Act of 1974 is the federal statute governing most voluntarily established private sector retirement plans: corporate pension plans, 401(k) plans, profit sharing plans, and their equivalents. ERISA imposes a demanding fiduciary standard on those who manage retirement plan assets, a set of prohibited transaction rules that restrict how those assets can be invested and with whom, and a reporting framework far more comprehensive than anything that applies to ordinary private investment funds. When ERISA's framework applies to a private real estate fund (when the fund's assets are deemed plan assets under ERISA) the legal and operational consequences for the fund manager are immediate, significant, and not easily unwound.

The ILPA Model LPA reflects the practical importance of ERISA compliance throughout its provisions. The definition of Benefit Plan Investor in the Model LPA's Definitions section tracks the regulatory definition precisely, covering employee benefit plans subject to Title I of ERISA, plans subject to Code Section 4975 (including IRAs), and any entity whose assets are deemed to include plan assets of such plans. Section 8.4.4 of the Model LPA specifically addresses the plan asset regulations, committing the GP to use reasonable best efforts to ensure that the fund either qualifies as a Venture Capital Operating Company or otherwise avoids plan asset treatment. Section 8.2.4 grants the GP the authority to take any action necessary to ensure that fund assets are not deemed plan assets. And Section 17.2.1.4 prohibits any transfer of a limited partner interest that would cause fund assets to constitute plan assets. These provisions collectively reflect the institutional market's settled view that plan asset treatment is an outcome to be avoided, and that avoiding it requires active structural attention.

### **When ERISA Applies to a Real Estate Fund**

The Department of Labor's Plan Asset Regulations, codified at 29 C.F.R. § 2510.3-101 and modified by Section 3(42) of ERISA, establish the rules for determining when a private fund's underlying assets are deemed to be plan assets of the ERISA investors who hold interests in

the fund. The default rule is look through treatment. When an ERISA plan or other benefit plan investor acquires an equity interest in a private fund, the fund's underlying assets are treated as plan assets unless the fund satisfies one of three exceptions.

The first two exceptions (the Venture Capital Operating Company and Real Estate Operating Company exceptions) require the fund to meet specific investment activity thresholds and to hold and exercise management or development rights in the underlying investments. The REOC exception is potentially relevant to real estate funds. A fund qualifies as a REOC if, during its most recent annual valuation period, at least 50 percent of its assets (valued at cost, excluding short term investments) are invested in real estate that the fund manages or develops and with respect to which the fund has the right to substantially participate directly in management or development activities. The VCOC exception requires that 50 percent of assets be invested in qualifying portfolio companies with actual management rights exercised within the relevant period. Both exceptions impose ongoing qualification requirements that must be tested annually.

The third exception (the Insignificant Benefit Plan Investor exception) is the one most real estate funds rely on, and it is the one that creates the 25 percent threshold that every sponsor accepting any form of pension or retirement capital must understand and actively monitor.

### **The 25 Percent Benefit Plan Investor Limitation: Five Mechanics That Must Be Understood**

The Insignificant Benefit Plan Investor exception provides that a fund's assets will not be treated as plan assets if benefit plan investors hold less than 25 percent of the value of each class of the fund's equity interests. When this threshold is satisfied across every equity class, the fund avoids look through treatment and the GP is not an ERISA fiduciary with respect to plan assets. The ILPA Model LPA's definition of ERISA Partner, its Section 6.2.6 deferral mechanism for benefit plan investor capital contributions pending VCOC qualification, and its Section 17.2.1.4 transfer restriction all reflect the structural importance of maintaining this exception.

The five specific mechanics of the 25 percent rule that sponsors must understand before accepting any benefit plan investor capital are the following.

- **First, the threshold applies to each class of equity separately.** If a fund has Class A and Class B equity interests, the 25 percent test must be satisfied independently for each class. A fund in which benefit plan investors hold 15 percent of Class A interests but 35 percent of Class B interests has crossed the threshold for Class B, even though total benefit plan ownership across both classes is well below 25 percent. The ILPA Model LPA's careful treatment of BHCA Partners and other special investor categories illustrates the class by class complexity that fund structures can involve.

- **Second, the threshold is aggregate across all benefit plan investors, not per investor.** Even if no single ERISA investor holds more than 5 percent of a class, if all ERISA investors collectively hold 25 percent or more of that class, the threshold is crossed. A fund with fifteen pension fund investors each holding 2 percent of a class has a 30 percent benefit plan investor concentration in that class.
- **Third, the GP and its affiliates are-excluded from both the numerator and denominator.** When calculating the 25 percent test, the equity interests held by the fund manager and its affiliates are-excluded from both the numerator (benefit plan investor holdings) and the denominator (total equity). This exclusion means that the effective capacity for benefit plan investment is determined by the third party investor base alone. A GP co-investment that represents a significant percentage of total fund equity does not create headroom for additional benefit plan investors.
- **Fourth, IRAs count in most circumstances.** Individual retirement accounts are subject to Code Section 4975, which is referenced in the plan asset regulations. When a fund has both ERISA plan investors and IRA investors, the IRA investments count toward the 25 percent threshold. If the fund has only IRA investors and no ERISA plan investors, Section 4975's prohibited transaction rules may still apply even though Title I of ERISA does not.
- **Fifth, the test must be performed continuously.** Every acquisition, transfer, or redemption of a fund interest requires re-examination of continued compliance with the 25 percent rule. A fund that is at 22 percent benefit plan investor concentration at one closing can cross the threshold at the next closing. A non-benefit plan investor who transfers their interest to a benefit plan investor triggers a re-examination. The ILPA Model LPA's definition of Limited Partner Regulatory Problem specifically includes a benefit plan investor whose participation would cause fund assets to constitute plan assets, and its Section 6.7 excused limited partner mechanism provides a pathway to exclude such investors from specific investments when regulatory problems arise.

## Consequences of Plan Asset Status

When a fund crosses the 25 percent threshold and its assets are deemed plan assets, the GP becomes an ERISA fiduciary with respect to all plan participants whose retirement assets are invested in the fund. ERISA's fiduciary standard (the prudent expert standard, requiring the care and diligence that a prudent expert in managing the same type of plan assets would exercise) applies to all investment and management decisions. The GP must act solely in the interest of plan participants and beneficiaries, must avoid prohibited transactions, and is personally liable for losses resulting from any breach of these obligations.

The prohibited transaction rules are directly relevant to the affiliated service provider arrangements that are common in real estate funds. A real estate fund sponsor whose affiliated entity provides property management, construction management, or other services to the fund's properties has an affiliated party transaction that, in a plan asset fund, is a potential prohibited transaction under ERISA Section 406. Conducting these transactions without an applicable prohibited transaction exemption (such as the QPAM exemption for registered investment advisers, or the specific statutory exemptions for real estate transactions) exposes the GP to personal liability for losses, disgorgement of profits from the prohibited transaction, and excise tax penalties under Code Section 4975.

The practical conclusion, reflected in the structure of the ILPA Model LPA and in the market practice of virtually every private real estate fund, is that managers work to maintain benefit plan investor participation below the 25 percent threshold rather than attempting to manage a plan asset fund. The threshold monitoring obligation, the structural provisions authorizing the GP to refuse transfers or subscriptions that would cross the threshold, and the legal review requirement before any benefit plan investor is admitted are not administrative overhead. They are risk management.

### **⚠ The 25 Percent ERISA Threshold Requires Structural Provisions in the Fund Documents at Formation**

*Many real estate fund sponsors who want to accept ERISA capital first encounter the 25 percent threshold when a pension fund's counsel asks how the fund monitors and enforces the limitation. The correct time to build the monitoring and enforcement framework is at fund formation, not in response to an institutional investor's question during due diligence.*

*The ILPA Model LPA builds this framework in through several specific mechanisms. The definition of Benefit Plan Investor establishes who must be tracked. The definition of ERISA Partner creates a formal category for investors who have self-identified as subject to ERISA. The definition of Limited Partner Regulatory Problem specifically includes circumstances where fund assets would become plan assets. The transfer restriction (Section 17.2.1.4) prohibits any transfer that would cause plan asset status. And Section 8.2.4 grants the GP authority to take any action necessary to ensure the fund's assets are not deemed plan assets.*

*A real estate fund operating agreement that does not contain provisions equivalent to these ILPA Model LPA mechanisms is structurally unprepared to accept ERISA capital, regardless of how much the sponsor wants to accept it. Retrofitting these provisions after the fact, when an institutional investor's counsel identifies their absence, is not an efficient*



*process. The legal and negotiation cost of retrofitting is substantially higher than the cost of building the provisions correctly from inception.*

*Sponsors who are designing fund documents with the intent to accept ERISA capital need ERISA counsel's involvement from the fund formation stage.*

## Institutional Due Diligence: What to Expect

The institutional due diligence process divides into two distinct streams that proceed in parallel and that produce independent recommendations to the investment committee. Investment due diligence evaluates the strategy, the track record, and the opportunity. Is this a compelling investment in an attractive market with a manager who has demonstrated the ability to execute? Operational due diligence evaluates the infrastructure. Is this an organization that can be trusted with institutional capital and that has the systems, governance, and compliance framework to manage it professionally? A manager can pass investment due diligence and fail operational due diligence, and in many institutional organizations the ODD team has independent authority to reject a manager whose operational infrastructure does not meet the required standard.

The ILPA DDQ, currently in its 2.0 version (updated in 2021) with dedicated 2025 modules for real estate and emerging managers, covers 21 sections that span both streams. ILPA's website at [ilpa.org](https://ilpa.org) makes the DDQ and its modules publicly available, and the structure of the questionnaire (its specific sections on firm overview and history, investment strategy and process, track record and performance, ESG integration, team and organizational structure, operations and compliance, and financial and management controls) is the closest available public specification of what institutional diligence comprehensively covers. The substantial majority of private equity and private real estate fund diligence questionnaires either follow the ILPA DDQ framework directly or track it closely enough that a manager who has prepared responses to the ILPA DDQ is positioned to respond efficiently to most institutional diligence requests.

### Operational Due Diligence

Operational due diligence focuses on six specific areas in real estate fund evaluations: financial reporting and accounting, compliance program documentation, cybersecurity, business continuity, service provider oversight, and AML and KYC procedures. Each area has specific minimum standards that institutional ODD teams apply, and gaps in any area will be identified and documented.

Financial reporting and accounting evaluation examines the fund's accounting platform and whether it produces output consistent with GAAP, the fund's valuation policy and its consistency with IPEV Guidelines, the audit firm and its experience with real estate fund accounting, and whether the fund's reporting practices are consistent with the ILPA Reporting Template. The ILPA Model LPA's Section 15.2.2 specifies that financial reports must be consistent with the ILPA Reporting Template, an explicit incorporation of ILPA's reporting standards into the fund's contractual obligations. Fund managers whose reporting does not meet the ILPA Reporting Template's specifications will face institutional LP requests, through side letters or direct negotiation, for upgraded reporting.

Compliance program evaluation examines whether the manager has a complete written compliance manual, a designated and genuinely independent CCO, a documented annual compliance review process, a code of ethics with specific provisions covering personal trading, and documented procedures for identifying and managing conflicts of interest. The ILPA Model LPA's Section 9.5 provides specific conflict of interest disclosure obligations that inform what institutional investors expect compliance programs to address: disclosure of all actual or material potential conflicts to the Advisory Committee, with the explicit statement that PPM risk factor disclosure alone does not constitute permissible conflict management.

Cybersecurity evaluation has become a specific, detailed focus of institutional ODD in recent years. Institutional ODD teams now routinely ask whether the manager conducts annual penetration testing, what the documented incident response plan is, how investor personal and financial data is stored and access controlled, and whether the manager has SOC 2 Type II certification or equivalent. Cybersecurity is one of the operational areas where emerging managers most often fall short of institutional expectations. A manager without a documented cybersecurity program will not automatically fail institutional ODD on this basis alone, but the gap will be noted and will contribute to an overall assessment of operational sophistication.

## Legal Document Review

Institutional investors' counsel review fund documents with a level of analytical depth that retail investor review does not approach. The legal review proceeds by comparing the fund's operating agreement or LPA against the ILPA Model LPA and ILPA Principles on the specific provisions that institutional investors care most about. The comparison is not merely conceptual. It is provision by provision, asking whether the specific language in the fund's documents meets the institutional market standard on each dimension.

The provisions most frequently identified as deficient in emerging manager real estate fund documents, measured against the ILPA Model LPA standard, are the following.



- **Advisory Committee authority.** Provisions that give the LPAC advisory only status rather than the specific approval authority over conflicts of interest transactions, co-investment allocations, valuations, related party transactions, and amendments that the ILPA Model LPA's Article 13 establishes.
- **No fault removal.** The absence of a no fault removal provision, or the presence of one requiring unanimity rather than the 75 percent in interest threshold specified in the ILPA Model LPA's Section 10.1.2.2.
- **Management fee offset.** Fee offset provisions that do not apply to all forms of affiliated party fee income (covering all the categories that the Model LPA's Fee Income definition encompasses: directors' fees, transaction fees, monitoring fees, breakup fees, advisory fees, and similar compensation), or that apply less than 100 percent of fee income as an offset.
- **Clawback.** Provisions drafted conceptually rather than as specific calculations, without the tax gross up mechanism, without a funded escrow alternative, and without the specific triggering events and timing the Model LPA's Section 14.7 addresses.
- **Reporting.** Quarterly and annual financial report requirements that do not match the content and timing specifications of the Model LPA's Section 15.2 and the ILPA Reporting Template, particularly the subscription line disclosure requirements.
- **Most favored nation provisions.** The right of each LP to receive the benefit of any more favorable economic or other terms offered to any other LP in the same fund, which the Model LPA's Section 20.6.2 addresses through its side letter transparency and MFN framework.

When institutional investors identify these deficiencies, they negotiate through side letters that modify the fund's terms for that specific investor. Side letter negotiation has its own costs. It consumes legal time on both sides, creates the risk of inconsistent terms across investors that must be tracked through the MFN framework, and can result in different investors operating under materially different legal arrangements within the same fund. A manager who builds institutional standard documents at inception will spend less time in side letter negotiation than one who builds retail market documents and then attempts to upgrade them investor by investor.

## Key Person and Team Assessment

The investment due diligence component of institutional diligence ultimately turns on whether the people managing the fund can execute the stated strategy consistently, and whether they will still be doing so when the capital is needed in Year Six. Institutional investment teams verify the track record at the individual deal level, confirm that the people presenting today were

actually responsible for the deals in the track record, and assess whether the team's composition and compensation structure creates genuine long term stability.

Reference checks in institutional diligence are thorough and deliberately go beyond the references the manager provides. Institutional investors independently identify and contact former business partners, co investors, lenders, and professionals who have worked with the manager under difficult circumstances: the lender who managed a troubled loan, the seller in a contentious acquisition negotiation, the co-investor who disagreed with the sponsor about a major asset management decision. These independent references produce a qualitative assessment of how the manager operates under pressure that self-selected references cannot provide.

Team depth below the key person level matters more than most emerging managers expect. A fund whose investment analysis, asset management, and investor relations functions are all effectively concentrated in one or two people has concentrated key person risk that the key person provisions in the LPA cannot fully address. Institutional investors who have made commitments to funds where key personnel departed mid hold know from experience that even well drafted key person provisions do not eliminate the operational disruption and performance risk that follow a key person's departure. Team depth (genuine, demonstrated depth, not org chart depth) is a competitive advantage in institutional capital raising.

## **Placement Agents for Institutional Capital Raises**

Institutional capital raising without a placement agent is possible. Some managers succeed entirely through direct relationships. But it is slow, inefficient, and difficult for managers who do not already have established relationships with the institutional investors they are targeting. Placement agents exist precisely because the institutional capital market is relationship driven, partially opaque to outside participants, and genuinely time consuming to navigate without an established presence in it.

### **What Placement Agents Do and What They Cost**

A placement agent is a registered broker dealer that provides capital raising services to fund managers on a fee basis. They serve as the intermediary between fund managers and institutional investors, providing the manager with introductions to LP relationships that would take years to develop independently, and providing institutional investors with a filter they trust to surface managers worthy of their attention. The services include identifying institutional LPs whose mandates align with the manager's strategy, arranging introductions and managing the meeting schedule, advising the manager on institutional LP positioning and document preparation, managing the diligence process, and providing strategic intelligence about current LP appetite and market terms.

Placement agent fees typically run 1 percent to 2 percent of capital committed by investors introduced through the placement agent, paid at the time of closing. Some placement arrangements include a retainer component alongside the success fee. Placement fees must be disclosed in the PPM as an offering cost. The ILPA Model LPA's Section 2.6.1 specifically designates placement agent fees as GP expenses, meaning they are borne by the GP and fund manager rather than by the fund, though this treatment can vary by fund. The fee negotiation should be evaluated as a cost of capital analysis. What percentage of committed capital is being paid for the LP introductions and diligence management that the placement agent provides, compared with the alternative cost of developing those relationships independently over the several years it would take?

## Pay to Play Compliance

Because placement agents introduce fund managers to institutional investors that include government pension funds, they are subject to the SEC's pay to play rules under Rule 206(4)-5 of the Investment Advisers Act. Pay to play refers to political contributions to government officials who influence pension fund investment decisions, made in exchange for access to the fund's investment committee. The consequences of a pay to play violation are severe. A two year prohibition on receiving compensation for investment advisory services from the affected government client, which effectively bars the adviser from managing any government pension capital for two years following the violation.

A fund manager who uses a placement agent that has made political contributions to officials who influence the pension funds the agent is soliciting on the manager's behalf may find those commitments invalidated. The manager's own principals and covered associates are also subject to Rule 206(4)-5's restrictions on political contributions to government officials in their jurisdiction. Before engaging any placement agent for an institutional capital raise that involves government pension funds, the manager must confirm that the placement agent has a documented pay to play compliance program and that no covered associates of the manager have made disqualifying political contributions in the relevant jurisdictions.

### **ILPA Resources for Sponsors Preparing for the Institutional Market**

#### **ILPA Model Limited Partnership Agreement (October 2019).**

*The institutional market standard for fund governance, LP protections, fee offset, clawback, LPAC authority, key person provisions, reporting obligations, and ERISA provisions. The starting point for any fund designed to accept institutional capital.*

#### **ILPA DDQ 2.0 (updated 2021) with 2025 real estate and emerging manager modules.**

*The de facto standard diligence questionnaire, covering all 21 sections of institutional evaluation: strategy, track record, team, operations, compliance, ESG, DEI, and financial controls.*

**ILPA Principles (most recent version).**

*Three pillars: alignment of interest, governance, and transparency. Covers GP and fund economics, fund terms and structure, key person provisions, governance, financial disclosures, and LP rights.*

**ILPA Reporting Template.**

*Required by the ILPA Model LPA as the standard for quarterly and annual financial reporting. Specifies content, format, and timing of LP reporting including capital account statements, fee disclosure, and subscription line disclosure.*

**ILPA Subscription Lines of Credit Guidance.**

*Addresses disclosure requirements for subscription facility usage, including the requirement to present IRR both with and without the credit facility.*

**ILPA NAV Based Facilities Guidance.**

*Parameters for transparency around NAV facility usage, an increasing feature of mature funds.*

**ILPA Continuation Funds Guidance and Disclosure Template.**

*Addresses conflicts, disclosure obligations, and process requirements for GP led fund restructurings.*

**ILPA Model Subscription Agreement (December 2017).**

*Standard subscription agreement designed to streamline fundraising and improve clarity.*

**ILPA Model Non-Disclosure Agreement.**

*Standard NDA for GP and LP information sharing during the diligence process.*

**All resources available at [ilpa.org](https://ilpa.org).**

*Sponsors preparing to approach institutional capital should download and study these documents before initial LP meetings, not during the diligence process when time pressure is highest.*

## Practical Takeaways

- ILPA connects more than 7,000 LP professionals across more than 600 institutions in 52 countries who together manage approximately half of the world's institutional private market assets. ILPA's published standards (the Principles, the Model LPA, the DDQ, the Reporting Template, and the full suite of best practice guidance available at [ilpa.org](http://ilpa.org)) are not aspirational guidelines. They are the operational benchmarks against which institutional investors measure every fund and every manager they evaluate. Familiarity with these documents is the floor for any real estate fund sponsor approaching the institutional market, not a differentiator.
- The ILPA Model LPA is the single most important reference document for understanding what institutional grade fund documents look like. Its Advisory Committee provisions establish approval authority over conflicts of interest, co-investment allocations, and related party transactions that go significantly beyond the advisory only status in most emerging manager documents. It's no fault removal provision requires only 75 percent in interest. Its fee offset provision covers 100 percent of all forms of fee income. Its clawback is a specific calculation with a tax gross up and an escrow funding mechanism. Real estate fund operating agreements that do not address these provisions at equivalent depth fall short of institutional market standard.
- The 25 percent ERISA benefit plan investor threshold requires structural provisions in the fund documents at formation, not reactive provisions added when an institutional investor's counsel asks about them. The ILPA Model LPA builds the required framework through its definitions of Benefit Plan Investor and ERISA Partner, its transfer restriction prohibiting transfers that would cause plan asset status, its GP authority to prevent threshold crossing, and its excused limited partner mechanism. A fund without equivalent provisions is structurally unprepared to accept ERISA capital regardless of the sponsor's intent.
- Crossing the 25 percent threshold transforms the GP into an ERISA fiduciary subject to the prudent expert standard and the prohibited transaction rules. Affiliated service provider arrangements (property management, construction management, disposition brokerage through affiliated entities) are exactly the transactions that ERISA's prohibited transaction rules restrict in a plan asset fund. The consequences include personal liability for losses, disgorgement of profits, and excise tax penalties. Most managers work to maintain benefit plan investor participation below the 25 percent threshold rather than attempting to manage a plan asset fund.
- Operational due diligence is an independent evaluation stream that produces an independent recommendation to the investment committee. A manager can pass investment diligence on strategy and track record and fail ODD on compliance, cybersecurity, or governance. A meaningful portion of institutional LPs have rejected

managers over operational concerns independent of investment merit. Compliance infrastructure, cybersecurity programs, AML and KYC procedures, and business continuity plans must be in place and documented before the institutional capital raising process begins.

- The ILPA DDQ 2.0, with its 2025 real estate and emerging manager modules, is the framework that the substantial majority of institutional diligence either follows directly or tracks closely. A manager who is not familiar with the DDQ's 21 sections before entering the institutional market will discover its requirements under time pressure during a live diligence process, the worst possible time to be reading the questionnaire for the first time.
- Side letters are the mechanism through which institutional investors modify fund terms that fall short of ILPA standards. A manager whose fund documents are built to institutional standards will face fewer, narrower side letter negotiations. A manager whose documents reflect retail market standards will face substantive side letter negotiations on fees, governance, LPAC authority, reporting, and removal rights that collectively consume significant legal time and create the risk of inconsistent terms across investors. ILPA's Model LPA and its MFN framework in Section 20.6.2 address how to manage side letter consistency.
- Placement agents are subject to the SEC's pay to play rules under Rule 206(4)-5 of the Investment Advisers Act, which imposes a two year prohibition on receiving compensation for investment advisory services from a government client after a disqualifying political contribution. Before engaging a placement agent for an institutional raise involving government pension funds, the manager must confirm that the placement agent has a documented pay to play compliance program and that no covered associates of the manager have made disqualifying political contributions in the relevant jurisdictions.

## CHAPTER THIRTY SEVEN

# The Future of Real Estate Syndication and Funds

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Predicting the future of any industry is an exercise in organized humility. The predictions that prove most useful are not the ones that claim to know what will happen. They are the ones that identify the forces that are clearly in motion, describe the directions those forces are pushing, and help practitioners position themselves to benefit from where the trajectory is heading rather than be caught unprepared by it. Real estate syndication and private fund management are undergoing exactly the kind of multi vector change that makes prediction both difficult and consequential. Technology is reshaping how deals are found, underwritten, and capitalized. Regulatory frameworks are expanding the investable universe to include investors who were previously excluded. Alternative fund structures are capturing retail capital at scales that were impossible a decade ago. And blockchain based ownership infrastructure is creating the possibility of secondary liquidity in an asset class that has been fundamentally illiquid since its inception.

None of these forces is operating in isolation. They interact in ways that compound their individual effects. AI driven underwriting that reduces deal screening time meaningfully becomes more valuable when paired with an investor portal that converts the efficiency savings into faster investor updates. Regulation A+ offerings become more viable when digital distribution platforms reduce the retail investor onboarding cost to a fraction of what it cost through traditional broker dealer networks. Tokenization becomes meaningful when the regulatory framework for digital securities provides the clarity that institutional investors require to allocate. The practical significance of any individual development depends on the state of the others, and the sponsors who position themselves best are those who understand how these forces interact rather than treating each in isolation.

This chapter surveys each of the major forces shaping the future of real estate syndication and funds: technology's impact on capital raising and investor relations, the growth of non-traded REITs and interval funds, Regulation A+ and the retail investor market, real estate tokenization, and the evolving regulatory landscape. It closes with a framework for building a platform that is positioned for each of these developments rather than merely responsive to them after the fact.

## Technology's Impact on Capital Raising and Investor Relations

Technology does not change the fundamental economics of real estate investment. Properties still need to be acquired at prices that support the business plan, managed competently through the hold period, and exited at a return that justifies the capital risk. What technology changes is the efficiency with which every function supporting those fundamentals is performed, and, critically, whether the efficiency gains accrue to sponsors who invest in adoption or are captured instead by the competitors who move first.

The PropTech market has continued to attract substantial venture investment, and AI adoption across the commercial real estate industry has moved from pilot stage to mainstream deployment in a remarkably short period. According to MetaProp and PwC's Global PropTech Confidence Index, the share of commercial real estate firms running AI initiatives has grown from a small fraction of the industry to a substantial majority over the past three years. The adoption curve has already inflected. The question for private real estate fund sponsors is not whether to engage with these tools but how to integrate them intelligently into a platform that retains the judgment driven elements that technology cannot replace.

### **Online Platforms and the Democratization of Real Estate Investing**

The syndication platform market (the technology infrastructure for managing investor relationships, processing subscriptions, delivering reporting, and administering distributions) has matured considerably since the first generation of real estate crowdfunding platforms launched in the 2012 to 2015 period. What began as platforms designed primarily to match issuers with investors has evolved into comprehensive fund administration ecosystems that serve the entire investor lifecycle from initial accreditation through final distribution.

Purpose built platforms like Juniper Square, InvestNext, Dynamo Software, and Cash Flow Portal now offer integrated capabilities that combine investor CRM, document delivery, subscription processing, distribution management, capital account tracking, and K-1 preparation workflow in a single system. These platforms have measurably changed what investors expect from sponsors who use them. Sponsors who have implemented purpose built investor relations infrastructure report higher operational efficiency and improved investor retention compared to those still managing relationships through generic tools. The administrative time savings allow the sponsor's team to focus on the substantive investor conversations that build relationships rather than answering procedural questions about distribution status, account balances, and document availability.

The broader online investment platform market (the regulated intermediaries that connect issuers with investors in Regulation Crowdfunding and Regulation A+ offerings) has continued to grow. Several dozen SEC registered funding portals are currently operating, and these platforms have facilitated investor access to real estate offerings at investment minimums substantially lower than the \$25,000 to \$100,000 minimums that characterize most traditional



private placements. The democratization effect is real, though its legal and structural implications require careful attention. Not every online platform is legally authorized to host every type of securities offering, and the consequences of using an improperly registered platform are the investor rescission rights and regulatory enforcement exposure addressed throughout this handbook.

The trajectory of online platform adoption is toward full integration of the investor experience, from discovery and due diligence through investment, reporting, and exit, in a single digital environment that matches the experience investors receive from the consumer financial platforms they use for every other financial relationship. Sponsors who have already built this infrastructure are positioned to attract the next generation of investors who will evaluate the quality of the technology experience alongside the quality of the investment opportunity. Sponsors who are still managing investor relationships through spreadsheets and email are delivering an investor experience that is measurably below the standard that the market is moving toward.

### **AI Driven Underwriting and Deal Sourcing**

Artificial intelligence is changing real estate underwriting in a specific, quantifiable way. It is compressing the time required for initial deal screening dramatically, freeing human judgment for the decisions that genuinely require it. AI underwriting platforms use machine learning to extract financial data from deal documents (offering memoranda, rent rolls, trailing expense reports) and generate cash flow models and pro forma projections in minutes rather than hours. The operational implication is direct. A firm that previously could underwrite a limited number of deals per analyst per month can underwrite many more, screening a larger deal universe with the same personnel and making better informed decisions about which opportunities warrant deeper analysis.

Deal sourcing has undergone a parallel transformation. Specialized data platforms now cover tens of millions of commercial properties and use machine learning to identify which properties are most likely to transact, flagging off market opportunities based on ownership patterns, loan maturity dates, permit filings, and other signals that predate the property's appearance on the marketed deal market. Real estate knowledge graph platforms connect billions of addresses across hundreds of data sources, enabling property intelligence that was previously achievable only through extensive manual research at the local level. These platforms level the playing field for regional operators competing against larger institutional buyers who previously had research advantages that smaller firms could not efficiently replicate.

The compliance and investor relations functions of a real estate fund platform are also being transformed by AI. Tools built on large language model infrastructure can generate draft quarterly reports from structured financial data, produce K-1 preparation summaries from fund

accounting records, and create personalized investor communications that acknowledge each investor's specific holdings and history. Industry reports from organizations like the Urban Land Institute and PwC note that agentic AI (systems that can perceive conditions, make decisions, and execute tasks without continuous human supervision) is beginning to appear in property management workflows, with measurable improvements in lead to lease timelines and operating efficiency in properties where these tools have been deployed.

The legal dimension of AI adoption in real estate investment deserves specific attention. AI underwriting tools produce outputs that fund managers use to make investment decisions, prepare PPM disclosures, and communicate projected returns to investors. The accuracy of those outputs, the reasonableness of the assumptions they embed, and the adequacy of the disclosure about AI's role in the underwriting process are all questions that touch on the antifraud obligations that apply to every investor facing communication. A sponsor who uses AI generated underwriting to support projected return disclosures in a PPM has not transferred the legal responsibility for those disclosures to the AI system. They remain the sponsor's obligation to verify and stand behind. Securities counsel's role in a platform that adopts AI tools includes evaluating how those tools affect the adequacy of investor facing disclosure.

## **The Growth of Non-traded REITs and Interval Funds**

Non-traded REITs (real estate investment trusts that are registered with the SEC, offer shares to the public, and are subject to ongoing reporting requirements, but whose shares do not trade on a national securities exchange) have grown substantially as a vehicle for accessing retail and semi institutional capital at scale. After a challenging period in 2023 and early 2024 when several of the largest non-traded REITs gated redemptions in response to investor exit requests that exceeded available liquidity (a consequence of the interest rate environment and the structural mismatch between daily redemption expectations and underlying property illiquidity) the non-traded REIT market has rebounded meaningfully. The industry has shown renewed retail investor appetite for yield generating real estate vehicles, with quarterly capital raises returning to levels that compare favorably with the post pandemic period.

The redemption gating events at Blackstone's BREIT and Starwood's SREIT in 2023 and 2024 taught the market an important structural lesson. Non-traded REITs with daily or monthly NAV pricing and periodic redemption programs create investor expectations of liquidity that the underlying real estate assets cannot consistently support. When a significant percentage of investors simultaneously seek redemption (as occurred when higher interest rates both reduced property valuations and made fixed income alternatives more attractive) the periodic redemption gates that limit exit to a percentage of NAV per period are not a comfortable investor experience. This tension between investor liquidity expectations and underlying asset illiquidity

is not resolved simply by adding a redemption facility. It is managed by designing the fund structure and investor communications to calibrate expectations accurately from the beginning.

Interval funds (closed end funds registered under the Investment Company Act of 1940 that offer periodic repurchases of a defined percentage of shares at NAV, typically quarterly) have emerged as a preferred structure for semi institutional capital seeking real estate exposure with more-explicit liquidity management than non-traded REITs. Interval funds are-explicitly designed around the acknowledgment that the underlying assets are illiquid. The periodic repurchase offer is disclosed as the only exit mechanism, and investors commit with the understanding that interim liquidity is limited rather than nominally promised. This structural honesty about liquidity has made interval funds attractive to RIA and OCIO platforms that are making portfolio allocations on behalf of clients and need a vehicle whose liquidity terms are precisely defined.

For private real estate fund sponsors, the growth of non-traded REITs and interval funds is relevant in two ways. First, these vehicles compete for the same retail and semi institutional capital that Regulation D sponsors access through their high net worth investor networks, and they compete with the marketing advantages of SEC registration, ongoing public disclosure, and the accessibility of broker dealer distribution networks that reach retail investors at scale. Second, they represent a structural progression path for sponsors who have built a track record and investor base that could support a registered vehicle. The regulatory and operational requirements for a non-traded REIT or interval fund are substantially higher than for a Regulation D fund (SEC registration, ongoing 1933 Act and 1934 Act reporting, Investment Company Act compliance for interval funds) but the capital raising capacity at that stage of the platform's evolution justifies those requirements for the right sponsor at the right scale.

## **Regulation A+ and the Retail Investor Market**

Regulation A+ (the SEC's Tier 2 offering exemption that permits issuers to raise up to \$75 million annually from both accredited and non-accredited investors, with SEC qualification of the offering circular and limited ongoing reporting obligations) occupies an important and underutilized position in the securities exemption landscape for real estate sponsors. Since Regulation A+'s adoption as part of the JOBS Act amendments in June 2015, the exemption has been used for a substantial volume of offerings seeking aggregate financing in the tens of billions of dollars, with real estate companies, including REITs, among the more active categories of Regulation A+ issuers.

The distinctive value of Regulation A+ for real estate sponsors is the ability to reach non-accredited investors through publicly marketed offerings while maintaining a substantially lighter regulatory burden than a traditional registered IPO. Unlike Rule 506(b) and Rule 506(c) of Regulation D, which limit offerings to accredited investors or impose significant ongoing

reporting obligations, Regulation A+ Tier 2 allows general solicitation and advertising to the broad public, permits non-accredited investors to participate subject to investment limits, requires SEC qualification of the offering circular (a less burdensome process than full registration), and imposes ongoing semi-annual and annual reporting obligations rather than the quarterly 10-Q filings required of fully registered issuers.

The practical limitations of Regulation A+ explain why it has remained less utilized than its advocates expected. The offering qualification process takes longer and costs more than a Regulation D offering, typically three to six months and \$75,000 to \$150,000 in legal and audit costs for a first time issuer, before any capital is raised. The investment limits for non-accredited investors (the greater of 10 percent of annual income or net worth for Tier 2 offerings) constrain the per investor check size from retail participants in a way that affects the fundraising economics. The ongoing reporting obligations, though lighter than full public company reporting, represent a meaningful compliance infrastructure commitment. And the \$75 million annual cap, while substantial for many real estate projects, can constrain multi asset fund programs that require more capital.

Despite these limitations, Regulation A+ is increasingly viable for specific real estate use cases. A sponsor who has an identified acquisition target in a market with strong retail investor interest (a local multifamily project in a growing metro, a commercial property in a recognizable location) can use Regulation A+ to build a broad base of smaller investors through publicly marketed offerings, while the non-accredited investor participation creates a genuine democratization effect that the sponsor's retail focused brand can be built around. Real estate focused fintech platforms that distribute Regulation A+ offerings through consumer facing interfaces have demonstrated that retail investor appetite for direct real estate investment is real and substantial when the product is structured accessibly.

Reform discussions are ongoing, with market participants and the SEC's Investor Advisory Committee discussing potential increases to the Regulation A+ offering cap and modifications to the Regulation CF investment limits. Sponsors who are monitoring the Regulation A+ space should pay attention to these reform discussions, as an increase in the offering cap would materially expand the addressable market for real estate specific Regulation A+ programs.

## **Real Estate Tokenization: The Next Frontier**

Real estate tokenization (the issuance of blockchain based digital securities representing fractional ownership interests in real property or real property owning entities) has moved from theoretical possibility to operational reality, and from regulatory ambiguity to a framework defined with meaningful specificity. The regulatory inflection point that the tokenized real estate market has been building toward materialized in early 2026 with the SEC and CFTC's joint

publication of Release Nos. 33-11412 and 34-105020, the Joint Interpretation, which provides the first Commission level classification taxonomy for digital assets and definitively confirms the regulatory framework applicable to tokenized real estate securities. Sponsors who want a comprehensive treatment of the tokenized offering structure (from the ERC-3643 compliance architecture through entity formation, PPM disclosure, secondary market infrastructure, and the full regulatory compliance program) will find that subject covered in depth in The Real Estate Tokenization Handbook, a companion volume to this one that addresses every dimension of the tokenized offering that this chapter can only summarize.

## How Tokenization Changes the Syndication Model

The traditional private real estate syndication model involves illiquid securities. LLC membership interests that exist in paper or electronic form, which cannot be transferred without the manager's consent, and that have no secondary market through which an investor who needs liquidity can exit before the investment's hold period ends. That illiquidity is a genuine cost of the structure that both investors and sponsors understand and accept. Investors accept it because the investment's projected returns compensate for the inability to exit at will, and sponsors accept it because the absence of a secondary market simplifies their investor relations and compliance obligations.

Tokenization does not eliminate illiquidity. The underlying real property remains illiquid in any conventional sense, and the economics of the investment do not change because ownership is recorded on a blockchain rather than in a paper ledger. What tokenization does is create the infrastructure through which a secondary market for the securities could eventually function: a compliant alternative trading system where accredited investors can offer to buy and sell token based membership interests, with the ERC-3643 compliance module ensuring that every transfer satisfies the applicable securities law requirements automatically rather than requiring manual review and approval for each transaction.

The operational changes that tokenization introduces into the syndication model are meaningful for sponsors who invest in the architecture correctly. Investor onboarding through the ONCHAINID credential system, where KYC and AML verification and accreditation confirmation are recorded as on chain credentials attached to each investor's digital wallet, creates a portable identity infrastructure that reduces friction for subsequent investments with the same platform. Distribution mechanics that deliver rental income directly to investor wallets in compliant stablecoins, once the GENIUS Act's payment stablecoin framework is fully implemented, automate a function that currently requires fund administrator manual processing and wire transfer coordination. Capital account records maintained on chain provide a tamper evident audit trail that reduces the compliance burden for sponsors and increases the transparency that institutional investors increasingly require.

The secondary market opportunity is the value proposition that most clearly differentiates tokenization from conventional syndication. An investor in a conventional Regulation D fund who needs liquidity before the hold period ends has few options. The operating agreement's transfer restriction provisions require manager consent for any transfer, and finding a willing buyer who can satisfy the accreditation and other transfer requirements is an entirely manual process with no established market. A tokenized fund whose interests are listed on a compliant alternative trading system gives that investor a mechanism to find a buyer, still subject to the compliance module's eligibility checks, still requiring that the transferee satisfy all applicable investor qualification requirements, but occurring on a platform with a defined market structure rather than through entirely ad hoc negotiation.

## Security Tokens and Blockchain Based Ownership

The ERC-3643 (T-REX) standard, the dominant compliance architecture for security tokens on Ethereum, implements the securities law's transfer restrictions at the protocol level rather than relying on contractual prohibitions that require human enforcement. The compliance module attached to an ERC-3643 token enforces the offering's eligibility requirements automatically. It checks the proposed recipient's ONCHAINID credentials against the required eligibility conditions before permitting any transfer, and it rejects non-compliant transfers at the blockchain level without requiring the sponsor or their counsel to review and approve each proposed transaction.

The Joint Interpretation's classification framework is directly relevant to how sponsors describe their tokenized offerings to investors and regulators. Under the five category taxonomy, tokenized real estate membership interests are digital securities, the fifth category, because they are financial instruments enumerated in the definition of security that are formatted as crypto assets where ownership is maintained on a blockchain. The ONCHAINID credentials that enable investors to hold and transfer these security tokens are digital tools, not securities, because their value is derived from functional utility (the ability to satisfy compliance checks) rather than from expectations of profit from managerial efforts. Ether and other network native digital commodities used to pay the gas fees that process compliance module checks are digital commodities, not securities, because they derive their value from the programmatic operation of their respective networks rather than from any issuer's managerial efforts.

These classifications have practical significance for sponsors designing the technical architecture of their tokenized offerings and drafting disclosure documents for investors. A PPM for a tokenized real estate offering must explain that the underlying membership interest is a digital security, that the ONCHAINID credential is a non-security digital tool that enables participation in the offering, and that gas fees paid in ETH or SOL are commodity payments for computational services rather than additional securities transactions. Getting these descriptions



accurate, and consistent with the Joint Interpretation's framework, is a document drafting task that requires counsel familiar with both securities law and the specific technical architecture of ERC-3643 tokenized offerings.

## The Regulatory Path Forward for Tokenized Real Estate

The Joint Interpretation resolves the foundational question that had generated uncertainty in the tokenized real estate market since at least 2017: whether tokenized real estate interests are securities, and what regulatory framework applies to them. The answer (yes, they are digital securities, and the full federal securities framework applies) is not a burden on the market. It is a foundation on which the market can build with confidence, because participants now have Commission level confirmation that the legal analysis that well-structured tokenized offerings have been operating on is correct.

Project Crypto's ongoing development agenda (the SEC's initiative to develop tailored disclosure frameworks for digital securities, realistic registration paths for token platforms and ATS operators, and updated investment adviser custody rules for digital securities holdings) represents the regulatory infrastructure buildout that will determine how quickly the tokenized real estate market achieves the institutional scale that its advocates envision. The institutional custody gap is the most immediate remaining barrier. Major financial institutions have accelerated their digital asset custody buildouts following the SEC's January 2025 rescission of SAB 121 (replaced by SAB 122) and the Joint Interpretation's confirmation that digital securities are treated as conventional securities for regulatory purposes, but broadly available institutional grade custody for tokenized real estate securities is still developing. The timeframe is measured in months to a few years, not in the indefinite future.

For conventional real estate fund sponsors who have not yet tokenized any offerings, the practical question is not whether to tokenize but when and for which offerings. The sponsors for whom tokenization makes strategic sense now are those who have identified a specific use case where the secondary market infrastructure, the investor base, and the deal economics support the additional complexity and cost: a real estate platform with a substantial accredited investor base that specifically values secondary market access; a portfolio of stabilized income producing properties whose steady distributions are well suited to on chain delivery; or a fund structure where fractional interests at lower minimum investments are necessary to access a specific investor community. The sponsors for whom tokenization does not yet make sense are those for whom the compliance overhead would consume a disproportionate share of the offering's economics without delivering a measurable benefit to investors.

## The Evolving Regulatory Landscape

The regulatory framework governing private real estate capital raising is not static. It has changed materially several times in the past fifteen years. The JOBS Act of 2012 created Regulation CF and revitalized Regulation A+. The 2020 amendments increased the Regulation CF cap from \$1.07 million to \$5 million and the Regulation A+ Tier 2 cap to \$75 million. The 2020 accredited investor definition amendments expanded the definition to include holders of certain professional certifications. And the SEC's enforcement priorities have shifted across administrations in ways that affect how aggressively violations are pursued. Sponsors who treat the regulatory environment as fixed are periodically surprised by changes that were visible in advance to those who monitor the landscape actively.

### **Crowdfunding Reform and Evolving Reg CF Limits**

Regulation CF, which allows issuers to raise up to \$5 million in a 12 month period from both accredited and non-accredited investors through SEC registered funding portals or broker dealers, has generated more than a billion dollars in aggregate proceeds across thousands of offerings since its 2016 implementation, a fraction of what Regulation D raises in any single year, but a meaningful democratization of access to investment opportunities for the substantial majority of U.S. households that do not qualify as accredited investors. Real estate sponsors who want to include genuinely retail investors in their offerings, not as a marketing message but as an actual capital source, should be monitoring Regulation CF reform discussions closely.

The current \$5 million annual cap limits Regulation CF's utility for most meaningful real estate transactions, where the equity raise alone may require \$2 million to \$5 million from a pool of investors who are each limited to a specific investment amount based on their income and net worth. A real estate multifamily acquisition requiring \$4 million of equity cannot be meaningfully financed through Regulation CF alone. The investor economics and offering costs do not work at that scale when non-accredited investor investment limits constrain per investor check size. If the cap were increased to \$20 million, a reform proposal that has been discussed in the context of the SEC's access to capital agenda, the calculus changes meaningfully for real estate sponsors whose deal pipelines and geographic markets include a strong retail investor constituency.

For sponsors who are considering Regulation CF now, the framework requires careful attention to the intermediary requirement. All Regulation CF offerings must be conducted through a single SEC registered funding portal or broker dealer, and the issuer must maintain that single portal relationship throughout the offering period. The compliance infrastructure of using a Regulation CF portal (Form C preparation, financial statement requirements, offering deadlines, investor communication restrictions) is meaningfully different from a Regulation D offering, and sponsors who approach Regulation CF with Regulation D assumptions create compliance problems that are discovered only after the offering is already underway.



## Accredited Investor Definition Changes

The accredited investor definition (the threshold below which investors cannot participate in most Regulation D offerings) was last substantively amended in 2020, when the SEC expanded it to include holders of certain professional licenses and certifications (Series 7, 65, and 82), knowledgeable employees of certain investment funds, and limited liability companies with \$5 million or more in assets. Those amendments were widely regarded as a meaningful but insufficient step toward recognizing financial sophistication criteria that are not captured by the existing income and net worth thresholds.

The fundamental limitation of the existing definition is that it excludes the substantial majority of U.S. households based primarily on wealth rather than investment sophistication. Per the SEC's most recent published estimates, approximately 19 percent of U.S. households qualify as accredited investors based on the existing income and net worth criteria, meaning more than 80 percent of households are excluded from Regulation D offerings. An individual with a bachelor's degree in finance, decades of investment experience, and a thorough understanding of private securities risks may not qualify as an accredited investor because their income or net worth falls below the thresholds, while a recent lottery winner who has never evaluated a private placement qualifies immediately upon receiving their winnings. This mismatch between the definition's intent (ensuring that investors in unregistered securities can fend for themselves) and its actual application has been the basis for persistent advocacy for definition reform.

The SEC and Congress have both considered expanding the accredited investor definition to include additional knowledge based criteria: professional certifications beyond those added in 2020, completion of a standardized financial literacy assessment, and in some proposals, a lower income or net worth threshold applicable to experienced investors with a demonstrated track record of private securities investment. The Equal Opportunity for All Investors Act of 2025, which would direct the SEC to create a qualification test that individuals could take regardless of wealth or income, passed the House in June 2025 and remains under consideration. None of these proposals has been enacted as of early 2026, but the direction of movement is toward expansion rather than contraction, and sponsors whose offering programs would benefit from a larger accredited investor universe should monitor these developments through securities counsel who tracks SEC rulemaking activity.

The practical implication for sponsors building multi-year offering programs is to design structures that can accommodate a larger accredited investor pool if and when the definition expands, rather than structures that would require significant rebuilding to adapt to a new investor eligibility standard. A Regulation D 506(c) program that uses documentary verification of accredited investor status, rather than self-certification, is already positioned to quickly incorporate any new investor category that the SEC adds to the accredited investor definition, because the verification infrastructure is already in place.

## SEC Enforcement Trends in Private Placements

SEC enforcement in the private placement space has followed the policy priorities of each administration, with meaningful variation in both volume and focus. The broad themes that have remained consistent across administrations (unregistered broker dealer activity, general solicitation violations in Rule 506(b) offerings, and material misrepresentation in investor communications) are the same themes that generate the most enforcement actions in every market cycle, regardless of the administration's stated priorities. These violations are enforced because they are discoverable. They leave paper trails (or digital trails) in the form of finder payment records, social media posts, and investor communications that can be reviewed in an examination.

The current enforcement environment reflects a stated commitment to using enforcement resources against conduct that directly harms investors rather than against technical violations that do not produce investor losses. That stated priority does not eliminate enforcement of technical violations. It means that enforcement resources may be more concentrated on the violations that produce the most investor harm, which are precisely the ones that this handbook's chapters on capital raising and structuring mistakes address in detail. The most consequential enforcement actions in the private real estate space have historically involved sponsors who raised capital through unregistered finders, made material misrepresentations in investor communications about projected returns or the use of investor funds, or commingled investor funds with sponsor personal accounts.

The digital trail that accompanies modern capital raising (email communications, social media posts, webinar recordings, investor portal records) has made enforcement investigations more efficient for the SEC's examination staff. A sponsor who conducted general solicitation through a LinkedIn post, sent marketing materials containing unsupported return projections, and maintained investor records in a disorganized manner is not harder to investigate in the current environment than in prior years. They are easier. The volume of electronically stored communications that can be reviewed in an examination, without the time and cost of physical document review, has reduced the investigative friction that previously functioned as a practical constraint on enforcement of smaller scale violations.

## Building a Platform for the Future

The forces described in this chapter are not going to arrive simultaneously, and they are not going to affect every sponsor equally. A regional multifamily operator whose investor base consists primarily of high net worth individuals in their home market will experience the technology adoption pressure immediately but will encounter tokenization and Regulation A+ as more distant possibilities relevant to a future scale that they are not yet building toward. An

emerging manager raising their first fund from family offices and smaller institutions will encounter ILPA standards and institutional due diligence requirements long before they need to think about AI driven deal sourcing at scale. A repeat sponsor with a growing retail investor base and a track record of successful Regulation D offerings may find that Regulation A+ or tokenization are the natural next step in reaching the broader investor community they want to serve.

The common thread across all of these trajectories is that the sponsors who position themselves best are those who build foundations that can accommodate the changes that are coming, rather than optimizing so tightly for the current environment that adaptation requires wholesale rebuilding. Three specific foundation elements apply across the entire spectrum of platform development stages.

### **Legal Infrastructure That Can Grow With the Platform**

A sponsor whose fund documents were designed for a specific first offering (a specific investor base, a specific exemption, a specific deal structure) and who applies those same documents to every subsequent offering without systematic review and updating has a legal infrastructure that is progressively more misaligned with their actual business as the platform grows. The master operating agreement template and form PPM that Chapter 35 describes as the legal infrastructure of a scalable platform are not just efficiency tools. They are adaptability tools that allow each new offering to be tailored to its specific requirements without rebuilding from scratch.

As the regulatory landscape evolves (as accredited investor definitions change, as tokenization disclosure requirements develop, as Regulation CF caps are potentially increased, as ILPA standards are updated) a platform with systematic annual document review by securities counsel can incorporate those changes into the next offering's template rather than discovering them when the change has already affected an offering that used the prior standard. That systematic review process is the mechanism through which legal infrastructure stays current rather than aging in place.

### **Compliance Infrastructure That Scales**

The compliance infrastructure that an institutional investor's ODD team evaluates (the compliance manual, the CCO, the annual review, the cybersecurity program, the AML and KYC procedures) is not infrastructure that can be built in the weeks before an institutional due diligence process begins. It is infrastructure that must be built during the period when the platform is serving a smaller investor base, so that it is operational and documented when the institutional due diligence asks for evidence of how long it has been in place and whether it has been tested.

Sponsors who are currently at Stage 1 or Stage 2 of the platform development ladder described in Chapter 35 should be building compliance infrastructure that is designed for Stage 3 and Stage 4 standards, even if the current offering size and investor base do not yet require it. The compliance program that is adequate for today's offering becomes inadequate when the platform grows, and the cost of building it correctly at a smaller scale is substantially lower than the cost of rebuilding it under time pressure when an institutional investor's ODD process reveals the gaps.

## Relationships With Counsel Who Understand Where the Market Is Going

The legal landscape for private real estate capital formation is moving at a pace that makes generalist legal counsel an inadequate resource for sponsors who are building platforms intended to remain competitive over the next decade. The Joint Interpretation's five category digital asset taxonomy, the Project Crypto regulatory development agenda, the ILPA Model LPA's institutional governance framework, the ERISA plan asset monitoring requirements, the Regulation A+ reform discussions, the Regulation CF cap and limit evolution: each of these requires sustained monitoring by counsel who is deeply engaged with the specific regulatory areas involved, not periodic catch up by counsel who handles real estate securities matters as one of many practice areas.

The sponsors who will be best positioned over the next decade are those who have established relationships with securities counsel who actively monitor and participate in the development of the regulatory frameworks that govern their offerings, who are in the comment process for proposed rules, who are involved in industry groups that interface with regulators, and who are advising clients at the leading edge of the structures and exemptions that are shaping the market. That kind of counsel relationship is not a one-time transaction cost. It is an ongoing operating investment that compounds in value as the regulatory landscape changes and the platform's needs become more complex.

| Force                               | Current State                                                                                                                                                          | Near Term Direction                                                                                                 | Platform Implication                                                                                                                                       |
|-------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Technology and AI                   | AI adoption has grown rapidly from a small fraction of CRE firms to a substantial majority within three years; PropTech venture investment continues at record levels. | AI underwriting, deal sourcing, and investor reporting become competitive requirements rather than differentiators. | Invest in purpose built fund administration and investor portal platforms; integrate AI underwriting tools; upgrade investor communication infrastructure. |
| Non-traded REITs and Interval Funds | Non-traded REIT market has rebounded after 2023 and 2024 redemption gating events; interval funds                                                                      | Continued growth with improved liquidity disclosure; potential                                                      | Monitor as competitive context for retail capital; understand as a progression path for sponsors at scale.                                                 |

| Force                          | Current State                                                                                                                                                 | Near Term Direction                                                                                                                                                        | Platform Implication                                                                                                                                                |
|--------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                | growing as preferred structure for semi institutional retail capital.                                                                                         | Regulation A+ reform expanding the offering cap.                                                                                                                           |                                                                                                                                                                     |
| Regulation A+                  | Tens of billions of dollars sought since 2015 across more than a thousand offerings; filings have declined from peak amid reform discussions.                 | Potential offering cap increase; ongoing reform discussion; valuable for specific retail focused real estate programs.                                                     | Monitor reform discussions; evaluate for sponsors whose deal pipeline and investor community include retail constituents.                                           |
| Real Estate Tokenization       | Joint Interpretation (2026) confirms digital securities framework; ERC 3643 tokenization operational but secondary markets nascent.                           | Institutional custody infrastructure developing; Project Crypto building regulatory framework for intermediaries; secondary markets expanding.                             | Evaluate for offerings where secondary market access or lower minimums create genuine investor value; engage counsel familiar with digital securities architecture. |
| Regulation CF Reform           | \$5 million cap limits utility for most real estate transactions; reform discussions ongoing for potential cap increase.                                      | Potential increase to \$20 million or higher cap; meaningful expansion of retail investor access if enacted.                                                               | Design offering programs to accommodate larger investor pools; monitor legislative and regulatory developments through securities counsel.                          |
| Accredited Investor Definition | 2020 amendments added professional certification criteria; approximately 19 percent of U.S. households qualify per the SEC's most recent published estimates. | Active discussion of knowledge based expansion criteria; direction toward expansion rather than contraction; House passed Equal Opportunity for All Investors Act of 2025. | Design 506(c) programs with verification infrastructure that can accommodate new investor categories quickly when definition expands.                               |
| SEC Enforcement                | Digital trails make private placement violations more discoverable; focus on conduct causing direct investor harm.                                            | Consistent enforcement of core violations: unregistered finders, general solicitation, material misrepresentation.                                                         | Maintain rigorous compliance with documented processes; treat every investor communication as potentially reviewable in an examination.                             |

## Practical Takeaways for Sponsors

- Technology adoption in real estate fund management has already inflected. The share of commercial real estate firms running AI initiatives has grown from a small fraction of the industry to a substantial majority within three years. Sponsors who are still managing investor relationships through spreadsheets and email are delivering an investor experience that is measurably below the standard the market is moving toward. Purpose

built fund administration platforms (Juniper Square, InvestNext, Dynamo Software, Cash Flow Portal) are the baseline infrastructure investment, not a differentiator.

- AI underwriting tools that reduce deal screening time substantially are legitimate productivity multipliers, but they do not transfer the sponsor's legal responsibility for the accuracy of investor facing projections and disclosures. AI generated underwriting that informs PPM return projections still requires the sponsor's verification and the securities counsel's review of the resulting disclosure. The tool accelerates the process. It does not substitute for the judgment and legal analysis that the disclosure obligation requires.
- Non-traded REITs and interval funds are both competitive context for private real estate fund sponsors and potential progression vehicles. The redemption gating events at BREIT and SREIT demonstrated that liquidity promises must match underlying asset characteristics. Sponsors designing any fund structure that includes periodic redemption or liquidity features must ensure that those features are honestly disclosed and that their availability is actually supportable given the underlying property's liquidity profile.
- Regulation A+ has been used by hundreds of issuers seeking tens of billions in aggregate financing since 2015, with real estate companies among the most active users. The exemption's ability to reach non-accredited investors through publicly marketed offerings is its primary value proposition for retail focused real estate programs. The qualification process costs \$75,000 to \$150,000 and takes three to six months for a first time issuer, a meaningful investment that must be justified by the offering's economics and the sponsor's retail investor strategy.
- The Joint Interpretation (SEC and CFTC Release Nos. 33-11412 and 34-105020) confirms that tokenized real estate membership interests are digital securities subject to the full federal securities framework. This confirmation is not a regulatory burden on well-structured tokenized offerings. It is the Commission level authority that removes the residual uncertainty that had prevented some institutional investors from allocating to this market. The compliance infrastructure required for a tokenized offering (valid exemption, PPM, KYC and AML, ONCHAINID credential program, Form D, blue sky filings) is unchanged from what was required before the Interpretation. What changed is the confidence with which sponsors can build on that framework.
- Real estate tokenization makes strategic sense now for sponsors who have identified a specific use case where secondary market access or lower minimum investments create genuine investor value. It does not make sense as a marketing strategy for sponsors who cannot articulate what specific investor problem the tokenized structure solves better than a conventional Regulation D offering. The technical complexity and compliance overhead of a properly structured tokenized offering require a clear value proposition to justify.

- The accredited investor definition currently includes approximately 19 percent of U.S. households per the SEC's most recent published estimates. Reform discussions are ongoing in the direction of expansion, including the Equal Opportunity for All Investors Act of 2025 passed by the House in June 2025. Sponsors whose offering programs are built on 506(c) documentary verification rather than 506(b) self-certification are better positioned to quickly incorporate new accredited investor categories when the definition expands, because the verification infrastructure can be adapted to a new definition without rebuilding the entire offering program.
- SEC enforcement of private placement violations is more efficient in the digital era. Electronically stored communications, social media posts, and investor portal records reduce the investigative cost of identifying violations. The core violations that generate enforcement actions (unregistered finders, general solicitation in 506(b) offerings, material misrepresentation in investor communications, commingling of investor funds) are not enforcement priorities that change with administrations. They are the permanent regulatory floor of private real estate capital formation.
- The sponsors who will build the most significant private real estate platforms over the next decade are those who build legal and compliance infrastructure that can grow with the platform, not infrastructure optimized for today's offering that must be rebuilt as the platform scales. Master operating agreement templates, form PPMs, systematic annual legal review, and compliance programs built to institutional standards before institutional capital makes them mandatory: these are the foundation investments that compound in value as the platform grows and the regulatory landscape evolves.

## APPENDIX A

# Glossary of Real Estate Syndication and Fund Terms

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*This glossary defines the principal terms used throughout this handbook. Terms that appear in the text in a context where their definition is essential are defined here in full. Terms that are less commonly encountered are defined in summary. Cross references to related definitions are provided where understanding one term requires familiarity with another. Where a term has a specific legal meaning under the securities laws or tax code, that legal meaning is described. Where market usage differs from strict legal usage, both are noted.*

## A

**3(c)(1) Exemption.** An exemption under Section 3(c)(1) of the Investment Company Act of 1940 that permits a fund to avoid registration as an investment company, provided the fund has no more than 100 beneficial owners of its outstanding securities and does not make or propose to make a public offering. Most early stage private real estate funds rely on this exemption or the 3(c)(7) exemption.

*See also: 3(c)(7) Exemption; Investment Company Act.*

**3(c)(5)(C) Exemption.** An exemption under Section 3(c)(5)(C) of the Investment Company Act of 1940 that allows certain funds to avoid registration as investment companies, provided they are primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Real estate funds that hold whole mortgage loans, participation interests, and similar instruments commonly rely on this exemption.

*See also: Investment Company Act.*

**3(c)(7) Exemption.** An exemption under Section 3(c)(7) of the Investment Company Act that permits a fund to avoid registration as an investment company, provided all investors are qualified purchasers and the fund does not make a public offering. The 3(c)(7) exemption allows an unlimited number of investors, making it the preferred structure for larger funds that expect significant institutional capital.

*See also: Qualified Purchaser; 3(c)(1) Exemption.*

**1031 Exchange.** A tax deferred exchange under Section 1031 of the Internal Revenue Code that allows a taxpayer to defer recognition of capital gain on the sale of investment real property by reinvesting the sale proceeds into a replacement property of like kind within specified timeframes. The taxpayer must identify replacement property within 45 days of the sale and



close on the replacement within 180 days. The 1031 exchange does not eliminate tax liability. It defers it until the replacement property is ultimately sold without reinvestment. Fund structures present complications for 1031 exchanges because the fund, not the individual investor, owns the property. Individual investors in a fund cannot conduct a 1031 exchange based on the fund's property sale unless the fund itself is the exchanger.

*See also: Section 1061; Depreciation Recapture; FIRPTA; DST.*

**506(b).** An exemption under Rule 506(b) of Regulation D that allows a fund to raise an unlimited amount of capital from accredited investors and up to 35 non-accredited but sophisticated investors, without engaging in any general solicitation or advertising. The 506(b) exemption is the most commonly used private offering exemption for real estate syndications. Non-accredited investors admitted under 506(b) trigger additional disclosure obligations, including the requirement to provide audited financial statements and a disclosure document equivalent to that required in a registered offering.

*See also: Regulation D; Accredited Investor; General Solicitation; 506(c).*

**506(c).** An exemption under Rule 506(c) of Regulation D that allows a fund to engage in general solicitation and advertising, provided all investors are accredited and the issuer takes reasonable steps to verify each investor's accredited status using the specific methods the rule prescribes. Unlike 506(b), investor self-certification of accredited status is insufficient under 506(c). Documentary verification through tax returns, bank statements, or written confirmation from a licensed professional is required. The SEC Division of Corporation Finance no action letter issued on March 12, 2025, provides an additional bright line safe harbor for 506(c) verification based on minimum investment amounts of \$200,000 for natural persons and \$1 million for legal entities combined with specified investor representations.

*See also: Regulation D; Accredited Investor; General Solicitation; 506(b).*

**Accredited Investor.** An individual or entity that meets financial or professional eligibility criteria defined by SEC Rule 501 of Regulation D, qualifying them to participate in private securities offerings. For individuals, the principal thresholds are: (1) net worth exceeding \$1 million, calculated excluding the value of the primary residence (and reduced by any debt secured by the primary residence that exceeds its value); or (2) annual income exceeding \$200,000 in each of the two most recent years (or \$300,000 jointly with a spouse or spousal equivalent), with a reasonable expectation of the same or higher income in the current year. The 2020 amendments expanded the definition to also include holders of certain professional securities licenses (Series 7, 65, or 82), knowledgeable employees of certain investment funds, and limited liability companies with more than \$5 million in assets. The accredited investor standard is lower than the qualified client and qualified purchaser standards and represents the baseline eligibility threshold for most Regulation D offerings. Per the SEC's most recent

published estimates, approximately 19 percent of U.S. households qualify as accredited investors under the current criteria.

*See also: Qualified Client; Qualified Purchaser; 506(b); 506(c).*

**Acquisition Fee.** A one-time fee paid to the GP, Manager, or an affiliate upon closing an asset acquisition, typically calculated as a percentage of the purchase price (commonly 1 percent to 3 percent). It compensates the sponsor for sourcing and executing the transaction, including due diligence, negotiation, and closing coordination. Acquisition fees must be disclosed in the PPM and, where a fee offset provision applies, reduce the management fee dollar for dollar to the extent required by the fund agreement.

*See also: Disposition Fee; Management Fee Offset; Fee Income.*

**Affiliate.** Any entity that controls, is controlled by, or is under common control with a specified person. In the fund context, affiliates of the GP or Manager include their parent companies, subsidiaries, commonly owned entities, key persons, and immediate family members of key persons. The definition of affiliate is significant because transactions between the fund and any affiliate of the GP require heightened scrutiny, LPAC approval, and disclosure to avoid prohibited transaction violations and conflicts of interest claims.

*See also: Conflicts of Interest; LPAC; Related Party Transaction.*

**American Waterfall.** A distribution methodology in which carried interest is calculated and distributed on a deal by deal basis rather than across the fund's aggregate portfolio. The GP may receive promote from an early successful deal even if subsequent deals underperform. This approach requires robust clawback provisions to protect LPs from overpaying promote in the aggregate.

*See also: European Waterfall; Waterfall; Clawback; Carried Interest.*

**Antifraud Provisions.** The federal securities law prohibitions against material misstatements and omissions in connection with the offer and sale of securities. The primary antifraud provisions applicable to private real estate offerings are Section 17(a) of the Securities Act of 1933 (which prohibits fraud in the offer and sale of securities) and Rule 10b-5 under the Securities Exchange Act of 1934 (which prohibits fraud in connection with the purchase or sale of securities). The antifraud provisions apply regardless of whether the offering is registered. They apply to every investor facing communication, including the PPM, marketing materials, investor presentations, and subscription agreements. Liability under the antifraud provisions requires proof that a material misstatement or omission was made, that it was made with scienter (or, for Section 17(a)(2) and (3), negligently), and that an investor relied on it.

*See also: Rule 10b-5; Material Misrepresentation; PPM; General Solicitation.*

**Asset Management Fee.** A recurring fee paid to the GP, Manager, or an affiliate for ongoing oversight of the fund's assets, including property level supervision, performance monitoring, lender covenant compliance, and investor reporting. In real estate funds, the asset management fee is often charged at the fund level (as distinguished from property management fees charged at the property level) and is typically calculated as a percentage of invested capital or gross asset value (1 percent to 2 percent per year).

*See also: Management Fee; Property Management Fee; Fee Income.*

**Auditor.** An independent accounting firm that reviews and expresses an opinion on the accuracy and integrity of the fund's financial statements, typically on an annual basis. Institutional investors generally require audited financial statements, and the ILPA Reporting Template specifies that audited annual statements be delivered within 90 days of year end. The fund agreement designates the auditor. Changes to the auditor typically require LPAC approval.

*See also: LPAC; K-1.*

## B

**Bad Actor Disqualification.** A provision of Rule 506 of Regulation D that disqualifies an issuer from relying on a Regulation D exemption if any covered person (including the issuer, its officers, directors, 20 percent beneficial owners, general partners, managing members, promoters, placement agents, and their personnel) has been subject to specified disqualifying events. Disqualifying events include criminal convictions for securities fraud or other specified felonies, SEC orders and injunctions, certain regulatory bars, and similar adverse regulatory history. Issuers must conduct reasonable disqualification checks on all covered persons before each offering. Disclosure of non-disqualifying (but potentially material) events in the PPM is also recommended as a matter of antifraud compliance.

*See also: 506(b); 506(c); PPM; Regulation D.*

**Basis (Tax Basis).** A taxpayer's economic investment in an asset for federal income tax purposes, used to calculate gain or loss on disposition. In a real estate investment, the initial tax basis equals the purchase price plus acquisition costs, adjusted upward for capital improvements and downward for depreciation claimed. A lower adjusted basis produces a higher taxable gain on sale. Cost segregation studies can accelerate depreciation deductions but also accelerate the reduction of basis and the amount of gain subject to depreciation recapture on sale.

*See also: Depreciation; Depreciation Recapture; Cost Segregation.*

**Benefit Plan Investor.** An investor whose capital is considered plan assets subject to ERISA or Code Section 4975, including ERISA covered employee benefit plans (corporate pension plans, 401(k) plans), individual retirement accounts (IRAs), and any entity that is itself deemed

to hold plan assets of such plans. The aggregate percentage of benefit plan investor ownership in each class of a fund's equity interests must remain below 25 percent for the fund to qualify for the Insignificant Benefit Plan Investor exception and avoid ERISA plan asset status.

*See also: ERISA; Plan Asset Regulations; 25 Percent Benefit Plan Investor Limitation; VCOC; REOC.*

**Blind Pool.** A fund structure in which investors commit capital before the specific investments to be made with that capital are identified. Investors in a blind pool rely on the sponsor's stated investment thesis, team qualifications, and track record rather than on analysis of specific identified assets. The opposite of a blind pool is a deal by deal offering, in which investors evaluate each specific investment before committing capital. Blind pool structures require a higher level of investor trust in the sponsor and are more common at more mature stages of a sponsor's platform development.

*See also: Closed End Fund; Investment Period; Deal by Deal Syndication.*

**Blocker Entity.** A legal entity (typically a corporation or a specially structured LLC) inserted between the fund and certain investors to prevent those investors from being directly exposed to tax obligations that the pass through structure of the fund would otherwise create. Blockers are commonly used for non U.S. investors (to shield against Effectively Connected Income and FIRPTA withholding), tax exempt investors (to shield against Unrelated Business Taxable Income), and certain institutional investors with specific regulatory constraints.

*See also: Effectively Connected Income; FIRPTA; Unrelated Business Taxable Income; UBTI.*

**Blue Sky Filings.** State level regulatory filings required to notify or qualify a securities offering with the relevant state securities authority. Rule 506 offerings are federally preempted from state registration requirements, but issuers must still make notice filings in each state where investors reside, typically by submitting a copy of the federal Form D and paying a filing fee within a specified deadline after the first sale in that state. Several states treat failure to make required notice filings as a basis for investor rescission rights. Annual renewal filings are required in some states for offerings that remain open beyond the initial filing period.

*See also: Blue Sky Laws; Form D; Regulation D.*

**Blue Sky Laws.** State level securities laws enacted in each U.S. state to protect investors from fraud by regulating the offer and sale of securities within that state. Requirements vary significantly by state and must be evaluated alongside federal securities law requirements for every offering. The name derives from an early twentieth century court opinion describing fraudulent investments that offered nothing but blue sky. NASAA coordinates state securities regulatory activities and maintains the Electronic Filing Depository (EFD) used for state level Form D submissions.

*See also: Blue Sky Filings; Form D; NASAA.*

**Broker Dealer.** A person or firm engaged in the business of buying and selling securities for the account of others (broker) or for its own account (dealer). Under Section 15(a) of the Securities Exchange Act of 1934, broker dealers must be registered with the SEC and, if applicable, with FINRA. Any person who receives transaction based compensation for introducing investors to a securities offering, regardless of title or how the arrangement is characterized, is engaged in broker dealer activity and must be registered or associated with a registered broker dealer. Paying unregistered finders a percentage of capital raised exposes both the finder and the issuer to enforcement and creates investor rescission rights.

*See also: Placement Agent; Finder; FINRA; Section 15(a).*

## C

**Capital Call.** A formal written request from the GP or Manager to LPs to contribute a specified portion of their committed but unfunded capital to the fund. Capital calls are typically issued when the fund is ready to close on an investment, pay fund expenses, or fund organizational costs. The fund agreement specifies the notice period (typically 10 business days), the wire transfer instructions, the consequences of failure to fund (default), and the callable and non-callable nature of any prior distributions that may reduce unfunded commitments.

*See also: Drawdown; Capital Commitment; Capital Contribution; Defaulting Partner.*

**Capital Commitment.** The total amount of capital an investor contractually agrees to contribute to the fund over its life, as set forth in the subscription agreement and reflected in the fund's register. Capital commitments are typically funded incrementally in response to capital calls during the investment period rather than being contributed in a single payment at closing. An investor's unfunded commitment remains at risk for capital calls until it is either drawn or the investment period expires.

*See also: Capital Call; Capital Contribution; Investment Period.*

**Capital Contribution.** The actual cash an investor transfers to the fund in response to a capital call, representing the funded portion of their capital commitment. Capital contributions reduce the investor's remaining unfunded commitment and form the basis on which the preferred return, distributions, and carried interest are calculated.

*See also: Capital Call; Capital Commitment.*

**Capital Stack.** The totality of the financial instruments used to fund a real estate acquisition or project, arranged in order of priority and risk. A typical real estate capital stack consists of (from most senior to most junior) senior debt (first mortgage loan), mezzanine debt or preferred equity, and common equity (LP and GP interests). Senior positions are repaid first in a liquidation or distribution, carry lower risk, and earn lower returns. Junior positions bear higher risk and earn higher returns if the investment succeeds. Understanding the capital stack is

essential for investors evaluating their position's priority in a distribution waterfall and in a distressed scenario.

*See also: Waterfall; Mezzanine Financing; Preferred Equity; Senior Debt.*

**Capitalization Rate (Cap Rate).** A commonly used real estate valuation metric calculated by dividing a property's net operating income (NOI) by its current market value or purchase price. A property with \$1 million in NOI trading at a 5 percent cap rate has a market value of \$20 million. Cap rates reflect the market's required yield for a property type, location, and risk profile. Higher cap rates indicate higher yield requirements and generally lower asset values (all else equal). Cap rate compression (declining cap rates over a hold period) is one source of appreciation in a value add investment. Cap rate expansion (rising cap rates) is a primary source of value loss.

*See also: Net Operating Income; Underwriting.*

**Carried Interest.** The GP's or Manager's share of the fund's profits, earned as compensation for managing the fund and generating returns above the investors' preferred return. Carried interest is typically expressed as a percentage (commonly 20 percent) of profits above the preferred return threshold, after the GP catch up. Carried interest is generally structured as a profits interest in the fund partnership for tax purposes, qualifying long term gains for capital gains tax treatment when the underlying assets are held for the required holding period. Section 1061 of the Internal Revenue Code imposes a three year holding period requirement on carried interest in certain investment partnerships. Gains on assets held for less than three years may be recharacterized as short term capital gains for carried interest holders.

*See also: Profits Interest; Promote; GP Catch Up; Section 1061; Waterfall; Preferred Return.*

**Clawback.** A provision in the fund agreement requiring the GP to return previously distributed carried interest if, upon the fund's final accounting, the total promote received exceeded what the waterfall calculation supports based on the fund's aggregate performance. The clawback protects LPs from paying promote on early successful deals that are later offset by losses on subsequent investments. A well drafted clawback provision specifies the calculation methodology (and its consistency with the waterfall that generated the distributions); a tax gross up provision acknowledging taxes paid on prior distributions; and a funding mechanism (escrow or personal guarantee) ensuring the GP can actually fund the obligation when it arises.

*See also: Carried Interest; Waterfall; GP Catch Up; Escrow.*

**Closed End Fund.** A fund with a fixed term, a defined investment period, and no ability for investors to redeem their interests on demand. After the investment period expires, the fund manages existing assets through the holding period and returns capital to investors through asset sales or refinancings, ultimately winding down at the end of the fund's term. Closed end structures are standard for illiquid asset classes such as private real estate, where the



investment strategy requires a defined hold period that cannot accommodate investor redemption requests.

*See also: Term; Investment Period; Open End Fund; Evergreen Fund.*

**Co-investment.** An opportunity for one or more LPs to invest additional capital directly alongside the fund in a specific deal, on a deal by deal basis and typically on more favorable economic terms (reduced or no management fee, reduced or no carried interest). Co-investment rights are often negotiated at the time of an LP's fund commitment, included in side letters, and subject to the LPAC's oversight of conflicts of interest when the co-investing LP's terms differ from other investors. Co-investments must be disclosed to the LPAC and, where the ILPA standards apply, to all LPs.

*See also: Side Letter; LPAC; Conflicts of Interest.*

**Committed Capital.** See: *Capital Commitment.*

**Conflicts of Interest.** Circumstances in which the GP's, Manager's, or their affiliates' financial interests diverge from the fund's or LPs' interests, creating the potential for the GP to act in its own interest at LPs' expense. Common conflicts include affiliated service provider arrangements (where the GP's affiliate provides property management, construction management, or other services to the fund); allocation of investment opportunities between the fund and other managed vehicles; timing of fund expenses; and related party transactions. Material conflicts must be disclosed in the PPM. Ongoing conflicts require LPAC approval in institutional grade fund documents.

*See also: LPAC; Related Party Transaction; Side Letter; PPM.*

**Continuation Fund.** A new fund vehicle created to hold and continue managing select assets from an existing fund beyond that fund's original term. Continuation funds allow GPs to avoid forced sales while giving existing LPs the option to either cash out at the continuation fund's pricing or roll over their investment into the new vehicle on updated terms. Continuation funds present inherent conflicts of interest. The GP sits on both sides of the transaction, setting the valuation at which LPs sell and new investors buy, and these structures require robust independent valuation, full disclosure, and LP consent processes. ILPA has published specific guidance on continuation fund structuring and disclosure best practices.

*See also: ILPA Principles; Term; Valuation.*

**Cost Segregation.** A tax strategy in which a real estate investor engages an engineering firm to reclassify building components from 39 year (commercial) or 27.5 year (residential) depreciable life to shorter lived 5 year, 7 year, or 15 year depreciable categories. The reclassification accelerates depreciation deductions into earlier tax years, creating a current year tax benefit for investors. The Tax Cuts and Jobs Act of 2017 enabled 100 percent bonus

depreciation of qualifying components placed in service through 2022, with phase down to 80 percent in 2023, 60 percent in 2024, and 40 percent scheduled for 2025. The One Big Beautiful Bill Act (OBBBA), signed into law on July 4, 2025, permanently restored 100 percent bonus depreciation for qualified property acquired and placed in service after January 19, 2025. Cost segregation produces significant Section 1245 depreciation recapture at ordinary income tax rates (up to 37 percent) upon sale of the property, which must be specifically disclosed to investors in the PPM.

*See also: Depreciation; Depreciation Recapture; Section 1245; Basis.*

## D

**Deal by Deal Syndication.** A capital raising structure in which investors evaluate and commit to each specific investment separately, rather than committing to a blind pool fund in advance of investments being identified. Deal by deal structures allow investors to apply their own underwriting judgment to each opportunity, but require the sponsor to conduct a new capital raise for each acquisition, a process that takes time, can cause deals to be lost if capital is not available quickly, and involves higher per transaction compliance costs.

*See also: Blind Pool; Syndication; Closed End Fund.*

**Debt Service Coverage Ratio (DSCR).** A measure of a property's ability to service its debt, calculated by dividing the property's net operating income (NOI) by its total annual debt service (principal and interest payments). A DSCR of 1.0x means the property generates exactly enough income to cover its debt payments. Lenders typically require DSCRs of 1.20x to 1.35x or higher as a condition of financing. DSCR is monitored by lenders as a covenant throughout the loan term and tested at refinancing.

*See also: Net Operating Income; Leverage; Loan to Value Ratio.*

**Deed in Lieu of Foreclosure.** An arrangement in which a borrower conveys title to real property directly to the lender in exchange for release from the mortgage loan obligation, as an alternative to formal foreclosure proceedings. A deed in lieu can reduce the cost and time of resolution compared to foreclosure, but the lender must accept it voluntarily and it typically requires that no junior liens encumber the property. For fund investors, a deed in lieu may produce phantom income (taxable gain recognized on the deemed disposition of the property even though no cash was received) based on the amount of debt forgiven relative to the property's adjusted tax basis.

*See also: Foreclosure; Phantom Income; Non-Recourse Carveouts.*

**Defaulting Partner.** A limited partner who fails to fund a required capital call within the cure period specified in the fund agreement (typically 5 to 10 business days after a default notice). The fund agreement typically provides a range of remedies against a defaulting partner,



including suspension of distribution and voting rights, forced sale of the defaulting partner's interest at a discount (commonly 50 percent to 75 percent of fair value), forfeiture of a portion of the interest, and legal action for the defaulted amount plus interest. The specific remedies must be specifically documented in the fund agreement to be enforceable.

*See also: Capital Call; Fund Agreement.*

**Depreciation.** A noncash tax deduction that allows a real estate investor to recover the cost of income producing property over its IRS defined useful life: 39 years for commercial real estate and 27.5 years for residential rental property. Depreciation reduces an investor's taxable income from the property during the hold period, creating a tax shield that is one of the primary tax advantages of real estate investment. Upon sale, depreciation that has been claimed must be recaptured: Section 1250 recapture on real property structures is taxed at a maximum 25 percent rate, while Section 1245 recapture on cost segregated components is taxed at ordinary income rates up to 37 percent.

*See also: Depreciation Recapture; Cost Segregation; Basis; Section 1250; Section 1245.*

**Depreciation Recapture.** The portion of gain recognized on the sale of depreciable real property that is attributable to prior depreciation deductions and is taxed at rates higher than the standard long term capital gains rate. Section 1250 recapture applies to straight line depreciation on real property structures and is taxed at a maximum federal rate of 25 percent. Section 1245 recapture applies to accelerated depreciation on personal property components reclassified through cost segregation studies and is taxed at ordinary income rates up to 37 percent. Sponsors who have pursued aggressive cost segregation strategies must disclose the recapture consequence with the same specificity as the depreciation benefit in the PPM.

*See also: Section 1245; Section 1250; Depreciation; Cost Segregation; Basis.*

**Disposition Fee.** A fee paid to the GP, Manager, or an affiliate upon the sale, transfer, or other disposition of a fund asset, typically calculated as a percentage of the gross sale price (commonly 1 percent to 2 percent). Similar to an acquisition fee, it compensates the sponsor for managing the disposition process, including broker selection, negotiation of the purchase agreement, due diligence coordination, and closing. Disposition fees must be disclosed in the PPM and are subject to fee offset provisions where applicable.

*See also: Acquisition Fee; Management Fee Offset; Fee Income.*

**Distribution.** A payment made by the fund to investors, either in cash or in kind. Distributions may represent a return of capital (returning previously contributed equity without taxable gain), a return on capital (distributing profits, which may be taxable), or proceeds from a sale or refinancing. The timing and priority of distributions are governed by the waterfall provisions of the fund agreement. Operating distributions during the hold period are typically funded from

property level cash flow above debt service and operating reserves. Disposition distributions are funded from asset sale or refinancing proceeds.

*See also: Waterfall; Preferred Return; Return of Capital; Return on Capital.*

**Drawdown.** See: *Capital Call*.

**Dry Powder.** Capital that investors have committed to a fund but that has not yet been drawn through capital calls. That is, the aggregate unfunded commitments available for investment. Dry powder represents the fund's remaining investment capacity and is an important metric for understanding a sponsor's deployment timeline.

*See also: Capital Commitment; Capital Call.*

**DST (Delaware Statutory Trust).** A legal entity created under Delaware law that is used to hold real estate for investment purposes. Interests in a DST qualify as real property interests for purposes of Section 1031 like kind exchange (per Revenue Ruling 2004-86), making DSTs a commonly used vehicle for investors seeking to defer capital gains through a 1031 exchange by investing in a fractional interest in a single property. DST interests are securities and must be offered through a valid exemption or registration. DST structures impose significant operating restrictions: the trust generally cannot renegotiate loan terms, accept new contributions after closing, or make substantial changes to the property, which distinguish them from conventional LLC structures.

*See also: 1031 Exchange; TIC; Securities Act.*

## E

**Effectively Connected Income (ECI).** Income earned by a non U.S. person that is treated as effectively connected with the conduct of a trade or business within the United States and subject to U.S. federal income tax at regular rates (rather than flat withholding rates). Real estate rental income can constitute ECI for non U.S. investors if the fund is engaged in the active conduct of a U.S. real estate business. Blocker entities are commonly used to prevent ECI from flowing directly through to non U.S. investors.

*See also: Blocker Entity; FIRPTA; Non U.S. Investor; Section 1446.*

**Employer Identification Number (EIN).** A unique nine digit tax identification number assigned by the IRS to entities such as partnerships, corporations, and LLCs for use in tax filings, financial accounts, and other reporting. Each fund entity, each property owning SPV, and the GP entity must have a separate EIN.

**ERISA (Employee Retirement Income Security Act of 1974).** The federal statute governing most voluntarily established private sector retirement plans, including corporate pension plans, 401(k) plans, and profit sharing plans. ERISA imposes a demanding fiduciary standard on those

who manage retirement plan assets, a set of prohibited transaction rules under ERISA Section 406, and comprehensive reporting and disclosure requirements. When a private fund's assets are deemed plan assets under the Plan Asset Regulations (29 C.F.R. § 2510.3-101, as modified by Section 3(42) of ERISA), the fund manager becomes an ERISA fiduciary subject to all of ERISA's requirements, including the prohibited transaction rules that restrict affiliated party transactions common in real estate funds.

*See also: Benefit Plan Investor; Plan Asset Regulations; 25 Percent Benefit Plan Investor Limitation; VCOC; REOC.*

**Escrow.** Cash or other property held by a neutral third party (the escrow agent) pending satisfaction of specified conditions. In real estate fund contexts, escrow is used in multiple ways. Purchase escrows hold earnest money deposits pending closing. Clawback escrows hold a portion of the GP's carried interest distributions as security for the GP's clawback obligation. FIRPTA withholding escrows hold withheld amounts pending IRS processing.

*See also: Clawback; FIRPTA.*

**European Waterfall.** A distribution methodology in which all returns are pooled across the fund's entire portfolio before the GP receives any carried interest. LPs must first receive back all invested capital across all investments, plus the full preferred return on all capital contributed, before the GP participates in any profits. The European waterfall is more LP protective than the American (deal by deal) waterfall because the GP's promote is calculated on the fund's aggregate performance rather than on each individual deal's performance. Institutional investors generally prefer European waterfall structures.

*See also: American Waterfall; Waterfall; Preferred Return; Carried Interest.*

**Evergreen Fund.** An open ended fund with no fixed termination date, designed to operate indefinitely. Capital returned from realized investments is typically recycled into new investments, allowing the fund to grow continuously. Evergreen structures require mechanisms for managing investor entry and exit, including NAV based subscription and redemption programs, and may use lockup periods and gates to manage liquidity risk. Interval funds are a registered form of evergreen fund structure.

*See also: Open End Fund; Interval Fund; Gate; NAV; Lockup Period.*

**Exempt Reporting Adviser (ERA).** An investment adviser that is exempt from full SEC registration under Section 203(l) (venture capital fund adviser exemption) or Section 203(m) (private fund adviser exemption, available to advisers with less than \$150 million in regulatory assets under management from U.S. clients) of the Investment Advisers Act. ERAs must file annual reports on Form ADV with the SEC but are subject to fewer ongoing compliance requirements than fully registered investment advisers. Sponsors approaching \$100 million in regulatory AUM should plan for the transition to full SEC registration.

*See also: Investment Advisers Act; Form ADV; Registered Investment Adviser.*

## F

**Fee Income.** All directors' fees, transaction fees, monitoring fees, advisory fees, consulting fees, breakup fees, and similar compensation received by the GP, Manager, or their affiliates in connection with the fund's investment activities. Under ILPA Principles and the ILPA Model LPA, 100 percent of fee income is required to be offset against the management fee, carried forward to subsequent periods where fee income exceeds the current period's management fee. Fee income disclosure must appear in the PPM and be reported annually to the LPAC.

*See also: Management Fee Offset; Acquisition Fee; LPAC; ILPA Principles.*

**Feeder Fund.** A separate fund entity that pools investor capital and channels it into a larger master fund. Feeder funds are used to accommodate investors with different tax, regulatory, or currency requirements. For example, an offshore feeder for non U.S. investors and a domestic blocker feeder for tax exempt U.S. investors, both investing alongside a domestic onshore fund in the same master fund.

*See also: Master Fund; Blocker Entity.*

**Final Closing Date.** The deadline after which no new investors may be admitted to a closed end fund. All LPs who join after the initial closing and before the final closing date are typically required to make an equalization payment, funding the same proportion of capital that would have been called if they had been admitted on the initial closing date, plus an additional interest payment at a defined rate to compensate earlier investors for the time value of money.

*See also: Initial Closing Date; Equalization Payment.*

**Finder.** An individual or entity who introduces investors to a securities offering. A finder who receives transaction based compensation tied to the amount of capital raised is performing broker dealer functions and must be registered as a broker dealer or associated with a registered broker dealer under Section 15(a) of the Securities Exchange Act. The SEC Division of Corporation Finance issued a no action letter on March 12, 2025, providing a limited framework under which certain finder activities may be conducted without broker dealer registration, subject to specific conditions. Paying unregistered finders outside that framework creates rescission rights for investors they introduced and regulatory exposure for both the finder and the issuer. Uncompensated introductions from personal network contacts (where no compensation of any kind is linked to the investment amount) are analyzed differently but should still be reviewed by securities counsel before implementation.

*See also: Broker Dealer; Placement Agent; Section 15(a); 506(b); 506(c).*

**FINRA (Financial Industry Regulatory Authority).** The self-regulatory organization that oversees broker dealers in the United States. FINRA registers broker dealers, their associated persons, and their representatives; establishes conduct rules; and enforces compliance with those rules. Placement agents must be FINRA registered broker dealers. FINRA's BrokerCheck database allows issuers and investors to verify the registration status and disciplinary history of broker dealers and their associated persons.

*See also: Broker Dealer; Placement Agent.*

**FIRPTA (Foreign Investment in Real Property Tax Act).** A U.S. federal law requiring withholding of U.S. income tax on dispositions by foreign persons of U.S. real property interests. Under FIRPTA, when a foreign investor receives proceeds from the sale of a U.S. real property interest (including a partnership interest in a fund that holds U.S. real property) the fund is required to withhold a percentage of the distribution and remit it to the IRS. Withholding obligations for partnerships with foreign partners arise primarily under Section 1446. Section 1446(a) requires withholding on effectively connected income at 21 percent for corporate foreign partners and at 37 percent for non-corporate foreign partners. Section 1446(f), enacted as part of the Tax Cuts and Jobs Act of 2017, requires 10 percent withholding on secondary market transfers of interests in partnerships that hold U.S. real property. FIRPTA provisions must be addressed in the fund agreement and the fund's investor onboarding process.

*See also: Effectively Connected Income; UBTI; Blocker Entity; Section 1446.*

**Follow On Investment.** Additional capital deployed into a property or asset already held by the fund, typically to fund capital improvements, renovations, refinancings, or to exercise an expansion option. The fund agreement specifies whether follow on investments require a capital call, may be funded from reserves or recycled capital, and whether they may be made after the expiration of the investment period.

*See also: Capital Call; Recycling; Reserves.*

**Form ADV.** The registration form that investment advisers must file with the SEC or state securities regulators. Form ADV Part 1 provides information about the adviser's business, ownership, clients, and disciplinary history. Form ADV Part 2 (the brochure) describes the adviser's services, fees, conflicts of interest, and investment strategies in narrative form and must be provided to advisory clients. ERAs file a limited version of Form ADV. Fully registered investment advisers must file and update Form ADV annually and provide clients with the brochure.

*See also: Registered Investment Adviser; Exempt Reporting Adviser; Investment Advisers Act.*

**Form D.** A brief notice filing required by the SEC when a company or fund conducts a private securities offering under Regulation D. Form D discloses basic information about the offering, including the exemption relied upon, the date and amount of the first sale, the names and

addresses of key persons, and the total offering size. Form D must be filed electronically with the SEC within 15 calendar days of the first sale of securities. Most states require a state level Form D filing as part of the blue sky notice process. Annual amendments are required for offerings that remain open more than one year.

*See also: Regulation D; Blue Sky Filings; 506(b); 506(c).*

**Form 1065.** The U.S. Return of Partnership Income filed annually by the fund with the IRS, reporting the fund's income, deductions, gains, losses, credits, and each partner's distributive share. The fund's tax adviser prepares Form 1065 and the related Schedule K-1s that are delivered to each investor. The 90 day delivery deadline in the ILPA Model LPA aligns with the practical timeline for preparing and delivering Form 1065 and K-1s.

*See also: K-1; Partnership Tax Audit Rules.*

**Fund Administration.** The operational function of maintaining the fund's financial records, capital accounts, distribution calculations, waterfall computations, investor reporting, and tax document preparation. Fund administration may be performed internally by the sponsor or outsourced to a third party fund administrator. Third party fund administration reduces the risk of calculation errors, provides an independent check on the accuracy of distributions and capital account balances, and is increasingly expected by institutional investors as a matter of operational due diligence.

*See also: Fund Administrator; K-1; Waterfall; NAV.*

**Fund Expenses.** Costs that are borne by the fund itself, and thus allocated among all investors proportionally, rather than by the GP personally. Common fund expenses include legal fees, audit fees, due diligence costs, regulatory filing fees, fund administration fees, custody fees, D and O insurance premiums, and broken deal expenses. The fund agreement defines specifically which categories of expenses are chargeable to the fund. The GP's internal overhead (salaries, rent, and general operating costs) are typically GP expenses borne exclusively by the GP out of its management fee.

*See also: GP Expenses; Management Fee; Organizational Expenses.*

**Fund of Funds.** An investment vehicle that allocates its capital across multiple underlying funds rather than making direct investments in properties or other assets. A real estate fund of funds provides investors with diversified exposure across multiple managers, strategies, and vintages but adds an additional layer of fees above the underlying fund fees.

## G

**Gate.** A contractual provision in an open end or evergreen fund that limits the total amount of capital investors can redeem during any given redemption period (typically expressed as a



percentage of NAV, commonly 5 percent to 25 percent per quarter). Gates prevent a run on the fund that could force the GP to sell assets at inopportune times to fund redemptions. The redemption gating events at several large non-traded REITs in 2023 and 2024 highlighted the importance of ensuring that redemption programs are designed to match the liquidity profile of the underlying assets.

*See also: Open End Fund; Evergreen Fund; NAV; Lockup Period; Redemption.*

**General Partner (GP).** The entity responsible for managing a fund structured as a limited partnership. The GP has broad authority to make investment decisions, manage fund operations, call capital from LPs, and bind the fund in contracts. The GP earns management fees and carried interest as compensation. Unlike LPs, whose liability is limited to their capital contribution, the GP bears unlimited personal liability for the fund's obligations under limited partnership law (though this is typically managed by structuring the GP as an LLC). See also Manager, for the equivalent role in an LLC structure.

*See also: Manager; Management Fee; Carried Interest; Limited Partner.*

**General Solicitation.** Public marketing or advertising of a securities offering to persons with whom the issuer has no pre-existing substantive relationship. Rule 506(b) categorically prohibits general solicitation. Any act of general solicitation in a purported 506(b) offering invalidates the exemption for all investors admitted after the solicitation occurs. Examples of general solicitation include publicly accessible websites describing an investment opportunity, social media posts discussing the offering, mass emails to recipients without pre-existing relationships, and pitches at publicly advertised events. Sponsors who wish to publicly market an offering must use Rule 506(c), which permits general solicitation but requires documented verification of every investor's accredited status.

*See also: 506(b); 506(c); Pre-existing Substantive Relationship; Accredited Investor.*

**GP Catch Up.** A distribution provision that allows the GP to receive an accelerated share of profits after LPs have received their full preferred return, until the GP has received its full carried interest percentage on the cumulative distributions. For example, if the preferred return is 8 percent and the carry is 20 percent with a full catch up, after LPs receive their 8 percent preferred return, 100 percent of further distributions go to the GP until the GP has received 20 percent of the total distributions paid (representing the GP's share of preferred return tier plus promote tier combined). After the catch up, subsequent distributions flow 80 percent to LPs and 20 percent to the GP. The catch up calculation must be precisely specified in the fund agreement to avoid disputes.

*See also: Carried Interest; Waterfall; Preferred Return.*

**GP Commitment.** The GP's own capital contribution to the fund, demonstrating alignment of interest with LPs. GP commitments are typically between 1 percent and 5 percent of total fund

commitments for emerging managers and may be higher for institutional grade funds where ILPA Principles encourage GP co-investment. The GP commitment is subject to the same terms as LP contributions, including the preferred return, the waterfall, and the clawback.

*See also: Carried Interest; Clawback; ILPA Principles.*

**GP Expenses.** Costs incurred by the GP in connection with its operations that are borne by the GP itself, out of its management fee, rather than charged to the fund. Under the ILPA Model LPA and ILPA Principles, GP expenses explicitly include the GP's internal compliance costs, salaries and compensation of investment personnel, office space and overhead, entertainment expenses, and costs of maintaining investment adviser registration. The boundary between fund expenses and GP expenses must be clearly defined in the fund agreement. Misclassification of GP expenses as fund expenses is a common source of investor disputes.

*See also: Fund Expenses; Management Fee.*

**GP Removal Clause.** A provision in the fund agreement giving LPs the right to remove the GP either for cause (upon occurrence of specified removal conduct including fraud, gross negligence, material breach, or regulatory violations) or without cause (upon a supermajority vote of LPs, typically 75 percent in interest under ILPA model standards, without the need to prove misconduct). Removal for cause typically results in immediate termination of management fees and forfeiture of future carried interest. Removal without cause typically results in termination of management fees and a reduced carried interest on prior investments. No fault removal rights are required by most institutional LPs and reflect market standard in ILPA aligned fund documents.

*See also: No Fault Divorce; ILPA Principles; Removal Conduct.*

**Gross Asset Value (GAV).** The total fair market value of a fund's assets before deducting liabilities. GAV is used as the basis for management fee calculations in some fund structures and as a measure of total portfolio scale. Contrast with Net Asset Value (NAV), which deducts the fund's liabilities.

*See also: Net Asset Value; Management Fee; Valuation.*

## H

**Howey Test.** The four part legal test established by the Supreme Court in SEC v. W.J. Howey Co., 328 U.S. 293 (1946), for determining whether an arrangement constitutes an investment contract and therefore a security subject to federal securities laws. Under the Howey Test, an arrangement is an investment contract (and a security) if it involves: (1) an investment of money; (2) in a common enterprise; (3) with an expectation of profits; (4) derived solely from the efforts of others (the promoter or a third party). All four elements must be present. Real estate syndications satisfy the Howey Test because investors expect profits derived from the sponsor's



management and operational efforts. The Howey Test is also used to distinguish joint ventures (where all parties have active management roles) from syndications (where investors are passive).

*See also: Security; Investment Contract; Syndication; Joint Venture.*

**Hurdle Rate.** See: *Preferred Return.*

## I

**ILPA (Institutional Limited Partners Association).** A global organization representing more than 7,000 investment professionals across 52 countries, drawn from over 600 member institutions that collectively manage approximately half of the world's institutional private market assets. ILPA publishes industry standards that define institutional market expectations for fund governance, economics, and reporting, including the ILPA Principles, the ILPA Model Limited Partnership Agreement (October 2019), the ILPA DDQ 2.0 (Due Diligence Questionnaire), and the ILPA Reporting Template. Familiarity with ILPA standards is essential for sponsors seeking to raise institutional capital. ILPA's resources are publicly available at [ilpa.org](http://ilpa.org).

*See also: ILPA Principles; LPAC; Management Fee Offset.*

**ILPA Principles.** Published guidelines developed by ILPA to define best practices for private fund governance, economics, and transparency. ILPA Principles are organized around three pillars: alignment of interest, governance, and transparency. They address fund and GP economics (including fee offset, clawback, and carried interest structure), fund terms and structure, key person provisions, fund governance (including LPAC authority and GP removal rights), financial disclosures, and LP information rights. Fund documents that reflect ILPA Principles on governance and fee offset are generally required for institutional capital allocation.

*See also: ILPA; Management Fee Offset; Clawback; LPAC; GP Removal Clause.*

**Initial Closing Date.** The date on which the first group of LPs are formally admitted to the fund, their capital commitments are accepted, and the fund begins its legal existence as an active vehicle. The fund may conduct multiple subsequent closings before the final closing date.

*See also: Final Closing Date; Equalization Payment.*

**Internal Rate of Return (IRR).** A measure of investment performance expressed as the annualized discount rate at which the net present value of all cash flows (contributions and distributions) equals zero. IRR accounts for the timing of cash flows. Earlier distributions produce higher IRRs than later distributions of the same total amount, all else equal. IRR is the most common performance metric in private real estate, but its sensitivity to the timing of early distributions (amplified by subscription line credit facilities) requires reporting alongside other metrics such as the equity multiple (MOIC).

*See also: Equity Multiple; J Curve; Track Record.*

**Interval Fund.** A closed end investment company registered under the Investment Company Act of 1940 that is designed to offer periodic, limited repurchases of shares at net asset value (typically on a quarterly basis), rather than providing continuous redemption availability. Interval funds are structured around the acknowledgment that the underlying assets are illiquid. The periodic repurchase offer is disclosed as the only exit mechanism, calibrating investor expectations accurately. Interval funds have become a preferred structure for semi institutional capital seeking real estate exposure through a vehicle with defined liquidity terms.

*See also: Non-traded REIT; Evergreen Fund; Gate; NAV.*

**Investment Adviser.** Any person who, for compensation, engages in the business of advising others as to the value of securities or the advisability of investing in, purchasing, or selling securities. Sponsors managing private investment funds (including private real estate funds) are generally investment advisers under the Investment Advisers Act of 1940 and must either register with the SEC (above the \$100 million regulatory AUM threshold) or qualify for an exemption such as the Exempt Reporting Adviser status (below \$150 million in regulatory AUM with only private fund clients) or the Venture Capital Adviser Exemption.

*See also: Investment Advisers Act; Registered Investment Adviser; Exempt Reporting Adviser; Form ADV.*

**Investment Advisers Act of 1940.** The federal statute regulating investment advisers in the United States. The Investment Advisers Act imposes a fiduciary duty on investment advisers to their clients, requires registration with the SEC (or relevant state securities regulators) above defined thresholds, and establishes requirements for written compliance programs, disclosure documents (Form ADV), recordkeeping, and antifraud compliance. Rule 206(4)-7 thereunder requires registered investment advisers to maintain a written compliance program and to designate a Chief Compliance Officer.

*See also: Registered Investment Adviser; Form ADV; Exempt Reporting Adviser.*

**Investment Company Act of 1940.** The federal statute regulating investment companies (vehicles whose primary business is investing, reinvesting, or trading in securities). Private real estate funds typically rely on exemptions from registration under the Investment Company Act, primarily Section 3(c)(1) (limit of 100 beneficial owners) or Section 3(c)(7) (qualified purchasers only), or Section 3(c)(5)(C) for funds primarily engaged in mortgage investments. Failure to qualify for an exemption requires full registration as an investment company, an extensive regulatory regime not feasible for private real estate funds.

*See also: 3(c)(1) Exemption; 3(c)(7) Exemption; 3(c)(5)(C) Exemption; Qualified Purchaser.*

**Investment Contract.** A category of security defined by the Howey Test. Any arrangement involving an investment of money in a common enterprise with an expectation of profits derived

solely from the efforts of others is an investment contract subject to the federal securities laws. Real estate syndications are investment contracts. The investment contract analysis is also central to the SEC and CFTC's Joint Interpretation of digital assets and the application of the Howey Test to tokenized real estate securities.

*See also: Howey Test; Security; Syndication.*

**Investment Period.** The defined period during which the GP is authorized to call capital from LPs to fund new investments, typically two to five years from the initial closing date. Capital not deployed during the investment period generally may not be called for new investments after the period expires, though it may still be called for follow on investments in existing assets, fund expenses, or to fund clawback obligations. The investment period's expiration shifts the fund into the holding and disposition phase.

*See also: Capital Call; Term; Key Person Event; Successor Fund.*

## J

**J Curve.** The characteristic pattern of investment returns in a closed end fund over its life, in which early period returns are negative (reflecting management fees, organizational expenses, and the underperformance of unrealized early investments) before rising steeply as assets mature, are marked up, and are ultimately realized at exit. The J curve illustrates why IRR measured at early points in a fund's life is not predictive of ultimate performance and why vintage year comparisons between funds require full cycle data.

*See also: IRR; Vintage Year; Track Record.*

**Joint Venture.** A business arrangement between two or more parties who each have an active, defined management role in the investment. The key legal distinction between a joint venture and a syndication is the Howey Test's fourth element. In a properly structured joint venture, all participants have genuine active management roles and do not rely solely on the efforts of others for their expected return, so the arrangement does not constitute a securities offering. Joint ventures typically involve a small number of sophisticated parties, are less expensive to form than securities offerings, and do not require a securities exemption. However, a transaction labeled a joint venture whose capital partner has no genuine management role is a securities offering in substance regardless of its label.

*See also: Howey Test; Syndication; Security.*

## K

**K-1 (Schedule K-1).** The annual tax form issued by the fund to each investor, reporting that investor's allocable share of the fund's income, gains, losses, deductions, and credits for the tax year. Investors use their K-1s to complete their own federal and state tax returns. Fund

agreements typically require K-1 delivery within 90 days of the fund's fiscal year end. Delay in K-1 delivery is a common source of investor complaints and late tax filing obligations.

*See also: Form 1065; Partnership Tax Audit Rules; FIRPTA.*

**Key Person Event.** An event triggered when one or more designated key persons ceases to devote the required time and attention to the fund (typically due to death, disability, resignation, or termination) or when a change of control of the GP or fund manager occurs without LP approval. Upon a key person event, the investment period is automatically suspended pending a Majority in Interest vote approving a remediation plan. If no remediation plan is approved within the specified cure period (typically 90 days under ILPA model standards), the investment period terminates automatically. Key person provisions must identify the specific individuals whose involvement is essential, the minimum time commitment required, and the precise triggering events.

*See also: Key Persons; GP Removal Clause; Investment Period; Change of Control.*

**Key Persons.** Individuals identified by name in the fund agreement whose active involvement is considered essential to the fund's investment strategy and operations. Key persons are typically the senior investment professionals primarily responsible for sourcing deals, making investment decisions, and managing the portfolio. Departure of a key person triggers a key person event. Institutional investors scrutinize key person provisions carefully, paying particular attention to whether the designated individuals are the same people who generated the fund's track record.

*See also: Key Person Event; Track Record.*

## L

**Late Admission Fee.** An amount paid by LPs admitted to a closed end fund after the initial closing, calculated to place them in an equivalent economic position as if they had been admitted at the initial closing. The late admission fee has two components: an equalization payment (funded share of capital already called) and an additional interest payment (typically at the fund's preferred return rate) on the equalization amount, compensating earlier investors for the time value of money during the period before the late closing LP was admitted.

*See also: Equalization Payment; Initial Closing Date; Final Closing Date.*

**Limited Partner (LP).** A passive investor in a fund structured as a limited partnership. LPs contribute capital and share in the fund's profits and losses but do not participate in day to day management and do not have authority to bind the fund. LPs' liability is generally limited to the amount of their capital commitment. They cannot lose more than they have invested. LPs receive distributions according to the waterfall, K-1s annually, and periodic reporting from the GP.

*See also: General Partner; Waterfall; LPAC.*

**Limited Partnership Agreement (LPA).** The primary governing document for a fund structured as a limited partnership. The LPA sets out the rights and obligations of the GP and LPs, the fund's investment strategy, term, fee structure, distribution waterfall, reporting obligations, LP protections, transfer restrictions, and all other key terms. The ILPA Model LPA (October 2019) represents the institutional market standard for LPA structure and is publicly available at [ilpa.org](http://ilpa.org). See also Operating Agreement, for the equivalent document in an LLC structure.

*See also: Operating Agreement; ILPA Principles; LPAC; Waterfall.*

**Loan to Value Ratio (LTV).** The ratio of the loan amount to the appraised value of the property securing the loan, expressed as a percentage. A property appraised at \$10 million with a \$7 million mortgage has an LTV of 70 percent. Lenders use LTV as a primary underwriting metric, with maximum LTVs varying by property type, market, and lender. A higher LTV increases equity returns in a rising market (leverage amplifies gains) but increases the risk of loss in a declining market (leverage amplifies losses). Loan covenants frequently include minimum LTV or maximum LTV maintenance tests.

*See also: Debt Service Coverage Ratio; Leverage; Capital Stack.*

**Lockup Period.** A period during which LPs in an open end or evergreen fund are contractually restricted from requesting redemptions of their capital. Lockup periods give the GP time to deploy capital into illiquid investments before managing redemption requests. Common lockup structures include a one year lockup from the date of initial investment, after which investors may request redemptions subject to any applicable gates.

*See also: Evergreen Fund; Gate; Redemption.*

**LP Advisory Committee (LPAC).** A committee composed of representatives from a select group of LPs (typically the fund's largest or most sophisticated investors) that provides oversight and approval authority on specified matters, including conflicts of interest, related party transactions, valuation disputes, extensions of the fund's term, and certain amendments to the fund agreement. Under ILPA Principles and the ILPA Model LPA, the LPAC has meaningful approval authority (not merely advisory status) over these matters. The LPAC does not manage the fund and does not make investment decisions. Its authority is limited to the specific governance matters designated in the fund agreement.

*See also: ILPA Principles; Conflicts of Interest; Valuation; Side Letter.*

## M

**Management Fee.** A recurring fee paid by the fund or directly by LPs to the GP or Manager as compensation for managing the fund. Management fees are typically calculated as an annual percentage of committed capital during the investment period (commonly 1.5 percent to 2.0 percent) and step down to a percentage of invested capital after the investment period expires (commonly 1.0 percent to 1.5 percent). The ILPA Model LPA requires 100 percent fee offset of fee income received by the GP or its affiliates from fund related activities against the management fee.

*See also: Management Fee Offset; Fee Income; Investment Period; ILPA Principles.*

**Management Fee Offset.** A provision reducing the management fee by some or all of the fee income received by the GP or its affiliates from the fund or its portfolio investments. Fee income subject to offset includes acquisition fees, disposition fees, monitoring fees, directors' fees, and other transaction related compensation. Under ILPA Principles, 100 percent of such fee income should offset the management fee. The fee offset provision prevents the GP from earning both the management fee and transaction level compensation for the same services. The fund agreement must specify the percentage of fee income subject to offset; whether the offset applies at the fund level or the LP level; and how excess fee income (above the current management fee) is carried forward.

*See also: Management Fee; Fee Income; ILPA Principles.*

**Manager.** The entity responsible for managing a fund structured as a limited liability company (LLC). The Manager performs the same role as a GP in a limited partnership structure, making investment decisions, managing fund operations, earning management fees and carried interest, but within the governance framework of the LLC operating agreement rather than the LPA.

*See also: General Partner; Operating Agreement.*

**Material Misrepresentation.** A false statement of fact, or an omission of a material fact necessary to make other statements not misleading, made in connection with the offer or sale of a security. A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. Material misrepresentations violate the antifraud provisions of the Securities Act and the Exchange Act, regardless of whether the offering is exempt from registration. Common sources of material misrepresentation in private real estate offerings include overstated track records, unsupported return projections, undisclosed conflicts of interest, and failure to update the PPM for material developments after it was prepared.

*See also: Antifraud Provisions; Rule 10b-5; PPM.*

**Master Fund.** The central investment entity into which one or more feeder funds channel their capital. The master fund makes the actual investments while feeder funds accommodate investors with different tax, regulatory, or currency requirements.

*See also: Feeder Fund; Parallel Fund.*

**Mezzanine Financing.** Debt or quasi equity financing that occupies a position in the capital stack between senior secured debt and common equity. Mezzanine debt is typically unsecured or secured by a pledge of the borrower entity's membership interests rather than a direct mortgage on the property. Preferred equity, while technically equity rather than debt, occupies a similar position in the return hierarchy. Both mezzanine debt and preferred equity carry higher interest rates than senior debt to compensate for their subordinated position.

*See also: Capital Stack; Preferred Equity; Senior Debt.*

**Most Favored Nation (MFN) Provision.** A side letter or fund agreement provision giving an LP the right to receive the benefit of any more favorable economic or other terms offered to any other LP in the same fund, subject to specified exceptions for anchor investors, minimum commitment tiers, or regulatory or tax specific accommodations. MFN provisions prevent the GP from offering materially better terms to preferred investors without extending those terms to other investors entitled to MFN treatment. The ILPA Model LPA's Section 20.6.2 addresses the MFN framework for side letters.

*See also: Side Letter; ILPA Principles; LPAC.*

## N

**NASAA (North American Securities Administrators Association).** The organization of securities regulators from the U.S., Canada, and Mexico, focused on investor protection and the coordination of state level securities regulation. NASAA maintains the Electronic Filing Depository (EFD), which accepts Form D filings and blue sky notice submissions from many participating states.

*See also: Blue Sky Filings; Blue Sky Laws.*

**Net Asset Value (NAV).** The net value of a fund's assets after deducting liabilities, calculated by subtracting total liabilities (including fund level debt) from total assets valued at fair market value. NAV represents the theoretical value of all investors' interests in the fund and is used as the basis for subscription pricing and redemption pricing in open end and interval fund structures. In closed end funds, NAV is reported to investors quarterly but does not serve as a transaction price.

*See also: Gross Asset Value; Valuation; Open End Fund; Interval Fund.*



**Net Operating Income (NOI).** A property's gross revenue less operating expenses, excluding debt service, depreciation, income taxes, and capital expenditures. NOI is the primary metric used to value income producing real estate through cap rate analysis and to assess a property's debt service coverage capacity. NOI equals Effective Gross Income minus Operating Expenses.

*See also: Capitalization Rate; Debt Service Coverage Ratio; Underwriting.*

**No Fault Divorce.** An informal term for a GP removal without cause provision: the right of a supermajority of LPs (typically 75 percent in interest under ILPA standards) to remove the GP without proving misconduct, fraud, or other cause. Upon a no fault removal, the GP generally retains a reduced carried interest on existing investments but forfeits future promote economics. No fault removal rights are a core institutional LP governance requirement.

*See also: GP Removal Clause; ILPA Principles; Carried Interest.*

**Non-Recourse Carveouts (Bad Boy Guarantees).** Personal guarantees from the GP or key principals that convert a Non-Recourse real estate loan into a recourse obligation upon the occurrence of specified bad boy acts. Carveout obligations typically fall into two categories: events that trigger full personal liability for the entire loan (such as fraud, intentional misrepresentation to the lender, voluntary bankruptcy filing, or unauthorized transfers) and events that trigger liability only for actual losses caused (such as misapplication of insurance proceeds or failure to maintain property insurance). Violating Non-Recourse carveout provisions can transform a limited liability investment into a personally guaranteed obligation for the GP and key principals.

*See also: General Partner; Recourse Debt.*

**Non-traded REIT.** A real estate investment trust whose shares are registered with the SEC for public offering but are not listed on a national securities exchange. Non-traded REITs offer retail investor access to real estate portfolios with periodic income distributions, without the daily price volatility of listed REITs, but also without the continuous liquidity of exchange traded shares. Investors can typically exit only through periodic redemption programs (subject to gates), secondary market transactions at a discount, or eventual liquidity events such as a listing or merger.

*See also: REIT; Gate; NAV; Interval Fund.*

## O

**Operating Agreement.** The primary governing document for a fund structured as a limited liability company (LLC). The operating agreement defines the manager's authority and obligations, the members' rights, the distribution waterfall, the fee structure, the governance framework, transfer restrictions, and dissolution procedures. It performs the same function as a limited partnership agreement in a limited partnership structure.



*See also: Limited Partnership Agreement; Waterfall; Manager.*

**Opportunity Zone.** A designated census tract in which investments made through a Qualified Opportunity Fund (QOF) may receive preferential tax treatment under Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code, enacted as part of the Tax Cuts and Jobs Act of 2017. Capital gains reinvested in a QOF within 180 days of realization receive temporary deferral of the original gain and potentially reduced gain recognition at the end of the deferral period. Gains from the QOF investment itself are permanently excluded from income if the investment is held for at least 10 years. QOF investments must be in Opportunity Zone property or Opportunity Zone businesses. There are specific requirements for the proportion of assets that must be located in the Opportunity Zone.

*See also: 1031 Exchange; Capital Gains.*

**Organizational Expenses.** Costs incurred in forming and establishing the fund, including legal fees for drafting fund documents, state formation and registration fees, and initial accounting setup costs. Fund agreements typically cap the amount of organizational expenses the fund will bear, with any excess borne by the GP. Under the ILPA Model LPA, placement agent fees are GP expenses rather than fund organizational expenses.

*See also: Fund Expenses; GP Expenses.*

## P

**Parallel Fund.** A separate investment vehicle that operates alongside the primary fund, invests in the same assets on substantially similar terms, and is created to accommodate specific investor groups (such as non U.S. investors, tax exempt entities, or investors subject to particular regulatory requirements). Parallel fund vehicles invest pro rata with the primary fund and share-expenses on the same proportional basis.

*See also: Master Fund; Feeder Fund; Blocker Entity.*

**Partnership Tax Audit Rules.** Provisions of the Bipartisan Budget Act of 2015 (effective for tax years beginning after December 31, 2017) that changed the audit and tax collection procedures for partnerships. Under the rules, the IRS generally assesses and collects any underpayment of tax resulting from a partnership audit at the partnership level (rather than from individual partners), unless the partnership makes a push out election requiring current and former partners to bear their share of the adjustment. Fund agreements designate a Partnership Representative (formerly the Tax Matters Partner) with authority to make elections and bind all partners in audit proceedings.

*See also: Form 1065; K-1.*

**Placement Agent.** A FINRA registered broker dealer engaged by the GP to assist in marketing the fund and raising capital from investors. Placement agents provide access to institutional investor relationships, manage the due diligence process on behalf of the manager, advise on fund positioning and terms, and facilitate introductions to LP prospects. Placement agents are compensated through a fee (typically 1 percent to 2 percent of capital committed by investors they introduce) which must be disclosed in the PPM. Placement agents soliciting government pension fund investors are subject to pay to play rules under SEC Rule 206(4)-5.

*See also: Broker Dealer; FINRA; Pay to Play; PPM.*

**Plan Asset Regulations.** The Department of Labor regulations (29 C.F.R. § 2510.3-101, as modified by ERISA Section 3(42)) governing when the underlying assets of a private investment fund are deemed to be plan assets of the ERISA investors who invest in it. When plan asset status applies, the fund manager becomes an ERISA fiduciary subject to the prudent expert standard and prohibited transaction rules. The primary exemptions from plan asset status are (1) the VCOC exception; (2) the REOC exception; and (3) the Insignificant Benefit Plan Investor exception (the 25 percent rule).

*See also: ERISA; Benefit Plan Investor; 25 Percent Benefit Plan Investor Limitation; VCOC; REOC.*

**Pre-existing Substantive Relationship.** A relationship between an issuer (or its agents) and a prospective investor that predates the offering, is genuinely substantive (based on meaningful information about the investor's financial situation and investment sophistication), and was not created for the purpose of conducting the specific offering. A pre-existing substantive relationship is the foundational requirement for including an investor in a Rule 506(b) offering without violating the prohibition on general solicitation. A recent connection on LinkedIn, a brief prior acquaintance at a conference, or a hasty questionnaire completed just before the offering launched do not constitute a pre-existing substantive relationship.

*See also: General Solicitation; 506(b).*

**Pre Negotiation Agreement (PNA).** An agreement between a borrower (or fund) and a lender establishing the ground rules for workout discussions, typically providing that neither party will assert estoppel or waiver claims based on communications during the negotiation period, that no agreement is binding until reduced to a signed definitive agreement, and that the existing loan terms remain in full force until a definitive agreement is reached. PNAs are commonly used in distressed real estate situations to create a protected negotiating environment.

*See also: Non-Recourse Carveouts; Deed in Lieu of Foreclosure.*

**Preferred Equity.** A form of investment that sits between senior debt and common equity in the capital stack, receiving distributions ahead of common equity holders but subordinate to senior debt. Preferred equity holders receive a defined preferred return (often 12 percent to 20 percent) before any distributions flow to common equity. Unlike mezzanine debt, preferred

equity is structured as an equity interest with preferred distribution rights rather than a debt obligation, though the economic effect is similar.

*See also: Capital Stack; Mezzanine Financing; Preferred Return.*

**Preferred Return.** A minimum annualized return that investors must receive on their contributed capital before the GP is entitled to any carried interest. Common preferred return rates in private real estate funds range from 6 percent to 8 percent per year. The preferred return may be structured as simple (accruing on contributed capital at a flat rate) or compound (accruing on the compounding balance of contributed capital plus unpaid prior period preferred return). The accrual basis (contributed capital versus unreturned capital) and the interaction between operating distributions and preferred return accrual must be precisely specified in the fund agreement to avoid disputes.

*See also: Carried Interest; Waterfall; GP Catch Up.*

**Private Placement Memorandum (PPM).** The comprehensive offering document provided to prospective investors in a private fund or syndication. The PPM describes the investment strategy, fund terms, fee structure, risk factors, conflicts of interest, management team backgrounds, and the legal structure of the offering. The PPM is the primary mechanism through which a private fund satisfies its antifraud disclosure obligations. Every material fact about the investment must be disclosed. The PPM is not filed with the SEC but may be reviewed in regulatory examinations. Risk factors in the PPM must be specific to the actual investment being offered. Generic risk factors that apply to any real estate investment do not satisfy the materiality and specificity requirements.

*See also: Antifraud Provisions; Subscription Agreement; Risk Factors; Material Misrepresentation.*

**Profits Interest.** An equity interest in a partnership or LLC that entitles the holder to a share of future profits or appreciation above the current value of the entity, but not a share of the entity's current capital. GPs typically receive carried interest in the form of a profits interest for tax efficiency purposes. At grant, a profits interest has no current liquidation value and is not taxable income. Subsequent gains attributable to the profits interest may qualify for capital gains tax treatment when the underlying assets have been held for the required period.

*See also: Carried Interest; Section 1061.*

**Promote.** Informal term for carried interest: the GP's or Manager's disproportionate share of profits above the preferred return, earned as performance based compensation. The term promote reflects the sponsor's promoted economic interest. On the promoted interest, the sponsor receives a larger percentage of returns than their percentage of contributed capital would otherwise warrant.

*See also: Carried Interest; Waterfall; Preferred Return.*

**Property Management Fee.** A recurring fee paid to the property manager (who may be an affiliate of the GP or a third party) for day to day management of the fund's properties, including rent collection, tenant relations, maintenance coordination, and operational oversight. Property management fees are typically calculated as a percentage of gross revenues collected (3 percent to 10 percent, varying by property type). Where an affiliate of the GP serves as property manager, the arrangement constitutes a conflict of interest and must be disclosed in the PPM.

*See also: Asset Management Fee; Conflicts of Interest; Fee Income.*

## Q

**Qualified Client.** A higher eligibility threshold than accredited investor, defined under the Investment Advisers Act and Rule 205-3. Only qualified clients may be charged performance based compensation (carried interest or incentive fees) by a registered investment adviser. The qualified client threshold requires a net worth exceeding \$2.2 million (excluding primary residence value) or at least \$1.1 million in assets under management with the registered adviser, as adjusted for inflation periodically by the SEC.

*See also: Accredited Investor; Qualified Purchaser; Registered Investment Adviser.*

**Qualified Opportunity Fund (QOF).** An investment vehicle organized to invest in Qualified Opportunity Zone property or businesses and certified by the Treasury as a QOF for purposes of the Opportunity Zone tax incentive program. Investors must contribute eligible capital gain proceeds to a QOF within 180 days of the gain realization event.

*See also: Opportunity Zone; Capital Gains; 1031 Exchange.*

**Qualified Purchaser.** The highest individual investor eligibility standard under the Investment Company Act, required for funds relying on the 3(c)(7) exemption (which allows an unlimited number of investors). Individuals must generally own at least \$5 million in investments. Family owned companies must own at least \$5 million in investments. Institutional investors must own at least \$25 million in investments.

*See also: 3(c)(7) Exemption; Accredited Investor; Qualified Client.*

## R

**Real Estate Investment Trust (REIT).** A tax advantaged entity that owns income producing real estate and is required by the Internal Revenue Code to distribute at least 90 percent of its taxable income to shareholders annually to qualify for pass through tax treatment at the entity level. REITs may be publicly traded (listed on a national exchange), publicly registered but non-traded, or private. Non-traded REITs and interval funds are registered public offering vehicles for retail and semi institutional capital. REIT structures are sometimes used by real estate funds to benefit non U.S. or tax exempt investors by shielding them from FIRPTA exposure and UBTI.

*See also: Non-traded REIT; Interval Fund; FIRPTA; UBTI.*

**Real Estate Operating Company (REOC).** An entity that qualifies as a real estate operating company under the Plan Asset Regulations because at least 50 percent of its assets (valued at cost) are invested in real estate that the entity manages or develops and with respect to which the entity has the right to substantially participate directly in management or development activities. Qualifying as a REOC is one of three primary methods by which a fund holding ERISA plan assets can avoid look through plan asset treatment.

*See also: ERISA; Plan Asset Regulations; VCOC; Benefit Plan Investor; 25 Percent Benefit Plan Investor Limitation.*

**Recycling.** A fund agreement provision permitting the GP to reinvest returned capital (from early asset sales, loan repayments, or other returns of invested amounts) into new investments rather than distributing it to LPs, up to specified limits. Recycling effectively increases the fund's total investment capacity beyond its committed capital base. Some investors negotiate caps on total recycled investment (for example, no more than 110 percent of total commitments may be invested through recycling).

*See also: Capital Call; Reserves; Capital Commitment.*

**Redemption.** The process by which an investor in an open end, evergreen, or interval fund exits their investment by tendering their interest for repurchase at NAV, subject to any applicable lockup periods, gates, or periodic repurchase limitations. Closed end funds do not offer redemptions. Investors in closed end funds exit only through the fund's wind down and distribution of proceeds at the end of the fund's term, or through a transfer of their interest.

*See also: Gate; NAV; Lockup Period; Open End Fund; Interval Fund.*

**Registered Investment Adviser (RIA).** An investment adviser registered with the SEC under the Investment Advisers Act of 1940. Full SEC registration is generally required for advisers with regulatory assets under management of \$100 million or more. Registered investment advisers must maintain comprehensive compliance programs under Rule 206(4)-7, designate a Chief Compliance Officer, file and update Form ADV annually, and comply with the antifraud and fiduciary provisions of the Investment Advisers Act. Sponsors approaching the \$100 million regulatory AUM threshold should begin planning for registration at least twelve months in advance.

*See also: Exempt Reporting Adviser; Investment Advisers Act; Form ADV.*

**Regulation A (Regulation A+).** A securities law exemption providing two tiers: Tier 1 permitting issuers to raise up to \$20 million in a 12 month period (with state qualification requirements) and Tier 2 permitting issuers to raise up to \$75 million in a 12 month period with SEC qualification of the offering circular, audited financials, and ongoing semi-annual and annual reporting. Regulation A+ allows general solicitation and public advertising, and Tier 2

offerings may be sold to both accredited and non-accredited investors (subject to individual investment limits of 10 percent of income or net worth). Real estate companies have been among the most active Regulation A+ issuers since the exemption was modernized under the JOBS Act in 2015.

*See also: Regulation D; Regulation CF; General Solicitation; Accredited Investor.*

**Regulation CF (Regulation Crowdfunding).** An SEC exemption allowing eligible companies to raise up to \$5 million per 12 month period from both accredited and non-accredited investors through a single SEC registered funding portal or broker dealer. Regulation CF requires specific disclosures including Form C filing, financial statements, and risk factors. It imposes individual investor investment limits based on income and net worth and restricts resale of the securities for one year. Regulation CF has generated more than a billion dollars in aggregate proceeds across thousands of offerings since its implementation in 2016.

*See also: Regulation A; Regulation D; General Solicitation; Accredited Investor.*

**Regulation D.** A set of SEC rules providing exemptions from the registration requirements of the Securities Act of 1933 for private offerings. The primary exemptions used in real estate fund formation are Rule 506(b) (unlimited capital from accredited investors, up to 35 sophisticated non-accredited investors, no general solicitation) and Rule 506(c) (unlimited capital, general solicitation permitted, all investors must be accredited with documented verification). Regulation D is the primary legal framework for private real estate capital raises. Issuers relying on Regulation D must file Form D with the SEC within 15 calendar days of the first sale.

*See also: 506(b); 506(c); Form D; Accredited Investor; General Solicitation.*

**Regulation S.** An SEC safe harbor from U.S. securities registration requirements for offers and sales of securities made outside the United States to non U.S. persons, provided certain conditions are met (including that no directed selling efforts are made in the United States and that the offering complies with applicable foreign regulations). Regulation S is commonly combined with Regulation D for funds accepting both U.S. and international capital.

*See also: Non U.S. Investor; FIRPTA; Blocker Entity.*

**Related Party Transaction.** Any transaction, arrangement, or relationship between the fund and the GP, the Manager, or any of their affiliates. Related party transactions create conflicts of interest because the GP's financial interest may diverge from the fund's and LPs' interests. The fund agreement requires LPAC consent for related party transactions and must specify the standard of review (arm's length, fair value, or otherwise). Common related party transactions in real estate funds include property management agreements, construction management agreements, and acquisition fee arrangements with affiliated service providers.

*See also: Conflicts of Interest; LPAC; Affiliate; Management Fee Offset.*



**Reserves.** Capital set aside from LP commitments or property level cash flow to cover anticipated future-expenses, capital improvements, debt service shortfalls, lease up costs, or other contingencies. Maintaining adequate reserves is a key aspect of real estate fund management and a fiduciary obligation of the GP. The fund agreement typically defines the maximum reserve level and any conditions on the use of reserves.

*See also: Capital Call; Fund Expenses.*

**Rescission.** The legal remedy available to investors who have purchased securities in violation of the securities laws: the right to recover the full amount of their investment, plus interest, regardless of the investment's financial performance. Rescission rights arise from violations including general solicitation in a 506(b) offering, use of an unregistered finder, failure to satisfy the verification requirements of 506(c), failure to make required blue sky filings, and material misrepresentation. A successful rescission claim from multiple investors can unwind an otherwise successful offering.

*See also: General Solicitation; Antifraud Provisions; Blue Sky Filings; Finder.*

**Rule 10b-5.** A broadly construed antifraud rule promulgated by the SEC under Section 10(b) of the Securities Exchange Act of 1934. Rule 10b-5 prohibits, in connection with the purchase or sale of any security, (a) employing any device, scheme, or artifice to defraud; (b) making any untrue statement of a material fact or omitting to state a material fact necessary to make statements not misleading; or (c) engaging in any act, practice, or course of business that operates as a fraud upon any person. Unlike Section 17(a) of the Securities Act (which applies only to sellers), Rule 10b-5 applies to both buyers and sellers and to secondary market transactions as well as primary offerings.

*See also: Antifraud Provisions; Material Misrepresentation; Securities Act.*

## S

**Section 1031 Exchange.** See: [1031 Exchange](#).

**Section 1061.** A provision of the Internal Revenue Code enacted as part of the Tax Cuts and Jobs Act of 2017 that imposes a three year holding period requirement on capital gains allocated to applicable partnership interests (including carried interest in investment partnerships) in order to qualify for long term capital gains tax treatment. Gains on assets held for more than one year but less than three years that are allocated to a carried interest are recharacterized as short term capital gains (taxed at ordinary income rates up to 37 percent) rather than long term capital gains for the carried interest holder. Treasury Regulations finalized in January 2021 (TD 9945) excluded Section 1231 gains and certain other categories from Section 1061's scope. Section 1061 is particularly consequential for value add funds with target hold periods of two to three years.

*See also: Carried Interest; Profits Interest; Capital Gains.*

**Section 1245.** The Internal Revenue Code provision governing the taxation of gain from the disposition of depreciable personal property. Section 1245 recapture applies to depreciation accelerated through cost segregation studies on the personal property components of real estate (components reclassified to 5 year, 7 year, or 15 year depreciable lives). Section 1245 recapture is taxed at ordinary income rates, currently up to 37 percent.

*See also: Depreciation Recapture; Section 1250; Cost Segregation.*

**Section 1250.** The Internal Revenue Code provision governing the taxation of gain from the disposition of real property structures. Section 1250 recapture applies to straight line depreciation claimed on the building structure itself and is taxed at a maximum federal rate of 25 percent (the unrecaptured Section 1250 gain rate).

*See also: Depreciation Recapture; Section 1245; Depreciation.*

**Section 1446.** Internal Revenue Code provisions imposing withholding obligations on partnerships with respect to income allocated to foreign partners. Section 1446(a) requires withholding on effectively connected income allocated to foreign partners at 21 percent for corporate foreign partners and 37 percent for non-corporate foreign partners. Section 1446(f), enacted in 2017, additionally requires 10 percent withholding on transfers of partnership interests by foreign persons. These withholding obligations apply continuously, not only at disposition, and the fund must collect W-8 series forms from foreign investors and remit required withholdings to the IRS. W-8BEN and W-8BEN-E forms expire by the end of the third calendar year following the year of signing and must be refreshed.

*See also: FIRPTA; Non U.S. Investor; Effectively Connected Income.*

**Securities Act of 1933.** The foundational U.S. federal law requiring companies that wish to offer or sell securities to the public to register those securities with the SEC and provide investors with full disclosure, unless a specific exemption applies. Private real estate offerings rely on exemptions from registration (primarily Regulation D) rather than registering with the SEC. The antifraud provisions of the Securities Act (Section 17(a)) apply to all offers and sales of securities, registered or exempt.

*See also: Antifraud Provisions; Regulation D; SEC.*

**Securities and Exchange Commission (SEC).** The primary U.S. federal regulatory agency responsible for administering and enforcing the federal securities laws, including the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. The SEC's mission is to protect investors, maintain fair and efficient markets, and facilitate capital formation.



**Securities Exchange Act of 1934.** The federal statute governing secondary market trading of securities and the ongoing reporting obligations of publicly registered issuers. For private real estate funds, the most relevant provisions are Section 10(b) (and Rule 10b-5 thereunder), which prohibits securities fraud, and Section 15(a), which requires broker dealer registration for persons engaged in effecting securities transactions for the account of others.

*See also: Rule 10b-5; Broker Dealer; Section 15(a).*

**Senior Debt.** The most senior financing in the capital stack: typically a first mortgage loan secured directly by the property. Senior debt is repaid first from asset cash flows and proceeds, carries the lowest interest rate (reflecting its lowest risk position), and is subject to institutional underwriting standards including LTV and DSCR requirements. Senior lenders' consent is typically required for any changes in ownership of the borrowing entity.

*See also: Capital Stack; Mezzanine Financing; Preferred Equity; Loan to Value Ratio.*

**Side Letter.** A separate, bilateral agreement between the GP and a specific LP that grants that LP particular rights or accommodations not available to all LPs, such as most favored nation status, reduced fees or carried interest, co-investment rights, enhanced reporting, or special ERISA provisions. Side letters are disclosed to the full LP group after the final closing, and MFN provisions require that any more favorable terms be extended to other MFN entitled LPs except for terms specific to the receiving LP's particular regulatory, tax, or legal situation.

*See also: MFN Provision; LPAC; Co-investment.*

**Special Purpose Vehicle (SPV).** A separate legal entity (typically a Delaware LLC) created to hold a specific investment or group of investments. In a multi asset fund, the SPV structure isolates each property's liabilities from the fund's other assets, simplifies asset level financing (each lender takes a mortgage on the specific SPV), and facilitates individual asset disposition (by transferring the SPV entity rather than the underlying property). Failure to use SPVs in a multi asset fund, or commingling multiple properties in a single entity, creates cross contamination of liability and complicates both lender relationships and individual asset dispositions.

*See also: Fund; Syndication.*

**Subscription Agreement.** The legal contract through which an investor formally commits to invest in the fund, represents their eligibility (accredited investor, qualified purchaser, or applicable status), acknowledges the risks described in the PPM, and agrees to be bound by the fund's operating agreement or LPA. The subscription agreement must contain representations appropriate to the specific securities exemption being relied upon (506(b) or 506(c)) and any state specific required representations. The ILPA published a Model Subscription Agreement in December 2017 as a standardization effort for private equity fund subscriptions.

*See also: Accredited Investor; PPM; 506(b); 506(c); ILPA.*

**Successor Fund.** A new fund raised by the same GP following (or near the end of) the current fund's investment period, typically with a similar strategy and target asset class. The timing of raising a successor fund is governed by restrictions in the existing fund's LPA (often limiting successor fund marketing until 80 percent of the existing fund's capital has been deployed or committed).

*See also: Investment Period; Conflicts of Interest.*

**Syndication.** A private real estate offering in which a sponsor (GP or Manager) pools capital from multiple passive investors to acquire, develop, or operate a specific property or portfolio of properties. A real estate syndication is a securities offering (satisfying the Howey Test) and must be conducted pursuant to a valid exemption from registration under the federal securities laws or through a registered offering. The term is sometimes used interchangeably with SPV to describe the specific investment entity, though technically syndication refers to the offering process and SPV to the vehicle.

*See also: SPV; Howey Test; Investment Contract; Security; 506(b); 506(c).*

## T

**Tenancy in Common (TIC).** A form of fractional ownership in which multiple investors each hold an undivided interest in real property. Unlike LLC membership interests, TIC interests represent a direct interest in the property itself, which qualifies as real property for purposes of Section 1031 like kind exchanges (per Revenue Procedure 2002-22). TIC interests are securities and must be offered through a valid exemption. The SEC has provided guidance addressing when TIC offerings constitute securities transactions. TIC structures are commonly used as 1031 exchange vehicles but impose significant practical and legal limitations, including governance difficulties when multiple co-owners cannot agree on management decisions.

*See also: DST; 1031 Exchange; Security.*

**Term.** The total lifespan of a closed end fund, from its formation through the end of its wind down and final distribution period. A typical closed end real estate fund has a term of 8 to 12 years, comprising a 2 to 5 year investment period followed by a holding and disposition period, with optional one or two year extension rights (typically requiring LPAC or LP approval).

*See also: Investment Period; LPAC; Closed End Fund.*

**Track Record.** The historical performance of a fund manager across prior investments, used by prospective investors to evaluate whether the manager's capabilities, strategy, and execution are likely to produce the projected returns in the new offering. For institutional capital raising purposes, a track record presentation must cover all investments under the current strategy (not

a selected subset), distinguish realized from unrealized returns, show actual versus projected returns for completed investments, and be prepared in a format that can be independently verified. Sponsors who systematically share full cycle performance data, including the deals that did not achieve their projections and how those situations were managed, differentiate themselves from sponsors who present only curated highlights of their best performing investments.

*See also: IRR; Equity Multiple; Vintage Year; J Curve.*

**Transfer Restrictions.** Limitations in the fund agreement on a limited partner's ability to transfer, assign, sell, or otherwise dispose of its interest in the fund without the GP's prior written consent. Transfer restrictions serve multiple purposes. They protect the fund's exempt status under the securities laws (by preventing transfers to non-accredited or otherwise ineligible investors), maintain compliance with the Investment Company Act beneficial owner limitations, preserve the fund's qualification under applicable state law, and allow the GP to vet incoming investors. The fund agreement should specify the manager's response timeline for transfer requests and cross reference any lender transfer restrictions in the loan documents.

*See also: Blue Sky Filings; 3(c)(1) Exemption; GP Removal Clause.*

**25 Percent Benefit Plan Investor Limitation.** The threshold under the Plan Asset Regulations that determines whether a fund's assets are deemed to be ERISA plan assets. If benefit plan investors hold less than 25 percent of the value of each class of the fund's equity interests, the fund qualifies for the Insignificant Benefit Plan Investor exception and avoids plan asset status. If the threshold is crossed in any equity class, the fund's underlying assets are deemed plan assets and the fund manager becomes an ERISA fiduciary. The 25 percent test applies to each equity class separately, is measured on an aggregate basis (not per investor), excludes the GP's and its affiliates' interests from both numerator and denominator, counts IRAs as benefit plan investors when ERISA plans are also present, and must be tested continuously at every acquisition, transfer, or redemption of fund interests.

*See also: ERISA; Plan Asset Regulations; Benefit Plan Investor; VCOC; REOC.*

## U

**Unrelated Business Taxable Income (UBTI).** Income earned by a tax exempt entity (such as a pension fund, endowment, or 501(c)(3) organization) from business activities unrelated to its tax exempt purpose, which is subject to federal income tax at regular corporate or trust rates. Real estate rental income and debt financed income can constitute UBTI for tax exempt investors in leveraged real estate funds. Blocker entities are commonly used to shield tax exempt investors from UBTI exposure.

*See also: Blocker Entity; ERISA; Benefit Plan Investor; FIRPTA.*

**Underwriting.** The process of analyzing and evaluating a potential real estate investment to determine its projected financial performance, risks, and investment merit. Real estate underwriting typically involves analysis of in place and projected rental income, operating expenses, vacancy and collection loss assumptions, capital expenditure requirements, financing terms, and exit cap rate assumptions. The underwriting produces a financial model showing projected cash flows, investment returns, and sensitivity to changes in key assumptions. AI powered underwriting tools are increasingly used to accelerate the initial analysis phase, though the accuracy and adequacy of the underlying assumptions remain the sponsor's responsibility.

*See also: Net Operating Income; Capitalization Rate; IRR.*

## V

**Valuation.** The process of determining the current fair market value of a fund's assets, typically conducted quarterly for reporting purposes and annually in connection with the audit. Real estate fund valuations are typically determined by the GP using a combination of internal appraisals, third party appraisals, and market comparable analysis, in accordance with GAAP and the IPEV (International Private Equity and Venture Capital) Valuation Guidelines. Institutional investors and the ILPA Reporting Template require disclosure of the valuation methodology applied to each asset. The LPAC has the authority to commission an independent valuation when it disagrees with the GP's assessment.

*See also: NAV; LPAC; Gross Asset Value; ILPA Principles.*

**Venture Capital Operating Company (VCOC).** An entity that qualifies as a venture capital operating company under the Plan Asset Regulations because at least 50 percent of its assets are invested in operating companies in which the entity holds management rights and actually exercises those rights. Qualifying as a VCOC is one of three primary methods by which a fund holding ERISA plan assets can avoid plan asset status. The VCOC exception requires more active management involvement than most passive real estate fund structures provide. The REOC exception is more commonly applicable to real estate funds.

*See also: REOC; Plan Asset Regulations; ERISA; Benefit Plan Investor.*

**Vintage Year.** The year in which a fund makes its first investment (or, in some contexts, its first capital call). The vintage year is used as the primary basis for benchmarking a fund's performance against peers investing in comparable market conditions. Comparisons across different vintage years are less meaningful because funds investing in different market environments face materially different acquisition pricing, interest rate, and exit market conditions.

*See also: Track Record; IRR; J Curve.*

## W

**Waterfall.** The contractual mechanism (set out in the fund's LPA or operating agreement) that defines the order of priority and the specific calculation methodology by which cash is distributed among LPs and the GP. A typical four tier waterfall distributes proceeds as follows: (1) first, 100 percent to LPs until all contributed capital is returned; (2) second, 100 percent to LPs until they have received their full preferred return on contributed capital; (3) third, to the GP as a catch up until the GP has received its full carried interest percentage on the cumulative profits distributed; (4) fourth, residual profits split between LPs and the GP in the agreed carried interest ratio (commonly 80/20). Every defined term in the waterfall, including distributable cash, preferred return, unreturned capital, and catch up, must be precisely defined in the fund agreement to permit mechanical calculation without judgment calls.

*See also: American Waterfall; European Waterfall; Preferred Return; Carried Interest; GP Catch Up.*

**Note on Usage:** *Defined terms in this glossary reflect both their specific legal meanings under applicable statutes, regulations, and judicial decisions and their market usage in private real estate fund practice. Where legal and market usage differ, both are described. The definitions provided are for educational purposes and do not constitute legal advice. The application of these terms to a specific transaction or offering requires analysis by qualified securities counsel familiar with the particular facts and circumstances.*

**APPENDIX B**

# Comparison of Securities Exemptions

Choosing a securities exemption is not a compliance checkbox filled in after the offering strategy is set. It is the first substantive legal decision in structuring a private real estate offering, and it shapes nearly every aspect of how the offering must be conducted. The exemption determines who may invest, how the offering can be marketed, how much capital may be raised, what federal and state filings are required before and after sales begin, how long investors must hold before they can sell, and what ongoing reporting the sponsor must maintain for years after the closing. Getting the selection right from the outset is clean and efficient. Discovering mid raise that the wrong exemption was chosen, or that it was applied without satisfying its specific requirements, is a rescission problem that cannot be undone by good intentions.

This appendix provides a structured comparison of the seven principal federal securities exemptions used in private real estate offerings: Rule 506(b) and Rule 506(c) under Regulation D, Regulation A+ Tier 1 and Tier 2, Regulation Crowdfunding (Regulation CF), Regulation S, and the intrastate exemptions under Rules 147 and 147A. The comparison tables below cover seventeen specific dimensions of each exemption, from statutory basis through investor eligibility, verification requirements, state preemption status, financial disclosure obligations, resale restrictions, and real estate fund suitability. Following the tables, each exemption receives its own narrative analysis covering the practical considerations that rows and columns cannot fully express: where judgment matters, what mistakes sponsors make, and what conditions genuinely warrant each structure.

All information reflects the regulatory framework as of early 2026, including the SEC Division of Corporation Finance no action letter issued on March 12, 2025, that materially simplified Rule 506(c) verification procedures for offerings with minimum investment thresholds of \$200,000 and above, the most significant update to the Regulation D framework in several years, addressed in detail in the 506(c) section below.

## Securities Exemption Comparison Tables

*Seventeen dimensions across seven exemptions, grouped into five tables for readability. Current as of Q1 2026, including the March 2025 SEC no action guidance on Rule 506(c) accredited investor verification.*

**Table 1. Statutory Basis, Offering Cap, and Eligible Investors**

| Dimension           | Rule 506(b) and Rule 506(c)                                                                                                                                                | Reg A+ Tier 1 and Tier 2                                                                                                                                                                          | Reg CF, Reg S, and Intrastate                                                                                                                                                                                                     |
|---------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Statutory Basis     | 506(b): Sec. 4(a)(2) and Reg D Rule 506(b). 506(c): Sec. 4(a)(2) and Reg D Rule 506(c).                                                                                    | Tier 1: Sec. 3(b)(1) and Reg A Tier 1. Tier 2: Sec. 3(b)(2) and Reg A Tier 2.                                                                                                                     | Reg CF: Sec. 4(a)(6) and Reg CF. Reg S: Reg S Rules 901 to 905. Intrastate: Sec. 3(a)(11) and Rule 147 or Rule 147A.                                                                                                              |
| Annual Offering Cap | 506(b) and 506(c): no cap. Unlimited.                                                                                                                                      | Tier 1: \$20 million. Tier 2: \$75 million.                                                                                                                                                       | Reg CF: \$5 million. Reg S: no cap (offshore transactions only). Intrastate: no federal cap; state law governs.                                                                                                                   |
| Eligible Investors  | 506(b): unlimited accredited investors; up to 35 sophisticated non-accredited investors. 506(c): accredited investors only; every investor must be independently verified. | Tier 1: accredited and non-accredited; no per investor investment limit. Tier 2: accredited and non-accredited; non-accredited capped at 10 percent of the greater of annual income or net worth. | Reg CF: accredited and non-accredited; tiered per investor limits based on income and net worth. Reg S: non U.S. persons only. Intrastate: in state residents only; all purchasers must reside in issuer's state at time of sale. |

**Table 2. General Solicitation and Investor Verification**

| Dimension            | Rule 506(b) and Rule 506(c)                                                                                                                                                                                                                                                                                   | Reg A+ Tier 1 and Tier 2                                                                                                                                | Reg CF, Reg S, and Intrastate                                                                                                                                                                                                                                                                                                                                                                                   |
|----------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| General Solicitation | 506(b): prohibited. No public advertising; offers limited to persons with whom the issuer had a pre-existing substantive relationship before the offering. 506(c): permitted. Broad public advertising, social media, webinars, and conferences allowed; all investors must still be accredited and verified. | Both Tiers: permitted. Testing the waters allowed before or after Form 1-A filing. General advertising to the public is permitted in Tier 1 and Tier 2. | Reg CF: permitted, conducted through a single SEC registered portal or broker dealer; portal may be publicly accessible. Reg S: offshore advertising to non U.S. persons permitted; no U.S. directed selling efforts. Intrastate: Rule 147 restricts offers and sales to in state residents. Rule 147A allows offers to be accessible to out of state residents; sales must close with in state residents only. |



| Dimension             | Rule 506(b) and Rule 506(c)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      | Reg A+ Tier 1 and Tier 2                                                                                                                                                                                    | Reg CF, Reg S, and Intrastate                                                                                                                                                                                                                                                                                                                                                                                                                        |
|-----------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Investor Verification | 506(b): reasonable belief standard; no documentary verification required; sophistication assessment required for non-accredited investors. 506(c): affirmative verification required. Traditional methods include tax returns, W-2s, bank statements, or CPA or attorney letter. March 2025 SEC no action guidance: \$200,000 minimum investment for natural persons (or \$1 million for legal entities) combined with a written accredited investor representation and confirmation that the investor has not borrowed for the specific purpose of the minimum investment, satisfies verification without documentary evidence. | Tier 1: self-certification by investor; no issuer verification required. Tier 2: non-accredited investors self-certify income or net worth for the 10 percent limit; no documentary verification by issuer. | Reg CF: investor self certifies on portal; portal operator performs identity and investment limit compliance checks. Reg S: issuer must reasonably believe purchaser is non U.S. person; precautionary measures required (offering legends, offshore transaction mechanics, distribution compliance period). Intrastate: issuer must reasonably believe each purchaser is an in state resident at time of sale; residency documentation recommended. |

**Table 3. SEC Filings, Pre-sale Qualification, and State Blue Sky**

| Dimension              | Rule 506(b) and Rule 506(c)                                                                                                                 | Reg A+ Tier 1 and Tier 2                                                                                                                                                                                                                                                                       | Reg CF, Reg S, and Intrastate                                                                                                                                                                                                                                                                          |
|------------------------|---------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| SEC Filing Required    | 506(b) and 506(c): Form D within 15 calendar days of first sale; annual amendment if offering remains open beyond 1 year.                   | Tier 1: Form 1-A offering statement filed and SEC qualified before sales begin; Form 1-Z final status report. Tier 2: Form 1-A with audited financials filed and SEC qualified before sales begin; Form 1-K (annual), Form 1-SA (semi-annual), Form 1-U (material events) on an ongoing basis. | Reg CF: Form C filed before first sale; no pre-qualification; Form C-AR annual report; Form C-U termination report. Reg S: no federal SEC filing required for pure offshore transactions; Form D filed if combined with Reg D. Intrastate: no federal SEC filing required; state law filings required. |
| Pre-sale Qualification | 506(b) and 506(c): none. Offering may launch once offering documents are finalized (and, for 506(c), the verification process is in place). | Tier 1: SEC qualification of Form 1-A required; typical timeline 5 to 8 months from initial filing. Tier 2: SEC qualification plus FINRA review; typical timeline 4 to 6 months to qualification.                                                                                              | Reg CF: Form C filing required before first sale; no SEC pre-qualification; offering may launch after filing. Reg S: none; exempt offshore transaction may proceed without pre-                                                                                                                        |



| Dimension      | Rule 506(b) and Rule 506(c)                                                                                                         | Reg A+ Tier 1 and Tier 2                                                                                                                                                                                                                                 | Reg CF, Reg S, and Intrastate                                                                                                                                                                                                                                                              |
|----------------|-------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                |                                                                                                                                     |                                                                                                                                                                                                                                                          | clearance. Intrastate: state registration or exemption qualification required; timeline varies by state (30 to 90 days typical).                                                                                                                                                           |
| State Blue Sky | 506(b) and 506(c): preempted for accredited investor sales (covered securities); state notice filing only in each investor's state. | Tier 1: not preempted; must register or qualify with each state where securities are offered and sold (or use NASAA coordinated review). Tier 2: preempted; federal Tier 2 qualification preempts state registration; limited state notice filings only. | Reg CF: not fully preempted; state portal oversight applies; some state notice requirements. Reg S: governed by state law of issuer; Reg S does not itself preempt state law. Intrastate: state law governs entirely; no federal preemption; must satisfy state exemption or registration. |

**Table 4. Ongoing Reporting, Financial Statements, and Other Compliance**

| Dimension                        | Rule 506(b) and Rule 506(c)                                                                                                                                                                                                                                                                     | Reg A+ Tier 1 and Tier 2                                                                                                                                                                                                                         | Reg CF, Reg S, and Intrastate                                                                                                                                                                                                                                                                                         |
|----------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Ongoing SEC Reporting            | 506(b) and 506(c): none beyond Form D annual amendment; no periodic financial reporting to the SEC.                                                                                                                                                                                             | Tier 1: Form 1-Z final status report only; no ongoing SEC reporting after offering closes. Tier 2: Form 1-K annually (due 120 days after fiscal year end); Form 1-SA semi-annually (90 days after 6 month period); Form 1-U for material events. | Reg CF: Form C-AR annual report; material change disclosures during offering; Form C-U termination report. Reg S: none specific to Reg S; other ongoing reporting may apply based on issuer's broader registration status. Intrastate: none under federal law; state reporting requirements vary.                     |
| Financial Statement Requirements | 506(b): non-accredited investors present means audited GAAP financials required. Accredited only offering: no SEC mandated financial statement requirement; PPM antifraud standards govern. 506(c): no SEC specific financial statement requirement; PPM antifraud disclosure standards govern. | Tier 1: financial statements required; unaudited financials acceptable (unless already prepared). Tier 2: audited financial statements required in Form 1-A; auditor must consent to SEC filing inclusion.                                       | Reg CF: scales with offering size. Up to \$124,000: financial statements and certain items from income tax returns certified by the principal executive officer. \$124,000 to \$618,000: reviewed by independent public accountant (or audited for repeat issuers). Over \$618,000: audited financials required (with |

| Dimension                        | Rule 506(b) and Rule 506(c)                                                                                                                                                                                                                 | Reg A+ Tier 1 and Tier 2                                                                                                                 | Reg CF, Reg S, and Intrastate                                                                                                                                                                                                                                                                                                                                                                                         |
|----------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                  |                                                                                                                                                                                                                                             |                                                                                                                                          | reviewed financials permitted for first time issuers raising up to \$1,235,000). Reg S: no Reg S specific financial statement requirement; offshore jurisdiction standards govern. Intrastate: no federal financial statement requirement; state disclosure standards govern.                                                                                                                                         |
| Resale and Transfer Restrictions | 506(b) and 506(c): restricted securities; 1 year holding period; Rule 144 required for most resales before 1 year.                                                                                                                          | Tier 1 and Tier 2: not restricted securities; freely tradable after qualification; affiliate lock up applies to selling securityholders. | Reg CF: 1 year transfer restriction from date of sale; exceptions for transfers to issuer, accredited investors, and registered offerings. Reg S: distribution compliance period of 40 days (Reg S Categories 1 and 2); 1 year for equity of U.S. domestic issuers (Category 3). Intrastate: resale restricted to in state residents for 6 months from issuer's original sale; no federal restriction after 6 months. |
| Investment Company Act           | 506(b) and 506(c): 3(c)(1) and 3(c)(7) funds eligible; Investment Company Act exclusion required separately.                                                                                                                                | Tier 1 and Tier 2: investment companies are not eligible; 3(c)(1) and 3(c)(7) funds cannot use Reg A+.                                   | Reg CF: investment companies are not eligible; funds cannot use Reg CF. Reg S: no prohibition specific to Reg S; Investment Company Act compliance must be addressed separately. Intrastate: investment companies registered under the ICA are not eligible.                                                                                                                                                          |
| Bad Actor Disqualification       | 506(b) and 506(c): applies. Covered persons (including the issuer, its officers, directors, 20 percent beneficial owners, general partners, managing members, promoters, placement agents, and their personnel) disqualified upon specified | Tier 1 and Tier 2: applies. Similar disqualification provisions; SEC qualification process and state qualification include screening.    | Reg CF: applies. Funding portal must screen issuers; similar disqualification rules govern. Reg S: no specific Reg S bad actor rule; Securities Act Section 17(a) antifraud provisions apply. Intrastate: no federal bad actor rule under Section 3(a)(11); state law                                                                                                                                                 |

| Dimension | Rule 506(b) and Rule 506(c)                  | Reg A+ Tier 1 and Tier 2 | Reg CF, Reg S, and Intrastate |
|-----------|----------------------------------------------|--------------------------|-------------------------------|
|           | events. All covered persons must be checked. |                          | may impose disqualifications. |

**Table 5. Cost, Timeline, Real Estate Suitability, and Primary Limitation**

| Dimension                         | Rule 506(b) and Rule 506(c)                                                                                                                                                                                                                                                                                                               | Reg A+ Tier 1 and Tier 2                                                                                                                                                                                                                                                                                    | Reg CF, Reg S, and Intrastate                                                                                                                                                                                                                                                                                                                                                                                                           |
|-----------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Typical Legal and Compliance Cost | 506(b): \$15,000 to \$50,000 (PPM, subscription documents, Form D, blue sky notice filings). 506(c): \$20,000 to \$65,000 (add verification infrastructure design and management).                                                                                                                                                        | Tier 1: \$50,000 to \$150,000 (Form 1-A, state qualification filings, NASAA coordinated review). Tier 2: \$75,000 to \$200,000 or more (Form 1-A, audited financials, SEC qualification, FINRA review, plus ongoing reporting infrastructure).                                                              | Reg CF: \$20,000 to \$60,000 (Form C, portal selection and setup, investor communication compliance). Reg S: \$20,000 to \$50,000 (legal structuring, offering documents, offshore compliance mechanics; lower for pure offshore). Intrastate: \$10,000 to \$40,000 (state exemption or qualification documents; varies by state).                                                                                                      |
| Time to First Close (Estimate)    | 506(b): 30 to 60 days from counsel engagement. 506(c): 45 to 75 days (add verification process design).                                                                                                                                                                                                                                   | Tier 1: 5 to 8 months (SEC review and state qualifications). Tier 2: 4 to 6 months minimum (SEC and FINRA review).                                                                                                                                                                                          | Reg CF: 45 to 90 days (Form C, portal launch, offering go live). Reg S: 30 to 60 days (combined with Reg D; shorter for pure offshore). Intrastate: 30 to 90 days (depends on state exemption availability).                                                                                                                                                                                                                            |
| Real Estate Fund Suitability      | 506(b): ideal. The primary vehicle for most private real estate fund raises. No size limit, institutional quality investor base, and full structural flexibility. 506(c): strong. Essential for sponsors using social media, webinars, or online platforms. March 2025 guidance streamlines verification at \$200,000 minimums and above. | Tier 1: limited. Not available to investment funds. State qualification burden is substantial. Better for real estate operating companies. Tier 2: moderate. Preempts state law and is viable for non-traded REITs and real estate operating companies targeting retail investors at \$5 million and above. | Reg CF: limited. The \$5 million cap constrains most real estate equity raises. Useful for smaller local acquisitions with strong retail investor community. Reg S: useful supplement. Routinely combined with Reg D for funds accepting non U.S. investors. Not a standalone domestic vehicle. Intrastate: narrow. Appropriate only when investors and property are entirely within one state. Not suitable for any multi-state raise. |

| Dimension                  | Rule 506(b) and Rule 506(c)                                                                                                                                                                                                                                                                             | Reg A+ Tier 1 and Tier 2                                                                                                                                                                                                                                | Reg CF, Reg S, and Intrastate                                                                                                                                                                                                                                                                                                                                                            |
|----------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Primary Limitation or Risk | 506(b): no general solicitation; pre-existing relationship required. One out of compliance act contaminates the offering for all subsequent investors. 506(c): every investor must be independently verified. Prior general solicitation before a purported 506(b) offering contaminates that offering. | Tier 1 and Tier 2: not available to investment companies. State by state qualification (Tier 1) is expensive and slow and rarely practical. Audit and ongoing SEC reporting (Tier 2) is a material cost. Four to six month pre-sale period is required. | Reg CF: \$5 million cap limits real estate utility. Single portal requirement. One year resale restriction. Ongoing reporting obligations. Reg S: any inadvertent sale to a U.S. person destroys the exemption. FIRPTA complexity for real estate investors. Intrastate: one out of state investor destroys the federal exemption. Six month resale restriction. Geographic confinement. |

## Rule 506(b): The Foundation of Private Real Estate Capital Raising

Rule 506(b) is where private real estate capital formation lives. The EDGAR system tracks more than \$2 trillion in capital raised annually under Regulation D, overwhelmingly Rule 506(b), a volume that dwarfs every other securities exemption by orders of magnitude. The reasons are straightforward. There is no cap on offering size, no pre offering registration or qualification with any government authority, no requirement to use specific investor facing documents beyond what the antifraud provisions require, and no restriction on who may invest as long as they qualify as accredited. A sponsor with a well prepared PPM, completed subscription documents, a timely Form D filing, and the right blue sky notices in each investor's state can close a \$50 million offering in 45 days from a standing start. No other exemption matches that combination of speed, flexibility, and institutional compatibility.

The single constraint that defines Rule 506(b) in practice is the prohibition on general solicitation. That prohibition runs deeper than many sponsors who are new to securities compliance expect. It is not a restriction on paid advertising alone. It covers any communication that constitutes an offer to a person with whom the issuer did not have a pre-existing substantive relationship before the offering began. A LinkedIn post describing the investment. An unsolicited email to a list compiled from a conference attendee database. A pitch at a publicly advertised real estate event. A referral introduction through a finder who brings investors without a prior relationship with the sponsor. Each of these is a potential general solicitation, and any one of them, if it reaches a person who later invests, gives that investor the right to seek rescission of their investment regardless of the investment's performance.

The pre-existing substantive relationship requirement has a specific legal meaning that market practice sometimes blurs. The relationship must be substantive in content (based on meaningful information about the investor's financial situation and investment experience, not merely an acquaintance) and it must predate the specific offering, not have been created in connection with it. A sponsor who has maintained investor relationships through years of professional contact, who has discussed prior investments, and whose investors know the sponsor's track record from direct experience satisfies the requirement comfortably. A sponsor who met a prospective investor two weeks ago and had them fill out a questionnaire before being admitted to the investor portal has not.

### **⚠ The Contamination Problem: When General Solicitation Breaks a 506(b) Offering**

*The consequences of a general solicitation in a purported 506(b) offering do not limit themselves to the specific investor who received the communication. The contamination runs forward from the date of the solicitation. Every investor admitted to the offering after that date is in an offering that no longer qualifies under 506(b), regardless of whether that investor personally received the solicitation, regardless of the investor's accredited status, and regardless of the quality of the investor's subscription documents.*

*The remedy for each such investor is rescission: a legal right to demand return of their full investment plus statutory interest, independent of whether the investment has performed well or poorly. In a successful real estate offering, rescission exposure from a contaminated 506(b) offering can exceed the value of the promote.*

*A sponsor who has already conducted general solicitation has one path forward: convert the offering to Rule 506(c) and implement proper accredited investor verification for every investor admitted after the first act of solicitation. This conversion cannot retroactively fix the problem for investors admitted before the conversion. It only establishes a compliant framework going forward.*

*Before any marketing communication leaves the sponsor's control, before any website goes live, any social media post is published, any finder is engaged, any email goes to a new list, the sponsor and their securities counsel must have agreed on whether this is a 506(b) or 506(c) offering. That decision must be made first.*

The non-accredited investor provision of 506(b), the ability to admit up to 35 sophisticated non-accredited investors, is less commonly used in real estate fund practice than it appears in the exemption's text. When non-accredited investors are included, the issuer must provide all investors with the same quality of financial information a registered offering would require,

including audited financial statements prepared in accordance with GAAP. The compliance cost of satisfying that disclosure obligation is disproportionate to the benefit of admitting the additional investors for most fund structures. Most 506(b) real estate offerings admit only accredited investors, preserving the non-accredited capacity as a theoretical option without exercising it.

## **Rule 506(c): Public Marketing With Documented Verification**

Rule 506(c) arrived in September 2013 under the JOBS Act of 2012, creating the first federal exemption that permits both public marketing and exemption from registration in the same offering. The tradeoff is unconditional. Broad marketing to anyone through any channel, in exchange for verified accreditation of every investor. No sophisticated non-accredited investors. No reasonable belief standard. Every investor must have their accredited status affirmatively confirmed before their subscription is accepted.

For nearly a decade after 506(c)'s adoption, sponsors who wanted to use it were deterred by the documentary verification requirement. The SEC's original guidance enumerated specific methods: reviewing the investor's federal tax returns, W-2s, or bank and brokerage statements; or obtaining written confirmation from a licensed attorney, CPA, registered investment adviser, or registered broker dealer. These methods are workable but operationally burdensome, particularly at scale. The result was that many sponsors who wanted the marketing flexibility of 506(c) chose 506(b) instead, accepting the marketing restriction to avoid the verification logistics.

The March 12, 2025 no action letter from the SEC's Division of Corporation Finance, issued in response to a request by Latham and Watkins LLP, changed this calculus in a meaningful way. The letter established that an issuer satisfies the reasonable steps verification requirement through a minimum investment amount standard, without requiring any documentary review, when three conditions are met. First, the minimum investment is at least \$200,000 per natural person (or \$1 million for entities qualifying solely because all equity owners are accredited, or \$200,000 per equity owner when fewer than five natural person equity owners are present). Second, each investor provides a written representation confirming they are an accredited investor and have not borrowed funds from a third party for the specific purpose of making the minimum investment. Third, no information in the issuer's possession contradicts the investor's accredited status claim. The traditional documentary methods remain fully available as alternative paths to verification.

### **The March 2025 506(c) Verification Update: What Changed**

**Before March 2025.**

*Rule 506(c) verification required documentary evidence in most cases. Tax returns, bank statements, brokerage account statements, or a licensed professional letter. This burden deterred widespread 506(c) adoption.*

**After March 2025 (Latham and Watkins no action letter, Division of Corporation Finance).**

*Verification is satisfied without documentary evidence when all of the following apply: (1) minimum investment of \$200,000 or more per natural person (\$1 million for entities, or \$200,000 per equity owner if fewer than five natural person owners); (2) the investor provides a written representation confirming both that they qualify as an accredited investor and that they have not borrowed the investment amount from a third party for the specific purpose of meeting the minimum; and (3) no contradictory information is in the issuer's possession.*

**Traditional documentary methods remain available as alternatives.**

*The no action letter creates an additional bright line safe harbor. It does not eliminate the original verification paths.*

**Practical result.**

*Sponsors with \$200,000 minimums and above can now advertise publicly, take investors from social media or public conferences, and satisfy verification through subscription document representations alone. A significant simplification of the 506(c) compliance burden.*

Rule 506(c) suits sponsors whose investor acquisition strategy is built around channels that inherently involve general solicitation: social media platforms, publicly accessible websites describing the investment opportunity, real estate conferences open to the general public, webinars promoted through email marketing, and online advertising. For these sponsors, 506(c) enables marketing activities that are commercially natural rather than legally constrained, and the March 2025 guidance ensures that the verification framework can be implemented without invasive documentation collection as long as the minimum investment threshold is met.

One asymmetry that sponsors who switch between exemptions need to understand: prior conduct under 506(c), including prior public advertising in connection with a specific offering, taints that offering for any sponsor who later tries to characterize the same offering as 506(b). The contamination logic runs in one direction only. A sponsor who conducted a completed 506(c) offering can separately conduct a new 506(b) offering for a different investment, fully



compliant with 506(b)'s no solicitation requirement. What they cannot do is conduct general solicitation for an offering and then call that same offering a 506(b) offering retroactively.

## **Regulation A+ (Tiers 1 and 2): Public Access With Meaningful Obligations**

Regulation A+ occupies a middle position between the private placement exemptions of Regulation D and a full SEC registered public offering, closer to public than private in its regulatory burden, but meaningfully lighter than a traditional IPO. The exemption has two tiers with materially different practical profiles, and understanding which tier applies to a given real estate scenario begins with understanding that one of the most important features of Regulation A+ is also one of its most frequently overlooked: investment company funds, including virtually every private real estate fund operating under a 3(c)(1) or 3(c)(7) exclusion from the Investment Company Act, are not eligible to use it.

Ten years of SEC Division of Economic and Risk Analysis (DERA) data, published in 2025, covers the full experience of Regulation A+ from its 2015 modernization through 2024. The exemption has been used for over a thousand offerings seeking aggregate financing in the tens of billions of dollars, with real estate companies, including non-traded REITs, among the more active issuers. Financial sector companies, including real estate, have accounted for the majority of reported proceeds across the period. The discrepancy between amounts sought and amounts raised reflects the challenges inherent in retail capital formation without the institutional infrastructure of a broker dealer distribution network.

Regulation A+ Tier 1 offers a \$20 million annual cap and no federal preemption of state registration requirements, meaning the issuer must register or qualify the offering in every state where securities will be offered and sold. For a multi-state offering, achieving state by state qualification through NASAA's coordinated review process is slow, expensive, and operationally complex. Tier 1 is rarely used in practice, and the data bears this out. The overwhelming majority of Regulation A+ activity occurs at the Tier 2 level.

Tier 2 is the operationally viable version of the exemption for real estate sponsors. Its \$75 million annual cap, combined with federal preemption of state registration requirements, creates a genuine capital raising vehicle for real estate operating companies and non-traded REITs targeting retail investors. The compliance requirements are substantially heavier than a Regulation D offering. Audited financial statements prepared in accordance with GAAP must be included in the Form 1-A offering circular, the offering must be qualified by the SEC before sales begin (a process that typically takes four to six months and requires FINRA review for compensation related matters), and ongoing annual, semi-annual, and current event reports must be filed with the SEC throughout the life of the offering.



The practical use case for Regulation A+ Tier 2 in real estate is the sponsor whose offering strategy requires reaching retail non-accredited investors at scale through publicly marketed channels, and whose deal economics justify the four to six month pre-sales period and the ongoing reporting infrastructure cost. Non-traded REIT structures are the most common vehicle, because non-traded REITs that qualify for the Section 3(c)(5)(C) exclusion from the Investment Company Act are not disqualified by the investment company restriction. For private funds structured under 3(c)(1) or 3(c)(7), Regulation A+ is simply not available, and the investment company eligibility row in the comparison tables is the first place sponsors should look when evaluating whether this exemption is even on the table.

## **Regulation CF: Retail Crowdfunding and the \$5 Million Ceiling**

Regulation Crowdfunding became effective in May 2016 and received its current \$5 million annual cap in March 2021, when the SEC raised the limit from the original \$1.07 million to \$5 million as part of a broader set of amendments to the exemption landscape. In aggregate, Regulation CF has generated more than a billion dollars in proceeds across thousands of offerings since its 2016 implementation, a meaningful achievement in democratizing investment access, and a modest figure relative to the trillions raised annually through Regulation D.

Regulation CF's distinctive value is the ability to raise capital from non-accredited retail investors, the substantial majority of U.S. households that do not qualify under the existing accredited investor definition, through publicly accessible online platforms. Per the SEC's most recent published estimates, approximately 19 percent of U.S. households qualify as accredited investors. The remaining U.S. households (more than 80 percent) are excluded from Regulation D offerings but are eligible to participate in Regulation CF subject to per investor investment limits. For a real estate sponsor with a strong local presence, a property in a recognizable market, and an investor community that includes ordinary residents who want to participate in local real estate without meeting accredited thresholds, Regulation CF provides a legitimate pathway that no other exemption offers at comparable cost and speed.

The \$5 million cap is the binding constraint for most meaningful real estate transactions. The non-accredited investor investment limits, as adjusted for inflation effective September 2022, are tiered by investor income and net worth. A non-accredited investor whose annual income or net worth is less than \$124,000 may invest up to the greater of \$2,500 or 5 percent of the greater of annual income or net worth in any 12 month period across all Regulation CF offerings combined. A non-accredited investor whose annual income and net worth are both at least \$124,000 may invest up to 10 percent of the greater of annual income or net worth, not to exceed \$124,000 in any 12 month period. An apartment building acquisition requiring \$4 million

of equity from investors whose individual investment limits constrain per investor check sizes requires a very large number of investors to reach the target. The logistics of managing hundreds of small investors, the portal fees, and the ongoing reporting obligations must all be weighed against the fundraising economics. For most mid-size real estate transactions, the math does not work at the \$5 million ceiling.

The single portal requirement is one of Regulation CF's most operationally significant features. Every Regulation CF offering must be conducted entirely through a single SEC registered funding portal or registered broker dealer for the full duration of the offering period. The issuer cannot split the same offering across multiple platforms, cannot conduct direct investor outreach in parallel with the portal process, and cannot change portals mid offering without material disclosure implications. Portal selection (choosing a platform with an established investor community relevant to the specific property type and geographic market) is consequently a decision with real economic consequences that should be made before the offering structure is finalized.

## Regulation S: The Offshore-exemption

Regulation S provides a safe harbor from the registration requirements of Section 5 of the Securities Act for offers and sales of securities that occur outside the United States to non U.S. persons. Its foundational logic is geographic. The Securities Act's registration provisions are designed primarily to protect U.S. investors, and transactions that are genuinely offshore (between non U.S. parties, conducted outside U.S. markets, without directed selling efforts in the United States) present a different policy case for the registration requirement.

In practice, Regulation S functions almost exclusively as a supplement to a Regulation D offering rather than as a standalone exemption. A U.S. real estate fund that wants to accept both U.S. and non U.S. investors in the same vehicle structures the offering in two tranches. The domestic tranche relies on Rule 506(b) or 506(c) for U.S. investors. The offshore tranche relies on Regulation S for non U.S. investors. The offering documents address both populations, the subscription process distinguishes between them based on investor residency, and the legal analysis confirms that the conditions of each exemption are independently satisfied.

The directed selling efforts prohibition is the compliance requirement that most frequently catches sponsors by surprise. No marketing activity may be conducted in the United States in connection with the Regulation S portion of the offering. This creates a practical problem for sponsors whose domestic marketing is conducted through channels that are accessible to non U.S. viewers, such as a publicly accessible website, social media accounts without geographic restrictions, or conference presentations in the U.S. that non U.S. attendees could view. The resolution typically involves maintaining clear separation between domestic marketing materials

(which may reach non U.S. viewers but are directed at U.S. investors and processed through the domestic exemption tranche) and non U.S. directed communications that are specifically designed for the offshore investor population.

FIRPTA (the Foreign Investment in Real Property Tax Act) is the more consequential compliance framework for non U.S. investors in U.S. real estate funds, and it operates entirely independently of Regulation S. Regulation S addresses the offering registration mechanics. FIRPTA addresses the tax consequences of a non U.S. person investing in U.S. real property interests: mandatory withholding at disposition, Section 1446(f) withholding on secondary market transfers of fund interests, and the treaty analysis required to reduce withholding rates for investors from treaty countries. A sponsor who has properly completed the Regulation S analysis but ignored FIRPTA has solved half the problem.

## **Intrastate Exemptions (Rules 147 and 147A): Local Capital for Local Projects**

The intrastate exemption (rooted in Section 3(a)(11) of the Securities Act and implemented through Rules 147 and 147A) provides a federal registration exemption for offerings conducted entirely within a single state by issuers that are resident and doing business in that state. The 2016 modernization amended Rule 147 and added new Rule 147A, expanding the flexibility available to sponsors who want to use internet based marketing without disqualifying the exemption through contact with out of state viewers.

The practical difference between Rule 147 and Rule 147A matters for any sponsor using online marketing. Under the original (amended) Rule 147, both offers and sales must be limited to in state residents. An offer that reaches an out of state resident (even inadvertently through a publicly accessible website) creates a compliance problem. Rule 147A allows offers to be accessible to out of state residents, as long as all actual sales close with in state residents only. For sponsors using platforms or channels that cannot geo restrict their audience at the offer stage, Rule 147A is the operative safe harbor.

To qualify under either rule, the issuer must satisfy at least one of four doing business tests: at least 80 percent of consolidated gross revenues derived from operations in state; at least 80 percent of consolidated assets located in state; at least 80 percent of net offering proceeds to be used in state; or a majority of employees based in state. For real estate sponsors, the proceeds test is the most commonly applicable. A sponsor who can represent that 80 percent or more of the offering proceeds will be deployed into an in state property acquisition can satisfy the test regardless of where the entity is incorporated or where the sponsor's offices are located.

The exemption's limitation is as straightforward as its name suggests. Every investor must be an in state resident at the time of sale. The consequence of admitting even a single out of state investor is not the loss of that investor's exemption. It is the loss of the federal exemption for the entire offering. One inadvertently admitted out of state investor creates a violation that cannot be retroactively corrected by returning that investor's money. The violation is complete the moment the sale is consummated. Sponsors who use the intrastate exemption should implement investor residence verification procedures that are robust enough to make out of state admission genuinely unlikely, not merely a stated policy that is not operationally enforced.

## A Note on Integration

Integration is the SEC's doctrine for treating separately labeled offerings as a single offering for regulatory purposes. When two offerings are integrated, the requirements of each are applied as if they were one combined transaction, which can cause a compliant offering to lose its exemption by inheriting characteristics that would not qualify under that exemption's rules. The 2020 harmonization amendments substantially reduced the integration risk between certain combinations of exemptions, particularly between a concurrent Regulation D offering and a Regulation S offshore offering, and between two Regulation D offerings that are legitimately independent transactions. The operative principle is that two offerings will not be integrated when the conditions of each exemption are independently satisfied and there is no indication that the separate structure is a device to circumvent any exemption's limitations.

The integration concern most directly relevant to real estate sponsors is the relationship between a current offering and a prior Regulation D offering. A sponsor who completed a 506(b) offering and commences a new offering within six months of its last sale, for the same class of securities, with overlapping investors, and without a meaningful substantive distinction in the offering's purpose, risks having the two treated as a single integrated offering. Successive offerings should be clearly separated by completing the prior offering before commencing the new one, maintaining separate investor lists, and using distinct offering terms and investor communications. Counsel review of the integration analysis before each successive offering launch is not optional overhead. It is the risk management that prevents a routine successive offering from carrying forward liability from its predecessor.

### Which Exemption Fits This Offering? A Starting Framework

**Most private real estate fund raises (blind pool or deal by deal, accredited investors).**

*Start with Rule 506(b). Add Reg S if non U.S. investors are anticipated.*

**Public marketing planned (social media, conferences, webinars, online platforms).**

*Rule 506(c) is mandatory. The March 2025 SEC guidance simplifies verification at \$200,000 minimums and above.*

**Non U.S. investors alongside U.S. investors in the same fund.**

*Combine Regulation D (506(b) or 506(c)) and Regulation S. Work with tax counsel on FIRPTA.*

**Non-accredited retail investors, raise under \$5 million.**

*Regulation CF through a single SEC registered portal.*

**Non-accredited retail investors, raise \$5 million to \$75 million, real estate operating company or non-traded REIT.**

*Regulation A+ Tier 2. Not available to 3(c)(1) or 3(c)(7) investment funds.*

**All investors located in one state, property in that state, proceeds used in state.**

*Intrastate exemption (Rule 147A preferred if any online marketing is used). See Appendix C for the full decision framework and flowchart.*

## APPENDIX C

# Quick Guide: Which Exemption Is Right for Your Offering?

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The comparison tables in Appendix B lay out seventeen dimensions across seven exemptions. This appendix does something different. It helps a sponsor work through the actual selection decision, accounting for the sequence in which the questions must be asked and the way each answer narrows the remaining options. Exemption selection is not a parallel evaluation of all available options against a uniform set of criteria. It is a sequential process in which certain threshold questions eliminate most of the field immediately, and the remaining questions determine which of the surviving options best matches the offering's specific profile.

This guide works through that sequence in three parts. Part One presents the threshold questions that must be asked first, the ones that eliminate exemptions before the sponsor even reaches the substantive comparison. The most important of these is the Investment Company Act analysis, including whether the fund will rely on Section 3(c)(1), Section 3(c)(7), or Section 3(c)(5)(C). For many real estate funds, the choice of 3(c)(5)(C) over the more familiar 3(c)(1) and 3(c)(7) exclusions unlocks Regulation A+ and Regulation CF availability that would otherwise be foreclosed. Part Two presents the decision flowchart organized around the five factors that drive most real estate exemption decisions: investor population, marketing strategy, offering size, geography, and timeline. Part Three provides calibrated guidance for the combinations of factors that appear most frequently in real estate syndication practice, with the practical considerations that each combination raises.

One note before beginning. This guide addresses the federal exemption decision. State blue sky requirements, which vary significantly across the seven exemptions and must be satisfied in each investor's state of residence, operate alongside the federal framework and are addressed where directly relevant to each exemption path. They do not change the federal selection logic, but they affect the cost and timeline of implementing the selected exemption and must be factored into the offering's compliance budget.

## Part One: Threshold Questions That Eliminate Options First

Before evaluating the merits of any particular exemption, three threshold questions must be answered. Each one can eliminate one or more exemptions from consideration entirely. Skipping these questions and jumping directly to the feature comparison is how sponsors end up selecting an exemption that was never available to them in the first place.

## **Threshold Question 1. What Is the Fund’s Investment Company Act Exclusion?**

The first question is whether the entity making the offering is, or would be required to register as, an investment company under the Investment Company Act of 1940. The answer drives the next several questions, because the specific Investment Company Act exclusion the fund relies on (or whether the issuer is outside the Investment Company Act entirely as a real estate operating company) determines which federal securities exemptions are even available.

Most sponsors default to Section 3(c)(1) or 3(c)(7) without fully evaluating Section 3(c)(5)(C), which is often the better choice for a fund that holds direct interests in real property and mortgage loans. The differences among these three exclusions, and the consequences for federal exemption availability, are summarized below.

### **Section 3(c)(1): The Default Choice With the Strictest Cap**

Section 3(c)(1) is the most familiar exclusion in private fund practice. It is available to a fund whose outstanding securities are beneficially owned by no more than 100 persons and that is not making, and does not propose to make, a public offering. The 100 beneficial owner cap is the structural constraint that defines 3(c)(1). Once the fund grows beyond 100 beneficial owners, the exclusion no longer applies, and the fund must either redeem some owners, restructure to a different exclusion, or register as an investment company. The 100 owner count is calculated specifically (with look through rules for certain entity investors that are themselves investment companies or knowledgeable employee arrangements), and continuous tracking is required.

3(c)(1) is appropriate for smaller funds with a defined, limited investor base where the 100 owner cap is not constraining. It is poorly suited to funds expecting broad investor participation, retail outreach, or significant scale.

### **Section 3(c)(7): No Investor Count Limit, But Qualified Purchasers Only**

Section 3(c)(7) is available to a fund whose investors are all qualified purchasers and that is not making, and does not propose to make, a public offering. Qualified purchaser status requires (for individuals) at least \$5 million in investments, and (for institutional investors) at least \$25 million in investments. The exclusion has no cap on the number of investors, making it the preferred structure for larger institutional funds.

The constraint on 3(c)(7) is the qualified purchaser threshold itself. A fund relying on 3(c)(7) cannot admit an accredited investor who is not also a qualified purchaser. For a fund whose investor base is primarily high net worth individuals at the \$1 million net worth or \$200,000 income accredited investor level rather than the \$5 million qualified purchaser level, 3(c)(7) is not available.



## **Section 3(c)(5)(C): The Real Estate Exclusion That Unlocks More-exemptions**

Section 3(c)(5)(C) is the exclusion specifically designed for real estate businesses. It is available to any person primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. The exclusion has no cap on the number of investors and no qualified purchaser requirement. It is available regardless of whether investors are accredited.

The tradeoff is that 3(c)(5)(C) is asset based rather than investor based. The fund must continuously satisfy a portfolio composition test, which the SEC staff has articulated through a long series of no action letters. Under the staff's framework, an issuer may rely on Section 3(c)(5)(C) if at least 55 percent of its total assets consist of qualifying interests (mortgages and other liens on and interests in real estate, including fee simple ownership, leasehold interests, whole mortgage loans secured by real property at a 100 percent loan to value ratio at acquisition, and similar direct real estate interests) and at least 80 percent of its total assets consist of qualifying interests plus real estate type interests (which include real estate related securities such as certain mortgage backed securities, REIT shares, and similar instruments). No more than 20 percent of total assets may be in miscellaneous investments. Class II loans, where the loan is secured by real estate at a fair market value ratio of at least 55 percent at acquisition, may be included as real estate type interests within the 25 percent permitted layer (subject to the 20 percent miscellaneous cap).

For a real estate fund whose business is exactly what the exclusion describes (acquiring and holding direct real estate, mortgage loans, and related instruments), 3(c)(5)(C) offers two significant advantages over 3(c)(1) and 3(c)(7). First, there is no investor count cap and no qualified purchaser requirement. The fund can admit an unlimited number of accredited investors, and (depending on the federal securities exemption chosen) can also admit non-accredited investors. Second, and consequentially, Regulation A+ and Regulation CF are available to a fund that relies on Section 3(c)(5)(C). They are not available to a fund that relies on Section 3(c)(1) or 3(c)(7), because Regulation A+ and Regulation CF are unavailable to investment companies, and the SEC treats 3(c)(1) and 3(c)(7) funds as investment companies for this purpose. A 3(c)(5)(C) entity is not an investment company because it is outside the definition entirely, not merely excluded from registration.

The structural compliance discipline that 3(c)(5)(C) requires is the ongoing portfolio composition monitoring. The fund's accounting and compliance systems must continuously verify that the 55 percent qualifying interests test and the 80 percent combined test are satisfied. A fund that drifts above the 45 percent non qualifying ceiling (or above the 20 percent miscellaneous cap) loses the exclusion. Temporary deviations are permitted under SEC staff guidance in limited circumstances (such as following a new offering with cash on hand that will be deployed within approximately one year), but the monitoring framework must be in place from inception.



## **Section 3(c)(5)(C) at a Glance: The Real Estate Fund Advantage**

### **Who it fits.**

*Funds whose business is primarily acquiring and holding direct real estate interests (fee simple ownership, leasehold interests), mortgage loans secured by real estate, and similar direct real estate assets. Mortgage REITs, equity real estate funds, and many private real estate operating funds.*

### **Asset composition test.**

*At least 55 percent of total assets in qualifying interests (direct real estate, whole mortgage loans secured 100 percent by real estate at acquisition, fee and leasehold interests). At least 80 percent of total assets in qualifying interests plus real estate type interests (real estate related securities, MBS, REIT shares, Class II loans at 55 percent or higher LTV). No more than 20 percent in miscellaneous investments.*

### **Investor base.**

*No cap on investor count. No qualified purchaser requirement. Non-accredited investor participation possible (depending on federal exemption chosen).*

### **Federal exemptions available.**

*All seven exemptions potentially available, including Regulation A+ and Regulation CF, which are foreclosed to 3(c)(1) and 3(c)(7) funds.*

### **Ongoing requirement.**

*Continuous monitoring of the 55 and 80 percent portfolio composition tests. Fund accounting and compliance systems must verify the tests at acquisition of each new asset and at periodic intervals.*

## **How the Exclusion Choice Drives Federal Exemption Availability**

Regulation A+, both Tier 1 and Tier 2, is not available to investment companies or issuers required to be registered under the Investment Company Act. A real estate fund structured as a 3(c)(1) or 3(c)(7) entity is treated as an investment company for this purpose and cannot use Regulation A+. A real estate fund structured as a 3(c)(5)(C) entity is not an investment company at all (it is outside the statutory definition), and Regulation A+ is available.

Regulation CF has the same prohibition. A 3(c)(1) or 3(c)(7) fund cannot use Regulation CF. A 3(c)(5)(C) fund can.

The intrastate exemption under Section 3(a)(11) and Rules 147 and 147A also specifically excludes investment companies registered or required to be registered under the Investment Company Act. A 3(c)(5)(C) fund qualifies; 3(c)(1) and 3(c)(7) funds generally do not.

After Threshold Question 1, the remaining federal exemption options depend on which exclusion the fund will rely on. A 3(c)(1) or 3(c)(7) fund has three remaining options: Rule 506(b), Rule 506(c), and Regulation S (typically as a supplement). A 3(c)(5)(C) fund has all seven exemptions potentially in play. A real estate operating company (non-traded REIT, real estate development company, or sponsor not operating as a pooled investment fund) is also outside the Investment Company Act and has all seven exemptions available.

For most real estate funds whose strategy is exactly what 3(c)(5)(C) describes, the decision to rely on 3(c)(5)(C) rather than defaulting to 3(c)(1) is one of the most consequential structural choices the fund will make. It is worth taking before the federal securities exemption is selected, because it materially expands the available options.

## **Threshold Question 2. Has General Solicitation Already Occurred?**

The second threshold question asks whether any act of general solicitation, any public communication constituting an offer to persons without a pre-existing substantive relationship, has already occurred in connection with this offering. The answer to this question determines whether Rule 506(b) is still available.

The contamination principle that governs this question is directional and permanent for the affected offering. A single act of general solicitation, once it has occurred, bars Rule 506(b) for every investor admitted to the offering after that act, regardless of whether that specific investor received or was aware of the solicitation. The scope of what constitutes general solicitation is broader than most sponsors expect when they first encounter it: a LinkedIn post describing the investment opportunity, a publicly announced webinar pitching the deal, an email to a list purchased at a trade conference, a referral from a person who was not in a prior relationship with the sponsor and who is being compensated to make introductions. Any of these, if they constitute an offer and reach persons without a prior relationship, are general solicitation.

If general solicitation has already occurred, Rule 506(b) is off the table for that offering. The sponsor's options going forward are (a) conduct the offering under Rule 506(c) and verify every investor's accredited status using the required methods, or (b) start over with a new, separate offering structured from the outset as a 506(b) offering, with no connection to the prior solicitation activity. There is no cleanse mechanism, no cure period, and no workaround that converts a contaminated 506(b) offering back into a compliant one.

If no general solicitation has occurred and the sponsor intends to keep it that way, Rule 506(b) remains available and the remaining questions in this guide are relevant to choosing between it and other options.

### Threshold Question 3. Are All Target Investors in One State?

The third threshold question applies specifically to sponsors evaluating the intrastate exemption. The intrastate exemption requires that every investor be a resident of the issuer's state at the time of sale, and that the issuer be doing business in that state as defined by the applicable doing business test. If any target investor resides out of state, the intrastate exemption is unavailable for the offering as a whole, not just for that investor. A single out of state sale destroys the federal exemption for every investor in the same offering.

For sponsors whose entire investor base is located in one state and whose property and business operations are in that state, the intrastate exemption may be the most cost efficient available path. For every other sponsor, which is most of them, the intrastate exemption is not on the table, and this threshold question resolves immediately.

## Part Two: The Decision Flowchart

With the threshold questions addressed, the following flowchart works through the five factors that drive the exemption selection decision for the offerings that remain in play. Each question should be answered in order. Early answers in the sequence often resolve the decision without needing to reach later questions.

### STEP 1. What is the issuer's Investment Company Act status? Which exclusion does it rely on (or is it outside the Investment Company Act entirely)?

|                                                                                                                                                                                                                                  |                                                                                                                                                                                                                                       |                                                                                                                                                                                               |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p><b>3(c)(1) or 3(c)(7) fund</b></p> <p>Reg A+, Reg CF, and the intrastate exemption are categorically unavailable. Remaining options: Rule 506(b), Rule 506(c), and Regulation S (as a supplement for non U.S. investors).</p> | <p><b>3(c)(5)(C) real estate fund</b></p> <p>Outside the Investment Company Act. All seven exemptions potentially available, including Reg A+ and Reg CF. Continuous 55 and 80 percent portfolio composition monitoring required.</p> | <p><b>Real estate operating company (non-traded REIT, development company)</b></p> <p>Outside the Investment Company Act. All seven exemptions potentially available. Continue to Step 2.</p> |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

## STEP 2. Does the offering involve any non U.S. investors?



### YES. Non U.S. investors anticipated

Add a Regulation S offshore tranche alongside the domestic exemption (506(b) or 506(c)).

Engage tax counsel separately for FIRPTA analysis.

Continue to Step 3 for the domestic tranche selection.

### NO. U.S. investors only

Regulation S is not needed.

Continue to Step 3.

## STEP 3. Will the offering involve any public marketing, that is, general solicitation to persons without a pre-existing substantive relationship with the sponsor?

*Examples: social media posts about the offering, publicly accessible website describing the investment, conference pitches to general audiences, webinars open to new contacts, paid digital advertising, email to purchased lists.*



### YES. General solicitation intended or already conducted

Rule 506(b) is unavailable. The choice is Rule 506(c) (accredited investors only, all verified).

If the issuer is a non-investment company entity and wants retail access, Reg A+ Tier 2 or Reg CF may also be in play.

Continue to Step 4.

### NO. Private offering only, existing relationships

Rule 506(b) is available and is likely the right choice for most private real estate funds.

Continue to Step 4 to confirm. Rule 506(c) also remains available if preferred.

## STEP 4. Does the offering need to include non-accredited investors?



### YES. Non-accredited investor access is needed

If issuer is a 3(c)(5)(C) real estate fund or a real estate operating company: Reg A+ Tier 2 (up to \$75 million), Reg CF (up to \$5 million), or, if all

### NO. Accredited investors only

Both Regulation D options (506(b) and 506(c)) remain available.

Continue to Step 5.

|                                                                                                                                                                                                                                                                                                                                                                                  |  |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--|
| <p>investors and the property are in one state, the intrastate exemption.</p> <p>If issuer is a 3(c)(1) or 3(c)(7) fund: Rule 506(b) is the only option, limited to up to 35 sophisticated non-accredited investors with enhanced disclosure. Consider whether the fund’s strategy supports restructuring to a 3(c)(5)(C) framework to unlock the broader retail exemptions.</p> |  |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--|

STEP 5. What is the offering size, and what timeline is acceptable before the first investment close?



|                                                                                                                                                                        |                                                                                                                                                                                                |                                                                                                                                                                                               |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p><b>Any size and fast close (30 to 75 days)</b></p> <p>Rule 506(b) or Rule 506(c). No pre-approval. Launch within weeks of document completion. No offering cap.</p> | <p><b>Up to \$5 million and can wait 45 to 90 days</b></p> <p>Reg CF (if non investment company). Non-accredited investors welcome. Single portal required. Ongoing reporting obligations.</p> | <p><b>\$5 million to \$75 million and can wait 4 to 8 months</b></p> <p>Reg A+ Tier 2 (if non investment company). Retail access. State preemption. Audit and SEC qualification required.</p> |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

Part Three: Scenario Analysis. The Combinations That Appear Most Often

Most real estate offering decisions cluster around a relatively small number of recurring fact patterns. This section works through the eleven most common scenarios in private real estate syndication and fund practice, identifying the right exemption for each and the specific practical considerations that apply. Scenario 7 specifically addresses the Section 3(c)(5)(C) structural choice that drives federal exemption availability for many real estate funds.

Scenario 1. First Time Sponsor, Established Local Network, Single Acquisition

|                    |
|--------------------|
| <b>The Profile</b> |
|--------------------|

- *Sponsor with 5 to 15 investors known personally from prior professional or social relationships.*
- *Target property identified; acquisition requires \$500,000 to \$2 million in equity.*
- *Investors are mostly accredited; one or two may be non-accredited family members.*
- *No public marketing planned; no social media presence for the offering.*
- *Timeline: need to close within 60 days.*

### **Recommended Exemption. Rule 506(b).**

Rule 506(b) was built for exactly this scenario. The pre-existing relationships are documented by years of professional contact. No general solicitation is required or intended. The non-accredited family members can be admitted as sophisticated investors (up to 35 in total), provided they receive enhanced financial disclosure if the issuer so chooses, or simply excluded and replaced by accredited investors, which is usually the simpler path for a small first offering.

The compliance cost is the lowest of any available option. One PPM, one subscription agreement (with 506(b) accreditation representations), one Form D within 15 days of first sale, and state notice filings in each investor's state of residence. Total legal cost for a well prepared first sponsor typically runs \$15,000 to \$35,000. Timeline from counsel engagement to first close: 30 to 45 days for a focused team.

What to watch. Document the pre-existing relationship with each investor before the offering is presented to them. A folder for each investor containing prior correspondence, meeting notes, and the investor questionnaire they completed before being presented with the specific opportunity is the standard. The documentation does not need to be elaborate, but it needs to exist before the first offer is made.

## **Scenario 2. Growing Sponsor, Active Social Media Presence, Mixed New and Known Investors**

### **The Profile**

- *Sponsor with 2 to 4 completed deals, active LinkedIn and email marketing presence.*
- *Some investors are from prior offerings (pre-existing relationship); others are new contacts from online outreach.*
- *Equity raise of \$2 million to \$5 million; all investors will be accredited.*
- *Sponsor wants to continue using social media and webinars as investor acquisition channels.*
- *Timeline: 45 to 60 days acceptable.*

### **Recommended Exemption. Rule 506(c).**

This is the scenario where 506(c) is not just available, it is the only compliant option. Social media posts about specific investment opportunities, webinars open to new contacts, and email outreach to lists that include persons without a prior relationship all constitute general solicitation. Once any of those activities occur in connection with this offering, Rule 506(b) is unavailable for any investor admitted after the solicitation.

The March 2025 SEC no action letter has materially changed the 506(c) verification landscape for sponsors in this scenario. If the offering minimum is \$200,000 or more per natural person investor, the verification requirement is satisfied through written investor representations (accredited investor status plus confirmation of no third party borrowing to fund the minimum) without requiring tax returns, bank statements, or professional verification letters. For most real estate fund offerings with \$200,000 minimums and above, this guidance transforms 506(c) from a burdensome compliance exercise into a manageable subscription document process.

For offerings with minimums below \$200,000 where the sponsor wants to maintain general solicitation, the traditional documentary verification methods remain required: tax returns, W-2s, bank statements, or a third party verification letter from a licensed professional. Several third party verification services can manage this process at scale at a cost of approximately \$100 to \$300 per investor.

### Scenario 3. Experienced Sponsor, Institutional Quality Investor Base, Blind Pool Fund

#### The Profile

- *Sponsor with 5 or more completed deals and an auditable track record.*
- *Raising a \$20 million to \$50 million blind pool fund from family offices, registered investment advisers, and individual accredited investors.*
- *All investors are accredited; several are qualified purchasers.*
- *No general solicitation; capital is sourced through direct relationships and placement agent introductions.*
- *Placement agent is FINRA registered; will introduce 15 to 20 institutional LP prospects.*

**Recommended Exemption.** Rule 506(b), with Regulation S supplement if non U.S. investors are anticipated.

At this scale and with this investor profile, 506(b) is the right choice. The fund will typically operate under a 3(c)(1) or 3(c)(7) Investment Company Act exclusion, which forecloses Regulation A+ and Regulation CF. The investor base is entirely accredited. The placement agent introduces prospects through direct, confidential presentations, not through general solicitation, and the FINRA registered broker dealer relationship satisfies the broker dealer

requirement without requiring the sponsor to conduct public marketing. If the fund's investment strategy is consistent with the 3(c)(5)(C) asset composition tests (direct real estate, whole mortgage loans, and similar qualifying interests), 3(c)(5)(C) is worth considering as the Investment Company Act exclusion, as discussed in Threshold Question 1. For institutional blind pool funds that hold mixed asset types or that anticipate building out a fund of funds structure, 3(c)(7) remains the more flexible choice.

The offering documents for a fund at this scale need to be meaningfully more sophisticated than a single asset syndication PPM. A complete fund level LPA or operating agreement, a PPM that addresses the fund's investment strategy and all material risk factors with the specificity institutional investors require, institutional quality subscription documents, and a documented bad actor questionnaire for all covered persons. The ILPA DDQ should be prepared alongside the offering documents, because institutional investors will send it before making a commitment.

The Regulation S supplement is worth building into the offering documents from inception if any non U.S. investors are on the prospect list. Adding Regulation S mid offering is possible but more disruptive than designing the documents to accommodate both tranches from the start. FIRPTA analysis, covering withholding obligations on distributions and on eventual disposition proceeds, must be part of the fund's tax planning from day one if non U.S. investors are anticipated.

## Scenario 4. Sponsor Evaluating the Switch from 506(b) to 506(c) After Marketing Misstep

### The Profile

- *Sponsor has been using 506(b) for prior offerings.*
- *For the current offering, one social media post describing the investment opportunity went live before the exemption election was confirmed.*
- *Three investors have already signed subscription documents and wired capital.*
- *Sponsor wants to know whether to proceed or restructure.*

**Recommended Path.** Convert the current offering to Rule 506(c) and implement verification for all subsequent admitted investors.

The social media post was general solicitation. From the date of that post forward, Rule 506(b) is unavailable for any investor admitted after that date. The three investors who wired capital before the post may still be in a compliant 506(b) tranche if their subscriptions were completed and the capital received before the post went live. That is a fact specific analysis that counsel needs to work through.



Going forward, the offering must be treated as a 506(c) offering. This means every investor admitted from this point must be accredited and must be independently verified using the methods required under Rule 506(c) (or through the minimum investment threshold approach under the March 2025 guidance, if the investment minimum qualifies). The subscription documents should be updated to add 506(c) specific accreditation representations and the verification documentation requirement.

The sponsor should not simply proceed with 506(b) subscription documents for future investors on the theory that the social media post was minor or unlikely to reach those specific investors. The contamination is not investor specific. It is offering specific. Every investor admitted after the solicitation is in a potentially uncompliant offering unless the offering is properly converted to 506(c) with proper verification.

### **⚠ The Conversion Is Forward Looking, Not Retroactive**

*Converting a contaminated 506(b) offering to 506(c) does not cure the problem for investors who were admitted after the general solicitation occurred but before the conversion was implemented without proper 506(c) verification.*

*Every investor admitted after the date of the general solicitation, regardless of when the conversion is made, must be properly verified under 506(c) standards. If an investor signed subscription documents and wired capital between the date of the solicitation and the date of the formal conversion, they are in a gray zone that requires careful individual analysis.*

*This situation requires securities counsel's involvement immediately upon discovery. The longer the offering continues after the solicitation event without addressing the issue, the larger the pool of potentially affected investors.*

## **Scenario 5. Retail Focused Sponsor, Local Property, Community Based Capital Raise**

### **The Profile**

- *Sponsor developing a mixed use property in a specific urban market.*
- *Wants to raise \$2 million from retail investors including non-accredited community members.*
- *Offering size under \$5 million; all investors will be local to the metropolitan area.*
- *Sponsor has a community facing brand and retail investor marketing capability.*
- *Timeline: 90 days to first close is acceptable.*

**Recommended Exemption. Regulation CF (with the fund structured as a 3(c)(5)(C) real estate fund or as a real estate operating company), or Rule 506(b) with sophisticated non-accredited investor provisions if the fund is structured under 3(c)(1).**

The sponsor's desire to include non-accredited retail investors and the \$2 million offering size both point toward Regulation CF. The structural decision that determines whether Regulation CF is available is the Investment Company Act exclusion. If the issuer is structured as a 3(c)(5)(C) real estate fund (continuously satisfying the 55 percent and 80 percent portfolio composition tests by holding direct real estate, whole mortgage loans, and qualifying real estate type interests) or as a non investment company real estate operating entity, Regulation CF is available. Regulation CF's \$5 million annual cap contains the raise, non-accredited investors can participate subject to their per investor limits, and the publicly accessible portal satisfies the marketing requirement for community facing outreach.

The key operational constraint is the single portal requirement. The sponsor must select one SEC registered funding portal and conduct the entire offering through that platform. Portal selection should be based on the platform's established retail investor community relevant to the specific market and property type. A portal with an existing multifamily investor base in the same metropolitan area will significantly reduce the marketing effort required to reach the \$2 million target within the timeline.

If the issuer is instead structured as a fund relying on a 3(c)(1) exclusion, Regulation CF is unavailable. The only path to non-accredited investor participation in that case is Rule 506(b)'s sophisticated investor provision: up to 35 non-accredited investors who have sufficient knowledge and experience in financial and business matters to evaluate the investment. Those investors require enhanced disclosure including the financial information a registered offering would provide. For a community focused offering of this size, restructuring the vehicle as a 3(c)(5)(C) fund to unlock Regulation CF is often the better path than trying to fit the offering into the 506(b) sophisticated investor framework.

## **Scenario 6. Real Estate Fund or Operating Company Targeting Retail Investors at Scale**

### **The Profile**

- *Real estate fund structured to qualify under Section 3(c)(5)(C), or a non-traded REIT, or a real estate operating company (in each case, not a 3(c)(1) or 3(c)(7) fund).*
- *Target raise of \$10 million to \$50 million over 12 to 18 months from retail and accredited investors.*
- *Wants to market through broker dealer networks and online platforms.*
- *Has the infrastructure for ongoing SEC reporting and audited financial statements.*

- *Timeline: 5 to 7 months acceptable; planning for a sustainable ongoing capital raise program.*

### **Recommended Exemption. Regulation A+ Tier 2.**

Regulation A+ Tier 2 was designed for exactly this profile. The \$75 million annual cap accommodates the target raise. Federal preemption of state registration requirements eliminates the state by state qualification that makes Tier 1 impractical for multi-state programs. The ability to include non-accredited investors, subject to the 10 percent of income or net worth investment limit, dramatically expands the addressable investor pool compared to Regulation D offerings. And the SEC qualified offering circular, while requiring audited financials and a 4 to 6 month qualification timeline, provides the credibility that retail investors and their financial advisers require.

The ongoing reporting obligations of Tier 2 (annual Form 1-K, semi-annual Form 1-SA, and current event Form 1-U filings) represent a meaningful compliance infrastructure investment that must be budgeted alongside the initial qualification costs. A 3(c)(5)(C) real estate fund, non-traded REIT, or real estate operating company with a functioning accounting and reporting team can manage these obligations. A single project sponsor without that infrastructure will find them burdensome.

The Investment Company Act analysis is the threshold structural decision. Regulation A+ is not available to a real estate fund organized under 3(c)(1) or 3(c)(7), because those funds are treated as investment companies for this purpose. A sponsor who wants retail access through Regulation A+ must structure the vehicle as a fund qualifying for the Section 3(c)(5)(C) exclusion (with the continuous 55 percent and 80 percent portfolio composition monitoring this requires), as a non-traded REIT, or as a direct real estate operating entity. For most real estate fund strategies that hold direct property interests and whole mortgage loans, 3(c)(5)(C) is the natural fit and is the structural choice that unlocks the Regulation A+ option.

## **Scenario 7. Real Estate Fund Choosing Between 3(c)(1) Restriction and 3(c)(5)(C) Flexibility**

### **The Profile**

- *Sponsor planning a real estate fund whose investments will be direct property acquisitions and whole mortgage loans secured by real estate.*
- *Anticipated investor base: 40 to 80 accredited investors initially, with plans to expand the program through follow on offerings.*
- *Sponsor would like the option to add a Regulation A+ Tier 2 retail program in 18 to 24 months if the initial fund performs well.*

- *All initial investors will be accredited; the sponsor is considering whether to admit non-accredited investors in future offerings.*
- *Timeline: initial close in 60 days; medium term flexibility is important.*

**Recommended Structure.** Structure the fund under Section 3(c)(5)(C) (rather than defaulting to 3(c)(1)) and conduct the initial offering under Rule 506(b) or Rule 506(c) depending on marketing strategy.

This is the scenario where the Investment Company Act exclusion choice is the single most consequential structural decision the fund will make. Defaulting to 3(c)(1) preserves the 100 beneficial owner cap as the binding constraint on the program. Defaulting to 3(c)(7) requires every investor to be a qualified purchaser (\$5 million in investments for individuals), which restricts the addressable investor base to a much smaller pool than the accredited investor base. Section 3(c)(5)(C) eliminates both constraints, provided the fund's investment strategy is consistent with the asset composition tests (which, for a fund focused on direct property and whole mortgage loans, it naturally is).

The first practical consequence is the absence of the 100 beneficial owner cap. The sponsor can admit unlimited accredited investors without tracking against the 3(c)(1) ceiling. The compliance overhead of continuous beneficial owner counting (with the look through rules for entity investors and knowledgeable employees) is eliminated.

The second practical consequence is that Regulation A+ and Regulation CF become available for any follow on offering. If the initial 506(b) or 506(c) fund performs well and the sponsor wants to launch a parallel retail program, the Regulation A+ Tier 2 path is open without restructuring. If the sponsor structures the initial fund as a 3(c)(1) fund and later wants Regulation A+ access, the only path forward is to launch a new, separately structured 3(c)(5)(C) vehicle and re raise from scratch.

The structural compliance discipline that 3(c)(5)(C) requires is the ongoing portfolio composition monitoring. The fund's acquisitions must be tracked against the 55 percent qualifying interests test (direct real estate, whole mortgage loans, fee and leasehold interests) and the 80 percent combined test (qualifying interests plus real estate type interests). Cash on hand from a recent capital raise is permitted to be temporarily outside the qualifying interests bucket while the sponsor deploys it, but the framework must be in place at the entity's formation. Fund counsel and the fund's accountants should design the compliance monitoring as part of the entity formation, not as an afterthought once acquisitions begin.

## Scenario 8. Sponsor with Entirely Local Market, Single State Investor Base

### The Profile

- *Sponsor located in, and purchasing property in, a single state (for example, Texas).*
- *All target investors are residents of the same state.*
- *Offering size under \$3 million; no institutional investors.*
- *Sponsor uses online marketing but can implement investor residence verification.*
- *Timeline: 30 to 60 days; wants lower compliance cost than Regulation D.*

### **Recommended Exemption. Rule 147A (Intrastate), with immediate fallback to 506(b) if any out of state investor is identified.**

For a truly local offering with a genuinely in state investor base, the intrastate exemption is the lowest cost federal compliance path available. There is no federal Form D to file, no federal ongoing reporting, and no investment minimum or accreditation requirement. Rule 147A, the more flexible of the two intrastate safe harbors, permits offers to be accessible to out of state residents (for example, through a publicly accessible website), provided that all actual sales close with in state residents.

The critical compliance discipline is investor residence verification at the subscription stage. Every subscriber must be confirmed as a state resident at the time of sale, by checking driver's licenses, utility bills, voter registration, or similar documentation. The single investor contamination risk, where one out of state sale destroys the federal exemption for the entire offering, is severe enough that the verification process must be operationally enforced, not just described in the subscription documents.

State law compliance is separately required. The intrastate federal exemption does not preempt state securities requirements, and every state has its own exemption or qualification process for intrastate offerings. Texas, for example, has a specific intrastate limited offering exemption with its own conditions. Sponsors should not assume that satisfying the federal Rule 147A conditions automatically satisfies the state's securities law requirements.

The recommended practice is to maintain Rule 506(b) as a backup structure that can be quickly implemented if any investor turns out to be an out of state resident. Having the 506(b) documentation ready, including an investor questionnaire establishing the pre-existing relationship and a PPM with appropriate representations, means that an inadvertent out of state contact can be redirected to the 506(b) structure before a sale is made, rather than after. Note that the intrastate exemption is not available to a fund relying on a 3(c)(1) or 3(c)(7) exclusion; a 3(c)(5)(C) fund qualifies because it is outside the Investment Company Act entirely.

## Scenario 9. Sponsor Adding Non U.S. Investors to an Existing 506(b) Offering

### The Profile

- Existing 506(b) fund offering, 12 domestic U.S. accredited investors already admitted.
- Two prospective investors are Canadian citizens residing in Canada.
- Sponsor wants to admit them in the current offering round.
- No domestic general solicitation has occurred.

### Recommended Path. Add a Regulation S offshore tranche to the existing offering for non U.S. investors.

Admitting non U.S. investors into a Regulation D offering requires careful attention to the interaction between Regulation D and Regulation S. Non U.S. investors are not automatically excluded from Rule 506(b) or 506(c). They may invest in Regulation D offerings if they qualify as accredited investors and the offering otherwise complies. However, adding a Regulation S offshore tranche provides a cleaner structure that explicitly addresses the offshore character of the transaction and satisfies the conditions of both exemptions independently.

For the two Canadian investors, the Regulation S analysis covers the offshore transaction requirements (transaction completed outside the United States, offshore transaction mechanics), the directed selling efforts prohibition (the sponsor's domestic marketing must not be directed at non U.S. persons), and the distribution compliance period (40 days for Regulation S Category 2, which covers most Canadian investors). The distribution compliance period means the investors cannot transfer their securities to U.S. persons for 40 days from the closing of the transaction.

The PPM and subscription documents should be supplemented to address the Regulation S tranche specifically: the offshore transaction representations, the legend requirements on certificates or transfer records, and the distribution compliance period disclosure. FIRPTA analysis must also be completed for the Canadian investors. Specifically, whether the withholding obligations under Section 1446(f) apply to their investment and how distributions will be structured to meet withholding requirements.

## Scenario 10. Sponsor Evaluating Whether to Change Exemptions for a Successor Fund

### The Profile

- Sponsor completing Fund II under Rule 506(b), raising Fund III.

- *Fund III is the same strategy, same investor base, with 5 to 6 new investors from webinar outreach.*
- *Webinar was publicly advertised and open to new contacts.*
- *Sponsor wants to know whether Fund III can be 506(b) or must be 506(c).*

**Recommended Exemption. Rule 506(c) for Fund III. 506(b) is not available given the webinar.**

The publicly advertised webinar open to new contacts was general solicitation. General solicitation in Fund III's capital raising activities, even before Fund III's documents are finalized, bars Rule 506(b) for Fund III if the webinar was conducted in connection with Fund III's fundraising. The fact that Fund II was a 506(b) offering does not cure the general solicitation in Fund III's raise.

Fund III should be structured as a 506(c) offering with proper accreditation verification for every investor, including the 5 to 6 new investors from the webinar. The existing Fund II investors who are re investing can be verified using the traditional methods or, if their minimum investment is \$200,000 or more, through the March 2025 no action letter approach.

Separately, the integration analysis should be confirmed with counsel. Fund II and Fund III are separate entities raising capital for separate investment programs, which generally means they will not be integrated even if the capital raising periods overlap. But the analysis requires attention to the specific facts. The same investor base, the same timing, and the same strategic positioning can create integration risk that must be evaluated before Fund III's offering documents are finalized.

## **Scenario 11. Sponsor Combining Multiple Exemptions in a Single Offering Program**

### **The Profile**

- *Sponsor running an ongoing multi asset real estate program.*
- *Domestic accredited investors: Rule 506(c) (active social media marketing).*
- *Non U.S. accredited investors: Regulation S offshore tranche.*
- *Wants to also accept non-accredited investors through a separate vehicle.*
- *Separate vehicle for non-accredited investors would be a non-traded REIT or LLC.*

**Recommended Structure. 506(c) plus Regulation S for the main fund; Regulation A+ Tier 2 or Reg CF for a separate non-accredited vehicle.**



A multi exemption platform is not only permissible. It is often the right structure for sponsors who want to serve distinct investor populations with distinct needs. The key is that each exemption must independently satisfy all of its conditions. The combined structure cannot be designed in a way that circumvents any individual exemption’s limitations.

The domestic 506(c) tranche and the Regulation S offshore tranche can coexist in the same fund vehicle, as discussed in Scenario 9. The 2020 SEC harmonization rules specifically address the integration treatment of a concurrent Regulation D and Regulation S offering, confirming that the two will not be integrated when each satisfies its own conditions independently.

The non-accredited investor vehicle must be structured separately, as a distinct legal entity, with its own offering documents, its own exemption, and its own investor population that does not overlap with the main fund. A non-traded REIT structured under a Section 3(c)(5)(C) exclusion from investment company status can use Regulation A+ Tier 2. A standalone real estate operating LLC can use Regulation CF for raises up to \$5 million. The sponsor’s brand and investment thesis can connect the two programs, but their legal structures and offering mechanics must be maintained independently.

## Quick Reference: Five Factors Across Five Primary Exemptions

The table below summarizes how the five most commonly used exemptions score on the five factors that drive real estate exemption decisions. Each factor is rated on a three point scale: Strong, Adequate, or Limited. The rating reflects how well each exemption serves that factor for a typical private real estate offering, not whether the exemption is technically available.

| Decision Factor                                 | 506(b)                                                           | 506(c)                                      | Reg A+ Tier 2                                                                     | Reg CF                                                           | Intrastate                                                                                    |
|-------------------------------------------------|------------------------------------------------------------------|---------------------------------------------|-----------------------------------------------------------------------------------|------------------------------------------------------------------|-----------------------------------------------------------------------------------------------|
| Investor eligibility (breadth of investor base) | Adequate. Accredited plus up to 35 sophisticated non-accredited. | Limited. Accredited only (no exceptions).   | Strong. Any investor; non-accredited capped at 10 percent of income or net worth. | Strong. Any investor; tiered per investor limits.                | Adequate. Any in state investor; no accreditation requirement; geographic confinement.        |
| Marketing flexibility                           | Limited. Private only; prior relationships required.             | Strong. Broad public advertising permitted. | Strong. Full general solicitation permitted.                                      | Adequate. Portal only; public but restricted to portal platform. | Adequate. Rule 147A permits broader online marketing; sales restricted to in state residents. |



| Decision Factor                       | 506(b)                 | 506(c)                                        | Reg A+ Tier 2                                                        | Reg CF                                                  | Intrastate                                                 |
|---------------------------------------|------------------------|-----------------------------------------------|----------------------------------------------------------------------|---------------------------------------------------------|------------------------------------------------------------|
| Offering size                         | Strong. No cap.        | Strong. No cap.                               | Adequate. \$75 million annual cap.                                   | Limited. \$5 million annual cap.                        | Adequate. No federal cap; state law governs.               |
| Speed to first close                  | Strong. 30 to 60 days. | Strong. 45 to 75 days.                        | Limited. 4 to 8 months.                                              | Adequate. 45 to 90 days.                                | Adequate. 30 to 90 days depending on state.                |
| Compliance cost and regulatory burden | Strong. Lowest cost.   | Adequate. Low to moderate (add verification). | Limited. Highest cost (audit, SEC qualification, ongoing reporting). | Adequate. Moderate (Form C, portal, ongoing reporting). | Strong. Often the lowest cost when the offering qualifies. |

## Before You Finalize the Selection

The flowchart and scenario analysis in this appendix lead to a recommended exemption in each case. What they cannot account for are the specific facts that modify the analysis in every real offering: the exact composition of the investor list, the specific marketing activities that have already occurred, the sponsor's prior offering history and integration exposure, the Investment Company Act structure of the vehicle, the ERISA implications if pension fund capital is anticipated, and the state specific blue sky requirements in each investor's state. Any one of these facts can change the recommended exemption or add compliance requirements that the general analysis does not capture.

There is also a timing dimension that this guide cannot fully address. The exemption selection must be made before the first offer. Not before the first sale, but before the first offer. An offer is any communication that constitutes an invitation to invest in specific terms. Once that communication goes out, the offering has begun and the exemption must be established. Revisiting the exemption selection after investors have been contacted is always harder and sometimes impossible without accepting rescission exposure.

APPENDIX D

# Real Estate Syndication and Fund Document Checklist

This checklist covers every document category involved in a private real estate syndication or fund offering, from initial entity formation through ongoing operations and eventual wind down. It is organized into four phases that track the natural sequence of an offering. Each item is tagged to indicate whether it applies to an LLC structure, an LP structure, both, or a specific offering type. Annotations below each item explain what the document does, the most common mistakes sponsors make in connection with it, and when it must be completed relative to other items in the sequence.

The checklist is designed to work for both a single asset syndication (where the investment entity acquires a specific identified property) and a blind pool fund (where the entity raises committed capital before investments are identified). Items that apply primarily to one structure or the other are tagged accordingly. Items without a tag apply universally.

### Checklist Tag Key

- [LLC]** Required for or specific to LLC (Operating Agreement) structures.
- [LP]** Required for or specific to LP (Limited Partnership Agreement) structures.
- [LLC/LP]** Exists in both structures but differs in form; see note.
- [FUND]** Applicable primarily to blind pool funds (not single asset syndications).
- [506(c)]** Specific requirement for Rule 506(c) general solicitation offerings.
- [OPTIONAL]** Best practice; not always required but strongly recommended.

## LLC and LP: Understanding the Two Primary Structures

Most private real estate offerings are structured as either a limited liability company (LLC) or a limited partnership (LP). The choice between them affects not just the governing document but the entity formation mechanics, the governance framework, the tax treatment election, and the institutional investor compatibility of the offering. The comparison below summarizes the key structural differences relevant to document preparation.

| LLC Structure (Member Managed or Manager Managed) | LP Structure (General Partner and Limited Partners)      |
|---------------------------------------------------|----------------------------------------------------------|
| Governing document: Operating Agreement.          | Governing document: Limited Partnership Agreement (LPA). |
| Passive investors are called Members.             | Passive investors are called Limited Partners (LPs).     |

| LLC Structure (Member Managed or Manager Managed)                  | LP Structure (General Partner and Limited Partners)                                                                   |
|--------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------|
| Manager (or Managing Member) controls operations.                  | General Partner (GP) controls operations.                                                                             |
| GP entity is the Manager LLC (or Managing Member).                 | GP entity is a separate LLC or corporation serving as GP.                                                             |
| Liability protection from state LLC statute.                       | LP liability limited to capital contribution; GP has unlimited personal liability (managed by structuring GP as LLC). |
| Manager managed LLC is most common for syndications.               | LP structure preferred by institutional investors; required for 3(c)(7) funds in some states.                         |
| Simpler governance; easier to amend.                               | More formalized governance; LP removal rights more-explicitly defined.                                                |
| Delaware LLC most common; Texas, Nevada, and Wyoming also popular. | Delaware LP nearly universal for institutional funds.                                                                 |
| Form: Certificate of Formation plus Operating Agreement.           | Form: Certificate of Limited Partnership plus LPA.                                                                    |
| Manager EIN separate from LLC EIN.                                 | GP EIN separate from LP entity EIN.                                                                                   |

For most single asset syndications and smaller real estate offerings, an LLC managed by a Manager LLC (sometimes called a manager managed LLC) is the standard structure. The Operating Agreement governs the relationship between the Manager and the passive Members. For institutional grade blind pool funds, especially those expecting institutional LP commitments and aiming for ILPA compliant governance, the Delaware LP structure with a separate GP entity is often preferred, both because institutional investors are more familiar with LP governance documents and because LP law provides a more developed framework for the key person, removal, and clawback provisions that institutional investors require.

A common variation is a hybrid. The investment entity is an LLC, but the GP or Manager itself is structured as a separate LLC (the Manager LLC or Managing Member LLC) that serves as the Managing Member of the investment vehicle. This structure provides the liability protection of an LLC throughout while maintaining operational simplicity. The Manager LLC's own operating agreement governs the internal economics of the sponsor team, including how fees are divided, how carried interest is allocated among team members, and what happens if a team member departs, and should be a distinct document from the investment vehicle's governing agreement.

## PHASE 1

### Pre Formation and Entity Structure

*Before any investor is contacted and before any offering document is prepared.*

Phase 1 covers everything that must exist before the offering can begin. Sponsors who skip or rush through this phase almost always pay for it in Phase 2, scrambling to revise documents that were inconsistent, discovering that entity formation was incomplete, or finding out that the operating agreement and PPM contradict each other on economic terms. The time invested in getting Phase 1 right is recovered multiple times over in offering execution efficiency.

## 1 A. Investment Vehicle Entity Formation

- **[LLC/LP]** Determine structure: LLC or LP (and jurisdiction of formation).
  - *Delaware is the default for most private real estate offerings. Texas, Nevada, and Wyoming LLCs are used when sponsors prefer home state formation, but Delaware's LLC and LP statutes are the most developed and most familiar to institutional investors and their counsel.*
- **[LLC]** LLC: File Certificate of Formation with the Secretary of State.
  - *Delaware Certificate of Formation requires entity name, registered agent, and registered office address. State filing fee for the basic certificate is approximately \$90 to \$110 depending on filing channel and any administrative fees. Processing: 1 to 3 business days standard; 1 hour expedited available for an additional fee.*
- **[LP]** LP: File Certificate of Limited Partnership with the Secretary of State.
  - *Delaware Certificate of Limited Partnership requires entity name, registered agent, registered office, and name and address of at least one general partner. Filing fee structure is similar to the LLC certificate.*
- **[LLC/LP]** Reserve entity name and confirm no conflicts with existing registrations or trademarks.
  - *Check the Secretary of State database and, for ongoing programs, consider a USPTO trademark search for the brand.*
- **[LLC/LP]** Appoint and engage registered agent in formation state (and in each state where qualified to do business).
  - *Annual registered agent fee: approximately \$50 to \$300 per state per year. Registered agent must maintain a physical address (not a P.O. Box) in the state. National registered agent services provide multi-state coverage.*
- **[LLC/LP]** Obtain Employer Identification Number (EIN) from the IRS for the investment entity.
  - *Required before opening a bank account, entering into contracts, or filing tax returns. Form SS-4 is filed online through IRS.gov. EIN is issued immediately online. Each entity (the investment vehicle, the GP or Manager entity, and any SPV) requires a separate EIN.*
- **[LLC/LP]** Qualify to do business (foreign qualification) in each state where the property is located.

→ *Required if the property is in a different state from the formation state. Foreign qualification involves filing an application with the target state's Secretary of State, paying a filing fee, and appointing a registered agent in that state. Failure to foreign qualify can limit the entity's ability to sue or enforce contracts in the target state.*

- **[LLC/LP]** Open dedicated bank account for the investment entity; no commingling with sponsor personal funds or other offerings.

→ *Commingling investor funds with sponsor personal accounts or other offerings is one of the most common and most seriously penalized violations in private real estate enforcement. The investment entity's bank account must be opened, funded only with investor capital and the sponsor's GP commitment, and used exclusively for the offering's activities.*

## 1 B. Sponsor, GP, or Manager Entity

- **[LLC/LP]** Form Manager LLC (for LLC structure) or GP LLC (for LP structure) as a separate entity from the investment vehicle.

→ *The Manager or GP entity is the sponsor's operating company that earns fees and carry. It should be a separate legal entity from the investment vehicle, not the same LLC or a division of it. This separation is what allows the Manager or GP to continue operating after the investment vehicle is dissolved.*

- **[LLC/LP]** Draft and execute the Manager or GP entity's own operating agreement, including internal economics of the sponsor team.

→ *The Manager LLC's operating agreement should address: how management fees are distributed among principals; how carried interest is allocated among team members; what happens if a key principal departs (buy out mechanics, carry continuation or forfeiture); and what vote is required for major decisions. This document governs the sponsor team's internal relationship and should be completed before any investor documents are finalized.*

- **[LLC/LP]** Obtain EIN for Manager or GP entity.

- **[LLC/LP]** Open bank account for Manager or GP entity.

→ *The Manager or GP entity receives fees from the investment vehicle and maintains its own operating expenses. Its account must be kept separate from the investment vehicle's account.*

- **[LLC/LP]** Bad Actor Questionnaire: complete for all covered persons of the Manager or GP entity, including managers, officers, 20 percent equity owners, promoters, and all placement agents and their associated persons.

→ *Rule 506(d) requires that the issuer and all covered persons be free of disqualifying events (SEC orders, criminal convictions for fraud, regulatory bars, and similar adverse regulatory history). The questionnaire must be completed before the first offering and should be re certified annually for continuous offerings. Documenting this review protects the sponsor in any future enforcement inquiry.*

- **[FUND]** Confirm investment adviser registration status: determine whether sponsor qualifies as an Exempt Reporting Adviser (ERA) or must register as a Registered Investment Adviser (RIA).
  - *Sponsors managing \$100 million or more in regulatory AUM generally must register with the SEC as RIAs. Sponsors managing only private fund clients with less than \$150 million in regulatory AUM may qualify as ERAs under the Private Fund Adviser Exemption, filing limited annual Form ADV reports. The threshold analysis should be completed early. The registration process takes at least 60 days and must be in place before commencing advisory activities at the required threshold.*

## 1 C. Exemption and Structure Planning

- Confirm applicable federal securities exemption: Rule 506(b), Rule 506(c), Regulation S (for non U.S. investors), or other.
  - *This decision must be made before any investor communication, any marketing activity, and any document preparation begins. Changing the exemption after investor contacts have been made may require revising all offering documents and re-examining whether prior communications constitute general solicitation. See Appendix C for the exemption selection framework.*
- **[506(c)]** If Rule 506(c): confirm minimum investment thresholds and design verification process.
  - *Under the March 2025 SEC Division of Corporation Finance no action letter, a minimum investment of \$200,000 per natural person combined with a written accredited investor representation and confirmation of no third party borrowing satisfies verification without documentary review. The verification method must be designed and documented before investors are contacted.*
- **[FUND]** Confirm Investment Company Act exclusion: 3(c)(1) (no more than 100 beneficial owners, no public offering), 3(c)(7) (qualified purchasers only), or 3(c)(5)(C) (primarily real estate assets and mortgage loans).
  - *A 3(c)(1) fund requires continuous tracking of beneficial owner count. A 3(c)(7) fund requires all investors to be qualified purchasers (individuals with \$5 million or more in investments; entities with \$25 million or more in investments). The 3(c)(5)(C) exclusion requires (under SEC staff no action positions) that at least 55 percent of assets be qualifying interests in real property or mortgage loans, with at least 80 percent in real estate related assets overall. It does not cap investor count or require qualified purchaser status.*
- **[FUND]** Determine ERISA plan asset exposure: assess whether benefit plan investors will be present and whether the 25 percent threshold monitoring obligation applies.
  - *If benefit plan investors (ERISA plans, IRAs) will participate, the fund must monitor the 25 percent benefit plan investor threshold on an ongoing basis or qualify for the VCOC or REOC exception. The fund documents must include the structural provisions required to maintain this analysis: benefit plan investor definitions, transfer restrictions, and GP authority to prevent threshold crossing.*
- Confirm state blue sky strategy: identify states where investors reside and map required notice filings and fee schedules.

→ *For Regulation D 506(b) and 506(c) offerings, state registration is preempted for accredited investors but notice filings are required in each investor's state of residence within 15 calendar days of the first sale in that state. Filing deadlines and fees vary by state.*

## PHASE 2

### Offering Document Preparation

*Draft, review, and finalize before the first investor communication.*

Phase 2 documents are the legal infrastructure of the offering itself. They must be completed, and reviewed for internal consistency, before the first investor receives any communication about the opportunity. The single most common document preparation mistake is preparing the PPM and operating agreement (or LPA) independently rather than in parallel, then discovering that they describe the waterfall, fees, or governance differently. These documents must be drafted as a unified system, not as separate instruments.

#### 2 A. Private Placement Memorandum (PPM)

- **[LLC/LP]** Executive Summary or Cover Page: entity name, offering amount, minimum investment, exemption relied upon, suitability requirements, date of PPM.
- **[LLC/LP]** Risk Factors section: specific, material risks tailored to this specific offering, not generic boilerplate.
  - *Generic risk factors that could apply to any real estate investment do not satisfy the antifraud disclosure standard. Each risk factor must be specific to the actual investment: the specific property, market, financing structure, sponsor experience level, and offering mechanics. Courts and regulators scrutinize risk factor specificity when evaluating PPM adequacy.*
- **[LLC/LP]** Offering Terms: total offering amount, minimum and maximum; per unit or per interest price; minimum investment; offering period; closing conditions.
- **[LLC/LP]** Use of Proceeds: detailed budget showing how investor capital will be deployed, including acquisition costs, closing costs, reserves, working capital, offering expenses, and any upfront fees.
  - *Vague use of proceeds descriptions are a frequent PPM deficiency. The budget should be specific enough that an investor can verify whether actual use of proceeds was consistent with the offering's representations.*
- **[LLC/LP]** Description of the investment vehicle and its structure (LLC or LP); roles of Manager or GP, Members or Limited Partners; Investment Company Act exclusion relied upon.



- **[LLC/LP]** Description of the investment: property address and description (for single asset syndications); investment thesis and strategy (for blind pool funds); acquisition price or target price range; business plan; projected hold period.
- **[LLC/LP]** Management team: biographies of all key persons, including relevant experience, prior deals, and any prior regulatory history or adverse legal proceedings.
  - *The management team disclosure must include all adverse regulatory and legal history. Omitting a prior SEC or FINRA matter, a judgment in a prior investor dispute, or a bankruptcy is a material omission that gives investors rescission rights and creates antifraud liability regardless of whether the matter feels embarrassing or was ultimately resolved favorably.*
- **[LLC/LP]** Fee disclosure: every fee the Manager or GP or its affiliates will receive (acquisition fees, management fees, disposition fees, construction management fees, property management fees, loan guarantee fees) with the specific dollar amounts or percentages and the calculation basis for each.
  - *Fee disclosure must cover affiliated party service arrangements separately. If a Manager affiliated entity will provide property management, the fee rate, scope, and the fact that it is an affiliated party must be disclosed. Undisclosed affiliated fees are one of the most common subjects of investor complaints and SEC enforcement.*
- **[LLC/LP]** Distribution waterfall: step by step description of the waterfall exactly as it appears in the Operating Agreement or LPA, including return of capital, preferred return (rate and accrual basis), GP catch up (if any), and residual split.
  - *The waterfall in the PPM must match the waterfall in the Operating Agreement or LPA verbatim. Any discrepancy between the two documents gives investors grounds to claim the less favorable version applies or creates ambiguity that must be resolved through litigation.*
- **[LLC/LP]** Conflicts of interest: every actual or potential conflict between the Manager or GP's interests and the investors' interests, including affiliated service providers, co-investment by Manager in competing offerings, and fees that reduce fund performance.
- **[LLC/LP]** Tax disclosure: pass through tax treatment; expected Schedule K-1 issuance and timing; depreciation and recapture consequences; FIRPTA implications for non U.S. investors; Opportunity Zone status (if applicable).
- **[FUND]** ERISA disclosure (if applicable): benefit plan investor participation; 25 percent threshold monitoring; VCOC or REOC status for funds with ERISA investors.
  - *If any ERISA plan assets may be invested, specific ERISA disclosure is required. Generic ERISA risk factors are insufficient. The PPM must describe how the fund monitors the 25 percent threshold and what happens if the threshold is approached or crossed.*
- **[LLC/LP]** Transfer restrictions: summary of the transfer restrictions that apply to investor interests under the Operating Agreement or LPA.



- **[LLC/LP]** How to subscribe: instructions for completing subscription documents, timing of closing, wire transfer information.
- **[LLC/LP]** Exhibits: Operating Agreement (LLC) or Limited Partnership Agreement (LP), Subscription Agreement, Accredited Investor Questionnaire.
- **[LLC/LP]** State legends: required state specific legends for each state where investors reside, typically including a legend stating securities are not registered and resale is restricted.
  - *NASAA maintains standard Regulation D jurisdictional legends for each state. All 50 states plus the District of Columbia require specific legends. New York real estate syndications require particular attention. The New York Attorney General's Real Estate Finance Bureau regulates real estate syndication offerings under Article 23-A of the General Business Law (the Martin Act), and the NY Form 99 notification filing applies to Rule 506 offerings with NY investors.*

## **2 B. Governing Agreement: Operating Agreement (LLC) or LPA (LP)**

- **[LLC]** Operating Agreement (Manager Managed LLC): names Manager; defines Manager's authority and limitations; sets out Members' rights; governs distributions, capital accounts, and tax elections.
- **[LP]** Limited Partnership Agreement: names General Partner; defines GP's authority and limitations; sets out Limited Partners' rights; addresses GP removal (for cause and without cause), key person provisions, and clawback.
- **[LLC/LP]** Distribution waterfall: precise, step by step calculation of how Distributable Cash is distributed among Members (LLC) or Partners (LP). Must match the PPM description exactly.
  - *Every defined term in the waterfall (Distributable Cash, Preferred Return, Unreturned Capital, GP Catch Up) must be defined in the document's definitions section. Ambiguity in any term can make the waterfall impossible to calculate mechanically, requiring judgment calls that lead to disputes.*
- **[LLC/LP]** Capital accounts: mechanism for maintaining each investor's capital account balance; compliance with Regulations Section 1.704-1(b) for proper tax allocations.
- **[LLC/LP]** Tax allocations: profit and loss allocations among Members or Partners consistent with capital account mechanics; qualified income offset, minimum gain chargeback, and other Section 704(b) regulatory compliance provisions.
- **[LLC/LP]** Manager or GP authority: specific enumeration of what Manager or GP may do without investor approval, and what actions require investor consent (majority, supermajority, or unanimous).
  - *Overly broad Manager or GP authority provisions ("Manager may take any action it deems necessary") are a red flag for institutional investors and a potential source of investor claims if the*

*Manager takes an action investors find objectionable. Authority provisions should be specific: what approvals are required for refinancing, for capital calls, for sale, for modifying the business plan.*

- **[LLC/LP]** Investor voting rights: what decisions require investor vote; threshold required (majority, 75 percent, unanimous); mechanics of voting (written consent, meeting).
- **[LP]** Key Person provisions (LP): identifies key persons by name; defines key person events (death, disability, departure, change of control); specifies consequence (suspension of investment period, LP vote on remediation or removal).
  - *Institutional investors require key person provisions that auto suspend the investment period upon a key person event. The ILPA Model LPA standard is automatic suspension pending a majority in interest vote on a remediation plan, with automatic termination of the investment period if no remediation plan is approved within 90 days.*
- **[LP]** GP removal provisions (LP): for cause removal (fraud, gross negligence, material breach by majority in interest); without cause removal (75 percent in interest under ILPA market standard).
  - *Without cause removal rights are essential for institutional capital. A fund whose governing documents lack a workable no fault removal mechanism is materially below institutional market standard and will face side letter negotiation on this point from every institutional investor.*
- **[LP]** Clawback (LP): obligation of GP to return excess carry; calculation methodology; tax gross up provision; funding mechanism (escrow or guarantee); timing.
  - *A clawback drafted at the conceptual level (“GP shall return excess distributions”) without specifying the calculation, the tax gross up, and the funding mechanism is unenforceable as a practical matter. The escrow mechanism, where a percentage of each distribution is held in a third party escrow until the LP preferred return is satisfied, provides the most reliable funding structure.*
- **[LLC/LP]** Transfer restrictions: conditions under which Members or LPs may transfer their interests; GP or Manager consent requirement; conditions for substitute investors; ERISA transfer restriction (prohibition on any transfer that would cause plan asset status).
- **[LLC/LP]** Dissolution and liquidation: events triggering dissolution; winding up procedures; distribution priority on liquidation.
- **[LLC/LP]** Regulatory provisions: Investment Company Act exclusion maintenance; ERISA plan asset provisions; AML and OFAC representations from investors.
- **[LLC/LP]** Indemnification: standard for indemnifying Manager or GP (gross negligence or willful misconduct standard for exclusion); indemnification of Members or LPs serving on advisory committees.

## 2 C. Subscription Agreement and Investor Onboarding Documents

- ☐ **[LLC/LP]** Subscription Agreement: investor's commitment to purchase a specific interest; representations by investor confirming eligibility, receipt and review of PPM, understanding of risks, and status as accredited investor (or qualified purchaser).
  - *The subscription agreement is the investor's formal commitment and the issuer's primary legal documentation of accreditation status. For 506(b) offerings, the investor self certifies accredited status and the issuer documents reasonable belief. For 506(c) offerings, the subscription agreement should contain the affirmative representations required by the March 2025 no action guidance: (1) confirmation of accredited investor status and (2) confirmation that the investment amount was not borrowed from a third party for the specific purpose of meeting the offering minimum.*
- ☐ **[LLC/LP]** Version for accredited investors: checkbox based self-certification of each basis for accreditation (income, net worth, professional license, entity threshold).
- ☐ Version for non-accredited sophisticated investors (506(b) only): additional suitability representations confirming knowledge, experience, and access to information.
  - *If sophisticated non-accredited investors will be admitted (up to 35 under Rule 506(b)), their subscription documents must include representations about their business and financial experience and their ability to evaluate the risks and merits of the investment. These investors also trigger the enhanced financial disclosure obligation in the PPM.*
- ☐ **[506(c)]** 506(c) Verification Documentation: for offerings not using the \$200,000 minimum investment approach, collect documentary verification (tax returns, W-2s, bank or brokerage statements, or third party CPA or attorney letter).
  - *Verification documentation must be collected and reviewed before the investor is admitted. A spreadsheet or investor management system should track the verification method used for each investor and the date reviewed. This documentation is what the sponsor produces in any examination or enforcement inquiry.*
- ☐ **[LLC/LP]** Accredited Investor Questionnaire: detailed questionnaire confirming the specific basis for accreditation, entity structure if the investor is not an individual, beneficial ownership information.
- ☐ **[LLC/LP]** Entity investor documentation: for LLCs, corporations, trusts, and other entity investors, confirm accreditation basis; obtain entity formation documents, authorization documents (operating agreement excerpt confirming signatory authority), and EIN.
  - *Each entity investor type has a different accreditation analysis. A corporation with \$5 million or more in assets is accredited on a different basis than an LLC all of whose equity owners are accredited individuals. The subscription documents should walk through the applicable basis specifically.*
- ☐ **[FUND]** ERISA investor documentation: for benefit plan investors (pension funds, IRAs), confirm benefit plan investor status; provide or obtain representations for 25 percent threshold monitoring.

- **[LLC/LP]** Non U.S. investor documentation (Regulation S): investor confirms non U.S. person status; offshore transaction representations; distribution compliance period acknowledgment; FIRPTA withholding representations.
- **[LLC/LP]** AML and KYC documentation: identity verification for all investors; OFAC sanctions screening; beneficial ownership information for entity investors.
  - *Real estate private offerings are subject to increasing FinCEN scrutiny on AML and KYC. Sponsors should collect and retain copies of government issued photo identification for every natural person investor, documentation of the source of funds (for larger investments), and OFAC sanctions screening results. Under the FinCEN interim final rule issued in March 2025, the Corporate Transparency Act beneficial ownership reporting requirements have been narrowed to apply only to foreign reporting companies registered to do business in the United States. U.S. formed entities and their beneficial owners are currently exempt from CTA reporting. New York's LLC Transparency Act, effective January 1, 2026, has reinstated a state level beneficial ownership reporting regime for entities formed in or registered to do business in New York.*
- **[LLC/LP]** Investor suitability questionnaire: investment experience, net worth range, investment objective, investment timeline, risk tolerance.
  - *A suitability questionnaire is not required by federal law for accredited investor offerings but is a best practice that creates a record of the sponsor's reasonable basis for accepting each investor and demonstrating the pre-existing substantive relationship required for 506(b) offerings.*
- **[LLC/LP]** Wire transfer instructions: confirmed account name, bank name, ABA routing number, account number, and reference instructions.
  - *Wire fraud targeting real estate transactions remains a significant and growing risk. Wire instructions should be delivered directly to investors through a secure channel (not through unencrypted email), and investors should be instructed to verify wire instructions by phone before sending any funds. A documented verbal confirmation protocol reduces wire fraud exposure.*

## 2 D. Investment Adviser Documents (If Applicable)

- **[FUND]** Form ADV Part 1 and Part 2 (Brochure): filed with SEC (or applicable state) if sponsor is an RIA or ERA; provided to advisory clients.
  - *RIAs must file Form ADV and deliver Part 2 to clients annually. ERAs file annually but have fewer client delivery obligations. Sponsors approaching the \$100 million regulatory AUM threshold should begin the RIA registration process at least 12 months in advance.*
- **[FUND]** Investment Advisory Agreement (if fund is managed by a separately registered investment adviser): defines advisory relationship between the adviser and the fund.
- **[FUND]** Written compliance policies and procedures (RIAs): required under Rule 206(4)-7 of the Investment Advisers Act; must designate a Chief Compliance Officer and include policies covering conflicts of interest, trading, marketing, recordkeeping, and cybersecurity.

- ❑ **[FUND]** Code of Ethics: personal trading policy, outside business activity policy, gift and entertainment policy.

## 2 E. Property Level and Transaction Documents

- ❑ **[LLC/LP]** Purchase and Sale Agreement (single asset syndication): confirms the specific property being acquired; must be consistent with the investment description in the PPM.
  - *The PPM should be drafted after the PSA is signed so that the investment description matches the actual acquisition. If the PPM is drafted before a PSA exists (as in a blind pool or during the capital raise), the PPM must describe the investment strategy and criteria rather than a specific property, and must be updated by amendment or supplement when the specific property is identified.*
- ❑ **[LLC/LP]** Property due diligence: environmental Phase I (and Phase II if Phase I reveals conditions); property condition assessment; title commitment; ALTA survey; zoning verification; existing lease review.
- ❑ **[LLC/LP]** Title Insurance: owner's policy and lender's policy; review of Schedule B exceptions for issues affecting use or value.
- ❑ **[LLC/LP]** Property Insurance: general liability, property and casualty, directors and officers, umbrella; confirm adequate limits for lender requirements.
- ❑ **[LLC/LP]** Lender documents: loan agreement, promissory note, deed of trust or mortgage, assignment of rents and leases, guaranty (if any), Non-Recourse carveout provisions and bad boy guaranty.
  - *Non-Recourse carveout guarantees impose personal liability on the GP or key principals for specified bad boy acts (fraud, misapplication of funds, voluntary bankruptcy, unauthorized transfer). The carveout guaranty should be reviewed by counsel before signing. The scope of covered acts varies significantly across lenders and can extend to team member conduct beyond the signatory.*
- ❑ **[LLC/LP]** Property Management Agreement (if using third party or affiliated manager): management fee rate, scope of services, term, termination rights.
- ❑ **[OPTIONAL]** Construction or Renovation Contract (if applicable): scope of work, contract price, payment schedule, completion deadline, lien waivers.

## PHASE 3

### Offering Launch and Closing

*From first investor contact through each closing.*

Phase 3 is where the offering goes live and capital is accepted. The document obligations in Phase 3 are time sensitive. Several have mandatory deadlines that run from the date of first sale, and errors in Phase 3 are the ones that most directly create investor rescission rights and regulatory exposure. The Form D deadline, the blue sky filing deadlines, and the investor onboarding documentation must be completed in the sequence and within the timeframes described below.

### 3 A. Pre Offering Launch Review

- **[LLC/LP]** Consistency review: confirm that the PPM and Operating Agreement (or LPA) describe the waterfall, fees, capital accounts, and investor rights identically.
  - *A mismatch between the PPM's description of the waterfall and the operating agreement's calculation mechanism is one of the most commonly litigated document deficiencies in private real estate investor disputes. Before the offering launches, a side by side comparison of the two documents' economic terms should be performed by counsel.*
- **[LLC/LP]** Bad actor re certification: confirm all covered persons remain free of disqualifying events immediately before offering launch.
- **[LLC/LP]** Marketing materials review: confirm no marketing materials constitute general solicitation (if 506(b) offering); confirm all materials are consistent with PPM disclosures; no unsupported return projections.
  - *Every investor facing communication is subject to the antifraud provisions. Projected returns presented without adequate disclosure of the assumptions underlying them, the range of possible outcomes, and the material risks to achieving the projections are a common source of investor claims. Return projections should be presented with the same specificity in marketing materials as in the PPM.*
- Pre-existing relationship documentation: for each target investor in a 506(b) offering, confirm and document the pre-existing substantive relationship that predates this offering.
  - *Documentation of pre-existing relationships does not need to be elaborate, but it needs to exist before the first offer is made to each investor. A summary note for each investor file describing the nature of the relationship, when it was established, and what prior contact occurred is adequate.*

### 3 B. At and After First Sale

- **[LLC/LP]** Form D: file with SEC through EDGAR within 15 calendar days of the date of first sale (defined as the date the first investor signs a subscription agreement).
  - *The Form D deadline runs from the date of signing, not the date capital is wired. Sponsors who wait until funds are received may miss the 15 day window. A late Form D does not automatically void the exemption, but it is a securities violation that creates enforcement exposure and can be used to support investor rescission claims in subsequent disputes.*



- ☐ **[LLC/LP]** State blue sky notice filings: file in each state where an investor resides within 15 calendar days of first sale in that state.
  - *Each state has its own fee schedule and filing mechanics. Most states accept electronic filings through the NASAA Electronic Filing Depository (EFD). New York requires separate Real Estate Finance Bureau filings for real estate syndications in addition to the standard notice (NY Form 99 for Rule 506 offerings; offering statement filings under General Business Law Section 352-e for broader public real estate offerings). Some states require paper filings by mail. State filing fees vary from a flat fee of approximately \$200 to tiered fees based on the amount sold in that state.*
- ☐ **[LLC/LP]** Maintain investor registry: for each investor, record name, address, state of residence, investment amount, entity type, accreditation basis, verification documentation, closing date, and wire confirmation.
  - *The investor registry is the source document for all compliance records, K-1 preparation, distribution calculations, and blue sky tracking. It must be maintained in an organized, current format throughout the offering and post-closing operations.*
- ☐ **[LLC/LP]** Closing documentation: countersigned subscription agreement; wire confirmation; admission of investor to the entity (Operating Agreement amendment for LLC or LP Register update for LP).
- ☐ **[LLC/LP]** Investor welcome package: confirmation of investment; copy of countersigned subscription agreement; wire confirmation; current Operating Agreement or LPA; investor portal access instructions.
- ☐ **[506(c)]** 506(c) verification file: maintain complete verification record for each investor, including verification method used, documentation reviewed, date reviewed, and reviewer's certification.
- ☐ **[LLC/LP]** Subsequent closing supplements (if rolling closings): amendment to Operating Agreement or LPA admitting new investors; updated cap table; any late admission fee calculation and documentation.

### 3 C . Acquisition Closing Documents

- ☐ **[LLC/LP]** Loan closing documents: execution of all lender documents; satisfaction of all loan conditions precedent.
- ☐ **[LLC/LP]** Title company closing package: execution of all title company documents; delivery of certified funds; recording of deed and deed of trust or mortgage.
- ☐ **[LLC/LP]** LLC or LP authority documents for closing: Operating Agreement or LPA confirming Manager or GP authority to execute; Certificate of Formation or Certificate of LP; Manager or GP certificate of incumbency; good standing certificate from formation state.

- ❑ **[LLC/LP]** Capital call notice (if equity raise precedes acquisition): formal notice to investors of the capital call amount, payment deadline, and wire instructions.
- ❑ **[LLC/LP]** Post-closing organizational matters: obtain post-closing title insurance; record all required instruments; update entity records with final acquisition details.

## PHASE 4

### Ongoing Operations, Compliance, and Wind Down

*From closing through disposition or fund termination.*

Phase 4 is where most sponsors' compliance attention drifts. The offering is closed, the property is acquired, the investor relations demands feel less acute, and the regulatory obligations can start to feel like background noise. They are not. Ongoing compliance failures, including missed Form D amendments, overdue K-1s, unreported material developments, and undisclosed affiliate transactions, are the source of most investor disputes and the most common findings in SEC examinations of private real estate operators.

#### 4 A. Ongoing SEC and State Regulatory Obligations

- ❑ **[LLC/LP]** Form D annual amendment: file an amendment to Form D within one year of the prior filing if the offering remains open and new investors continue to be admitted.
  - *The annual amendment requirement applies to continuous or long term offerings where investors continue to be admitted after the first year. For single asset syndications where all investors were admitted in a single closing or a short initial period, an annual amendment may not be required. Counsel should confirm the applicable requirement based on the offering's facts.*
- ❑ **[LLC/LP]** State blue sky annual renewals: monitor renewal deadlines for each state where filings were made; renew annual filings before-expiration.
  - *State blue sky renewal requirements vary significantly. Some states' filings are effective indefinitely. Others expire annually. A compliance calendar tracking each state's renewal deadline is essential for offerings with investors in multiple states.*
- ❑ **[FUND]** Form ADV annual amendment (RIAs and ERAs): file annual amendment within 90 days of fiscal year end.
- ❑ **[LLC/LP]** New investor admissions: for each new investor admitted after initial closing, complete all Phase 3B steps; file state blue sky notice in investor's state if not previously filed.
- ❑ **[LLC/LP]** Material change amendments: update Form D for material changes; update PPM for material developments affecting the investment (significant change in property condition, material loan modification, departure of a key principal, significant financial development).



→ *The antifraud provisions require disclosure of material developments on an ongoing basis to investors who are still making investment decisions. A PPM prepared in 2023 that does not reflect a material development occurring in 2024 may be misleading to investors who read it after the development occurred.*

#### 4 B. Investor Reporting and Communications

- **[LLC/LP]** Quarterly financial reports: unaudited income statement, balance sheet, and cash flow statement for the investment entity; property level operating summary; capital account balances.
  - *Institutional investors expect quarterly financial reports within 45 days of quarter end. The ILPA Reporting Template specifies the content and format of quarterly reports for fund level investments. Retail investor offerings may have less demanding reporting expectations, but at minimum a quarterly operating summary should be provided.*
- **[LLC/LP]** Annual financial statements: audited GAAP financial statements (required if any non-accredited investors are present; expected by institutional investors regardless); provided within 90 days of fiscal year end.
- **[LLC/LP]** Annual Schedule K-1s: prepared and delivered to each investor by the later of 90 days after fiscal year end or the date reasonably necessary for investors to complete their tax returns; include all items of income, gain, loss, deduction, and credit.
  - *K-1 delays are the single most common source of investor complaints in private real estate. Many investors have accountants or RIAs who file for extensions specifically because of late K-1s, and this creates friction that damages the investor relationship. A realistic K-1 preparation timeline, building in time for the fund's tax return preparation, investor data review, and K-1 distribution, should be established with the fund's CPA before the first fiscal year close.*
- **[LLC/LP]** Distribution notices: for each distribution, identify amount per unit or interest; characterization (return of capital, ordinary income, capital gain); record date; payment date; wire instructions.
- **[FUND]** Capital call notices (if applicable): amount; due date (minimum 10 business days' notice under ILPA standard); purpose; wire instructions.
- **[LLC/LP]** Material development disclosures: notify investors promptly of any material change in property condition, financing, occupancy, business plan, or management team.

#### 4 C. Tax and Accounting Records

- **[LLC/LP]** Entity tax return (Form 1065): filed annually for partnership taxed entities (LLCs taxed as partnerships and LPs); due March 15 (or September 15 with extension).
- **[LLC/LP]** Form 1042 and Form 1042-S (if non U.S. investors present): report income allocable to foreign investors; pay withholding; file by March 15.

- ❑ **[LLC/LP]** FIRPTA withholding documentation: for each distribution to non U.S. investors, calculate withholding; remit to IRS; provide Form 8805 (for partnership withholding on effectively connected income allocable to foreign partners under Section 1446).
- ❑ **[LLC/LP]** Section 1446(f) withholding compliance: if any non U.S. investor transfers their LP or LLC interest, the partnership (or transferee) must withhold and remit 10 percent of the amount realized to the IRS.
- ❑ **[OPTIONAL]** Cost segregation study (if applicable): engage cost segregation firm; obtain report; coordinate with CPA for bonus depreciation elections on Form 1065.  
 → *Under the One Big Beautiful Bill Act (OBBBA), signed July 4, 2025, 100 percent bonus depreciation has been permanently restored for qualified property acquired and placed in service after January 19, 2025. Cost segregation studies have therefore become significantly more valuable for real estate funds acquiring property in 2025 and later.*
- ❑ **[LLC/LP]** Property tax filings: annual property tax assessments; appeal deadlines; payment calendar.
- ❑ **[LLC/LP]** Capital accounts: maintain and update each investor's capital account after each allocation of income or loss and each distribution.

#### 4 D. Asset Management and Operations Records

- ❑ **[LLC/LP]** Property management reports: monthly operating statements; rent rolls; maintenance and capital expenditure tracking; occupancy and leasing activity.
- ❑ **[LLC/LP]** Loan compliance calendar: debt service payment dates; covenant testing dates; required lender reporting; insurance renewal dates; maturity and refinancing planning timeline.  
 → *Loan covenant violations, particularly DSCR tests and occupancy requirements, are frequently discovered late because sponsors do not maintain a systematic covenant monitoring process. A compliance calendar maintained by the asset manager and reviewed quarterly by the sponsor reduces the risk of an inadvertent covenant default.*
- ❑ **[LLC/LP]** Insurance renewals: track policy expiration dates; obtain renewal quotes; confirm coverage remains consistent with lender requirements and offering disclosures.
- ❑ **[LLC/LP]** Material contract renewals: property management agreement; construction and renovation contracts; vendor agreements with terms exceeding one year.
- ❑ **[LLC/LP]** Affiliate transaction documentation: for each payment to an affiliated person or entity, document the transaction; confirm terms are at least as favorable as arm's length; obtain any required investor consent.

→ *Affiliate transactions that occur after the initial closing require the same level of documentation and disclosure as those disclosed in the PPM. An undisclosed affiliate fee paid after closing that was not anticipated in the PPM is a post-closing material misrepresentation.*

- **[LLC/LP]** Investor information requests: maintain a log of all investor information requests and responses; respond to all reasonable requests within the timeframe specified in the Operating Agreement or LPA.

#### 4 E. Disposition, Refinancing, and Wind Down

- **[LLC/LP]** Sale process documentation: listing agreement or broker engagement; PSA for disposition; disclosure to investors of material sale terms before closing.
- **[LLC/LP]** Investor consent (if required by Operating Agreement or LPA): vote or written consent of the required percentage of Members or LPs approving the sale.
- **[LLC/LP]** Payoff letter and loan discharge: obtain payoff letter from lender; arrange payoff at closing; obtain recorded release of deed of trust or mortgage.
- **[LLC/LP]** Final distribution calculation: calculate final waterfall distribution based on net sale proceeds; confirm clawback calculation (LP); prepare distribution statement for each investor.
  - *The final distribution is where errors in the waterfall calculation are most consequential. The calculation should be reviewed by counsel before funds are distributed, particularly for offerings where the actual returns were close to the preferred return threshold or where there are multiple investor classes with different priority rights.*
- **[FUND]** Clawback calculation (LP or FUND): determine whether GP has received more than its contractually entitled promote across the entire fund's life; calculate any required clawback amount; fund the obligation from escrow or GP resources.
- **[LLC/LP]** Final K-1s: prepare and distribute final year K-1s reflecting all income, gains, and losses from the disposition.
- **[LLC/LP]** Entity dissolution: file Articles of Dissolution (LLC) or Certificate of Cancellation (LP) with the Secretary of State of formation and each state where qualified to do business.
  - *Many sponsors forget to dissolve the entity after the investment is wound up and the final distribution is made. An undissolved entity continues to accrue annual state fees, registered agent fees, and may trigger ongoing filing requirements. Dissolution is the last administrative step and should be calendared as part of the wind down plan.*
- **[LLC/LP]** Records retention: maintain all offering documents, investor records, financial statements, tax returns, and communications for at least 7 years (or longer if required by state law or lender requirements).

→ *The SEC and state securities regulators may examine records from prior offerings years after the offering closes. SEC RIA recordkeeping rules under Rule 204-2 generally require 5 years of records. Many private real estate sponsors retain offering files for 7 to 10 years as a conservative best practice. Signed subscription agreements, investor questionnaires, accreditation verification files, Form D filings, blue sky notice confirmations, wire records, and investor communications should all be retained in organized, retrievable form.*

### **⚠ The Three Most Common Document Failures and Their Consequences**

- 1. PPM and Operating Agreement or LPA describe the waterfall differently. Consequence: the sponsor cannot mechanically calculate distributions and must resolve the ambiguity by negotiation or litigation with investors who claim the interpretation most favorable to them.*
- 2. Form D is filed late or blue sky notices are missed. Consequence: state securities violations; late filing fees; potential cease and desist orders from state securities regulators; investor rescission rights in some states.*
- 3. Affiliated fees are paid that were not disclosed in the PPM. Consequence: material misrepresentation; investor rescission rights regardless of investment performance; SEC antifraud exposure under Rule 10b-5 and Securities Act Section 17(a).*

**APPENDIX E**

# Real Estate Syndication Timeline: From Deal to Closing

The sequence matters as much as the substance. A sponsor who completes every document correctly but assembles them in the wrong order (presenting offering documents to investors before the purchase contract is signed, or launching the capital raise without confirming the exemption) has done most of the work and still managed to create compliance exposure. This appendix maps the syndication process from the moment a property first comes into view through the day the acquisition closes and the entity is fully constituted with its investor base in place.

The timeline uses a 90 day escrow as its baseline, the minimum period most experienced sponsors budget for a properly executed syndication. That 90 day window is not a standard imposed by law. It is the practical minimum that the sequential dependencies of the process demand. Document preparation takes 3 to 4 weeks for a first time sponsor working with counsel, 1 to 2 weeks for a repeat sponsor with a template infrastructure. Investor outreach and capital raise takes 30 to 60 days for a warm network. Lender underwriting takes 30 to 45 days. Title work, property condition assessments, and environmental reviews each take 2 to 4 weeks. These tracks run in parallel, but each has its own critical path, and each has a deadline that cannot be moved without renegotiating the PSA.

The timeline is organized in six phases. Each phase includes the parallel tracks running through it (the legal document track, the investor relations track, and the property and lender track) and identifies the specific points where those tracks must converge before the next phase can begin. The appendix covers both LLC and LP structures, identifying where the two paths diverge and what the structural difference means for timing.

## How to Read This Timeline

### Day numbering.

*The day numbers in this timeline assume a Day 0 equal to the date the Letter of Intent is accepted. All subsequent milestones are counted from that starting point. Day 1 is the first day after LOI acceptance.*

### Structure notations.

*LLC Structure notations indicate steps that apply specifically to an LLC and Operating Agreement structure. LP Structure notations indicate steps that apply specifically to a Limited Partnership and LPA structure. Items without a notation apply to both.*

### Baseline assumptions.

*The 90 day baseline assumes a well prepared sponsor with an established investor network and experienced securities counsel. First time sponsors should budget 100 to 120 days. Complex properties (major value add renovations, complicated title, environmental concerns) may require 120 to 150 days.*

**Where most timelines fail.**

*The critical constraint in most syndication timelines is not the legal document preparation. Experienced counsel can complete offering documents in 7 to 14 days. The constraint is the capital raise. A sponsor who has not begun building their investor network before the deal is under contract will rarely succeed in a 90 day window.*

## Timeline Overview: Six Phases from LOI to Closing

The full timeline is summarized below. Each phase is then walked through in detail with the specific events, responsibilities, structural distinctions between LLC and LP, and critical dependencies that connect each phase to the next.

| Phase                                                             | Day Range        |
|-------------------------------------------------------------------|------------------|
| Phase 1. Deal Sourcing and LOI Execution                          | Pre Day 0        |
| Phase 2. PSA Negotiation and Execution                            | Day 0 to Day 7   |
| Phase 3. Entity Formation and Counsel Engagement                  | Day 1 to Day 14  |
| Phase 4. Offering Document Preparation and Parallel Due Diligence | Day 7 to Day 35  |
| Phase 5. Capital Raise and Lender Underwriting                    | Day 14 to Day 75 |
| Phase 6. Final Closing Preparations and Close                     | Day 75 to Day 90 |

### PHASE 1

## Deal Sourcing and LOI Execution

*Before Day 0.*

Nothing in the syndication timeline is more important than what happens before the timeline begins. The sponsor who identifies a compelling acquisition, builds a preliminary financial model, confirms the deal's fit with their investment thesis, and assembles the key relationships (with the seller, with the prospective lender, and with the initial investor pool) before the LOI is signed is working from a position of strength throughout the subsequent 90 days. The sponsor who signs an LOI before doing any of this is working from a position of hope.

**PRE 1**

Deal identification. Property sourced through broker relationship, direct to owner outreach, data driven off market identification, or auction process.

→ *Most sponsors underestimate how long the sourcing phase takes. Building a reliable deal flow pipeline through broker relationships in a specific market typically requires 6 to 18 months of consistent engagement before the first quality deal is presented.*

**PRE 2**

Preliminary underwriting. Sponsor builds financial model: purchase price, projected NOI, debt service, capital expenditures, IRR and equity multiple projections at target purchase price and at stress scenarios.

→ *The preliminary underwriting is what the LOI offer price is based on. It should be stress tested at multiple cap rate assumptions and debt scenarios before the LOI is submitted.*

**PRE 3**

Investor network assessment. Sponsor confirms that sufficient investor capital can likely be raised for this transaction. Not formally, but through prior conversations with the investor network.

→ *For a 506(b) offering, this assessment must occur through prior relationship conversations, not through any communication that could constitute general solicitation in connection with the specific offering. Telling investors, "I think I'll have a deal for you in the next few months, are you allocating capital?" is different from "I have a deal at 123 Main Street with an 8 percent preferred return, are you in?" The first is relationship cultivation. The second may be a general solicitation of the offering.*

**PRE 4**

LOI preparation. Draft and submit Letter of Intent with proposed purchase price, earnest money amount, due diligence period (request minimum 45 days, ideally 60 to 90 days), closing date, key contingencies (financing, due diligence), and identity of buyer entity.

→ *Negotiate the due diligence period aggressively at the LOI stage. Requesting extensions after PSA execution is expensive. Sellers typically require additional earnest money to be made nonrefundable in exchange. A 60 day due diligence period negotiated in the LOI costs nothing. The same extension negotiated after*



*PSA execution typically costs \$25,000 to \$100,000 in additional at risk earnest money.*

## PRE 5

LOI negotiation. Seller counters on price and terms; parties negotiate to agreement on principal terms.

→ *LOI typically executed within 1 to 7 business days of initial submission. LOI acceptance is Day 0 for this timeline.*

## PHASE 2

### PSA Negotiation and Execution

*Day 1 to Day 7.*

The PSA is the contract that governs the acquisition. Every right and protection the sponsor has between LOI acceptance and closing is defined by the PSA. The document preparation timeline, the due diligence period, the earnest money structure, the closing date, and the extension rights are all PSA terms. Once the PSA is signed, changing any of them requires the seller's consent, which typically comes at a cost.

## DAY 1

Engage real estate attorney for PSA review and negotiation; deliver LOI terms for PSA drafting.

→ *Many sponsors use a single attorney for both the real estate transaction and the securities offering. While convenient, this requires that the attorney have genuine depth in both areas. Securities counsel who does not regularly work with commercial real estate PSAs and lender documents will miss things, and real estate transactional counsel without securities experience should not be drafting the PPM.*

## DAY 1

Engage securities counsel; begin preliminary structure analysis: LLC versus LP decision, federal exemption selection, Investment Company Act exclusion analysis (3(c)(1), 3(c)(7), or 3(c)(5)(C)), ERISA assessment, and investor pool composition.

→ *Securities counsel engagement should happen on Day 1, not after the PSA is signed. The exemption election and structure decision must be made before any investor communication about this specific deal begins. A securities attorney who is brought in after the sponsor has already told investors about the deal on social media cannot undo the general solicitation that may have already occurred. The Investment Company Act exclusion analysis is particularly consequential. For a real estate fund whose strategy fits the 3(c)(5)(C) asset composition tests, structuring under 3(c)(5)(C) (rather than defaulting to 3(c)(1))*

*eliminates the 100 beneficial owner cap and preserves access to Regulation A+ and Regulation CF for future offerings. See Appendix C for the exemption and structure decision framework.*

### DAY 1 to 3

Seller's counsel drafts PSA (typical for marketed deals) or buyer's counsel drafts (typical for off market deals). First draft delivered.

### DAY 2 to 5

PSA negotiation. Critical terms to protect: (a) due diligence period length and extension rights; (b) earnest money refundability and hard money dates; (c) seller representation and warranty scope; (d) title and survey objection periods; (e) closing conditions and walk away rights; (f) assignment clause confirming entity can be assigned to or formed after PSA execution.

→ *The assignment clause is critical for syndications. The PSA should permit the buyer to assign the contract to a newly formed entity or to close through a designated entity without seller consent, or at minimum to close through an affiliated entity. If the PSA does not permit assignment, the buyer is locked into closing through the identified entity, which creates complications if the final syndication entity is formed after PSA execution.*

### DAY 5 to 7

PSA executed. Earnest money deposited with title company per PSA terms (typically within 3 business days of execution); due diligence period commences.

→ *PSA execution is the event that starts the due diligence clock. From this point, every day of the due diligence period is being consumed. Securities counsel should receive the executed PSA on the same day it is signed.*

## PHASE 3

### Entity Formation and Counsel Engagement

Day 1 to Day 14.

Entity formation runs in parallel with PSA negotiation. In a 90 day syndication, there is no time to wait until the PSA is signed to form the entities. The investment vehicle (LLC or LP), the Manager or GP entity, and any state foreign qualification filings need to be in process by Day 7 at the latest, or earlier if the sponsor wants the entities available for the lender's use in their underwriting process.

### LLC Structure Track. Days 1 to 14.

**DAY 1 to 3**

LLC: Form Manager LLC (Managing Member). File Certificate of Formation in Delaware or home state; obtain EIN; open bank account.

→ *The Manager LLC is the sponsor's operating company that will sign the Operating Agreement, receive management fees, and hold the carried interest. It must be a separate entity from the investment vehicle. For first time sponsors, this may already exist from prior deals.*

**DAY 3 to 7**

LLC: Form investment vehicle LLC. File Certificate of Formation; designate Manager LLC as the Manager; obtain EIN.

→ *The investment vehicle LLC's Certificate of Formation need only state the name, registered agent, and registered office. The detailed governance is in the Operating Agreement, which is drafted in Phase 4.*

**DAY 7 to 10**

LLC: Foreign qualify in property's state if different from formation state. File Foreign Application; appoint registered agent in that state.

→ *Failure to foreign qualify before closing can delay closing if the title company or lender requires proof of good standing in the property's state. Budget 5 to 10 business days for foreign qualification processing.*

**DAY 7 to 14**

LLC: Open bank account for investment vehicle; confirm Manager LLC's signatory authority.

**LP Structure Track. Days 1 to 14.**
**DAY 1 to 3**

LP: Form GP LLC. File Certificate of Formation for the general partner LLC in Delaware; obtain EIN; execute the GP LLC's internal operating agreement governing sponsor team economics, carry allocation, and key person provisions.

→ *The GP LLC's own operating agreement is often the most negotiated document in a multi principal partnership. It governs how the promote is divided among principals, what happens if a principal leaves, and who controls the GP entity's decisions. This document should be completed before the LP entity is formed, not after.*

**DAY 3 to 7**

LP: File Certificate of Limited Partnership for the investment LP. Name, registered agent, and identity of GP; obtain EIN.

→ *Delaware Certificate of Limited Partnership is a short document. The substantive LP governance is in the LPA, drafted in Phase 4.*

**DAY 7 to  
10**

LP: Foreign qualify both the LP entity and the GP LLC in the property's state.

**DAY 7 to  
14**

LP: Open bank account for the LP investment vehicle; confirm GP LLC as authorized signatory.

### Both Structures: Concurrent Tasks, Days 1 to 14.

**DAY 1 to  
7**

Complete bad actor questionnaire for all covered persons: Manager or GP principals, 20 percent or greater equity owners, promoters, and any placement agents.

→ *The bad actor questionnaire must be completed before the offering commences. Not before the PSA, not before the closing, but before the first communication to any investor about this specific opportunity.*

**DAY 1 to  
7**

Confirm federal securities exemption: Rule 506(b) or Rule 506(c); if 506(c), design verification process under the March 2025 SEC no action guidance (\$200,000 minimum approach) or traditional documentary verification; if non U.S. investors are anticipated, plan Regulation S tranche; confirm Investment Company Act exclusion (3(c)(1), 3(c)(7), or 3(c)(5)(C)).

**DAY 7 to  
14**

Lender selection and application submission. Begin lender outreach, distribute offering memorandum and rent roll to prospective lenders, begin formal loan application.

→ *Lenders do not begin substantive underwriting until the PSA is signed. Beginning the lender process on Day 7 (one week post PSA) is the earliest practical window. Commercial lenders for multifamily and other stabilized properties typically require 30 to 45 days for underwriting, with an additional 2 to 3 weeks for loan document preparation and execution. Starting lender outreach on Day 7 is necessary to have a lender commitment in hand by Day 45 to 50.*

## PHASE 4

### Offering Document Preparation and Parallel Due Diligence

Day 7 to Day 35.

Phase 4 is the most document intensive period. Securities counsel is drafting the PPM, Operating Agreement (or LPA), and subscription documents while the sponsor is simultaneously completing property due diligence. These two tracks (legal documents and due diligence) must converge by approximately Day 35. The offering documents cannot be finalized without the due diligence findings, and the capital raise cannot begin before the offering documents are finalized.

#### Legal Document Track. Days 7 to 35.

##### DAY 7 to 10

Deal structuring call with securities counsel. Confirm structure (LLC or LP), federal exemption, Investment Company Act exclusion, distribution waterfall, sponsor compensation, investor eligibility requirements, and ERISA treatment.

→ *The deal structuring call establishes every economic term that must appear consistently in both the PPM and the Operating Agreement or LPA. Sponsors who try to skip this call and simply ask counsel to draft something standard routinely end up with documents that do not reflect the actual deal terms or that contradict each other.*

##### DAY 10 to 14

Counsel completes first draft: PPM (cover, risk factors, offering terms, use of proceeds, team, property description, fee schedule, waterfall); Operating Agreement (LLC) or LPA (LP); Subscription Agreement with accreditation representations.

→ *For experienced counsel with a good deal structuring call, first draft delivery in 7 to 10 business days is achievable. For first time sponsors who require additional calls to resolve structuring questions, budget 14 to 21 days to first draft.*

##### DAY 14 to 21

Sponsor reviews draft documents. Identifies required changes to waterfall, fee structure, property description, team biographies, and risk factors; returns markup to counsel.

→ *Sponsors should review the PPM in detail and treat it as what it is: a legal document they are signing and will be held to, not a marketing brochure. The risk factors section in particular needs sponsor attention. Generic risk factors that do not address the specific property, market, and business plan are inadequate disclosures.*

##### DAY 21 to 28

Second draft delivered and revised. Consistency review between PPM and Operating Agreement or LPA on waterfall, fees, and governance.

→ *The consistency review between the PPM and the Operating Agreement or LPA is not optional. A mismatch on any economic term (the preferred return rate, the GP catch up mechanics, the acquisition fee calculation, the manager*

*removal threshold) creates an ambiguity that investors or their counsel will exploit if there is ever a dispute. Experienced counsel builds this review into the drafting process.*

### DAY 28 to 35

Final offering documents completed. State legend review (all required state legends added for each state where investors reside); bad actor certifications finalized.

→ *State legends must be specific to each state. NASAA maintains standardized Regulation D jurisdictional legends for all 50 states plus the District of Columbia. Adding legends mid raise when a new investor from a new state is identified is a manageable correction. Missing legends entirely is a compliance failure.*

## Property Due Diligence Track. Days 7 to 35.

Property due diligence runs in parallel with document preparation. The sponsor cannot finalize the offering documents without the due diligence findings, particularly the physical condition assessment, the environmental status, and the financial review of actual operating history. The rule of thumb: start due diligence on Day 7, expect the major third party reports back by Day 25 to 30, and budget Days 30 to 35 to review findings, confirm the deal thesis, and incorporate any material findings into the PPM's risk factors.

| Weeks 1 to 2 (Days 7 to 21). Initiate All Tracks.                                                                                                                                             | Weeks 2 to 4 (Days 14 to 35). Review and Confirm.                                                                                                                |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Engage Phase I Environmental Site Assessment firm. Standard turnaround: 14 to 21 days.                                                                                                        | Review Phase I ESA report. If Recognized Environmental Conditions (RECs) are identified, determine whether Phase II investigation is needed (adds 3 to 6 weeks). |
| Order ALTA/NSPS survey. Standard turnaround: 14 to 21 days.                                                                                                                                   | Review PCA report. Identify capital expenditure items; update financial model for actual CapEx estimates.                                                        |
| Engage Property Condition Assessment firm. Standard turnaround: 10 to 14 days.                                                                                                                | Review title commitment. Identify Schedule B exceptions; send objection letter to seller within contractual objection deadline.                                  |
| Order title commitment from title company. Standard turnaround: 7 to 14 days.                                                                                                                 | Review ALTA survey. Confirm property boundaries, easements, and improvements match contract description.                                                         |
| Request full financial package from seller: 2 to 3 years of operating statements, current rent roll, existing lease abstracts, property tax bills, utility statements, and insurance history. | Abstract all existing leases. Confirm term, rent, options to renew or purchase, and landlord and tenant obligations.                                             |

| Weeks 1 to 2 (Days 7 to 21). Initiate All Tracks.                                   | Weeks 2 to 4 (Days 14 to 35). Review and Confirm.                                                                                 |
|-------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------|
| Confirm zoning classification and use compliance with local planning department.    | Conduct physical site walk with property manager, contractor (for value add deals), and lender representative.                    |
| Order property tax assessment review. Verify current assessment and appeal history. | Update financial model with actual operating data; confirm deal thesis; make go or no go decision before earnest money goes hard. |

### ⚠ The Most Important Due Diligence Moment: When Earnest Money Goes Hard

*Every PSA has a point (the hard date) at which the earnest money becomes nonrefundable. Before that date, the buyer can terminate and recover their deposit for any reason. After that date, terminating means forfeiting the earnest money.*

*In a syndication, the hard date creates a strategic inflection point. A sponsor who has not completed sufficient due diligence to confirm the deal thesis before the hard date faces a stark choice: terminate and lose the deposit, or proceed with unresolved uncertainty and risk that further findings will require a retrade or a deal collapse. By that point, the sponsor has already distributed offering documents to investors based on assumptions that may no longer hold.*

*The correct approach: structure the PSA with a hard date that gives the sponsor enough time to complete all major third party reports and financial review (at minimum 30 days from PSA execution, ideally 45 days). Then treat the hard date as a genuine go or no go decision point, not a formality.*

## PHASE 5

### Capital Raise and Lender Underwriting

Day 14 to Day 75.

Phase 5 is where the capital for the acquisition is assembled. Two parallel tracks run through it (investor capital from the offering, and debt capital from the lender) and both must be confirmed before the closing date. The offering track generates the equity the transaction needs. The lender track generates the debt. Each has its own timeline constraints and dependencies, and they interact at closing when both must be funded on the same day.

#### Investor Capital Raise Track. Days 14 to 75.



The capital raise cannot begin, legally, until the offering documents are finalized and available for delivery to investors. Presenting terms to investors before the PPM is complete is not only premature. It creates the risk of communicating material information that is not consistent with the final PPM, giving investors grounds to claim they were misled by the pre PPM communications.

#### DAY 14 to 35

Soft commitments (506(b) only). For sponsors with established investor relationships, gauge soft commitments through private conversations: “I expect to have the documents ready in two weeks; are you likely to allocate \$X?” This is relationship management, not general solicitation, as long as no specific offering terms are communicated.

→ *The line between relationship management and general solicitation is real and consequential. Communications that describe the property, the projected returns, the fee structure, or the investment terms, even informally and to investors with prior relationships, in advance of the completed PPM create the risk of a material omission if the final PPM differs from the preliminary communications.*

#### DAY 14 to 35

506(c) public marketing preparation. If using general solicitation, prepare website landing page, email campaign, webinar materials, and social media content. All materials reviewed by counsel before launch.

→ *All 506(c) marketing materials are investor facing communications subject to the antifraud provisions. Return projections in marketing materials must be presented with the same basis, assumptions, and risk disclosure as in the PPM.*

#### DAY 28 to 35

Offering documents finalized and available for delivery. Capital raise formally opens.

→ *The offering period begins when the first investor receives offering documents. The Form D must be filed with the SEC within 15 calendar days of the date of first sale, defined by the SEC as the date the first investor is irrevocably contractually committed to invest.*

#### DAY 28 to 35

Launch investor outreach. Distribute PPM, Operating Agreement or LPA, and Subscription Agreement to prospective investors; send personal outreach communications.

#### DAY 35 to 45

First investor closings. Investors complete and return subscription documents; sponsor countersigns and accepts subscriptions; investors wire capital to the investment entity's bank account.

→ Each accepted subscription that results in a sale is an event that may start the 15 day Form D and blue sky filing clock. Under the SEC's Form D guidance, the date of first sale is the date on which the first investor is irrevocably contractually committed to invest, which depending on the terms of the subscription agreement may be the date the issuer accepts the investor's subscription. Sponsors should not let subscriptions accumulate without confirming when the first sale clock has started.

#### DAY 35 to 45

Form D filed with SEC through EDGAR within 15 calendar days of first sale.

→ Common mistake: sponsors wait until all investors have signed before filing Form D. The 15 day clock runs from the date of first sale (when the first investor is irrevocably committed), not from the last investor's closing. A 25 investor offering that takes 60 days to complete may have multiple separate state blue sky deadlines running simultaneously if investors from different states became bound at different times.

#### DAY 35 to 45

State blue sky notice filings. File in each state where investors reside within 15 calendar days of first sale in that state. Use NASAA EFD for electronic filings; track each state separately.

#### DAY 45 to 60

Investor tracking. Maintain running cap table with each investor's name, state, amount, accreditation basis, subscription date, and wire confirmation. Track remaining equity raise against target amount.

#### DAY 60 to 75

Capital raise closes. Equity target met or minimum offering amount satisfied; confirm total capitalization is sufficient to close the acquisition with the agreed lender proceeds.

→ If the equity raise falls short of the target, the sponsor must decide whether to close with reduced equity (adjusting the debt or using bridge financing), extend the offering period (which requires lender cooperation on extending the closing date), or decline to close. Each of these decisions has implications for investors who have already subscribed and for the offering's disclosure.

### Lender Underwriting Track. Days 7 to 75.

Lender underwriting in commercial real estate does not begin in earnest until the PSA is signed. From that point, the typical commercial lender timeline for a stabilized multifamily property is 30 to 45 days to a loan commitment and another 2 to 3 weeks to finalize loan documents. For office, retail, or specialized properties, the underwriting timeline is longer. 60 to 90 days is common for more complex

deals. A HUD multifamily loan, which offers superior terms for eligible properties, can take 6 to 12 months, making it incompatible with a 90 day syndication timeline.

|                     |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|---------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>DAY 7 to 14</b>  | <p>Submit loan application to primary lender and 1 to 2 backup lenders. Provide PSA, rent roll, operating history, environmental reports (if available), and preliminary financial model.</p>                                                                                                                                                                                                                                                                                                                                                                                                               |
| <b>DAY 14 to 21</b> | <p>Lender's initial review. Lender orders third party reports: MAI appraisal, lender's Phase I ESA, lender's PCA (separate from buyer's); begins financial underwriting; may request additional information.</p> <p>→ <i>Lenders order their own third party reports independently of the buyer's. These reports must be completed before the lender can issue a commitment. For this reason, starting the lender process early in Phase 4 (Day 7 to 14) is essential. Waiting until documents are finalized (Day 28 to 35) leaves insufficient time for lender underwriting within a 90 day close.</i></p> |
| <b>DAY 21 to 35</b> | <p>Lender's formal underwriting. NOI analysis, DSCR calculation, valuation review, borrower credit analysis, and loan sizing; lender may issue indicative terms or term sheet.</p>                                                                                                                                                                                                                                                                                                                                                                                                                          |
| <b>DAY 35 to 50</b> | <p>Lender issues loan commitment letter. Confirms loan amount, interest rate, term, amortization, required reserves, and conditions precedent to closing.</p> <p>→ <i>The loan commitment letter is the lender's binding (or near binding) agreement to fund the loan. It includes conditions precedent, items that must be satisfied before the loan will fund, including satisfactory completion of due diligence, no material adverse change in property condition, and confirmation of insurance. All conditions precedent must be satisfied before the closing date.</i></p>                           |
| <b>DAY 50 to 65</b> | <p>Loan document preparation. Lender's counsel drafts promissory note, deed of trust or mortgage, assignment of rents and leases, loan agreement, and guaranty documents; sponsor reviews with real estate counsel.</p> <p>→ <i>Non-Recourse carveout guaranty review is critical. The scope of personal liability for bad boy acts varies across lenders and can include acts by principals, affiliates, and even property managers. Carveouts that are triggered by events outside the sponsor's control (such as a co guarantor's bankruptcy) should be negotiated before the sponsor signs.</i></p>     |

**DAY 65 to  
75**

Loan documents finalized; lender issues funding commitment; closing agent confirms funds are available for simultaneous closing with equity.

## PHASE 6

### Final Closing Preparations and Close

*Day 75 to Day 90.*

Phase 6 is where every track converges. The equity is in the investment entity's bank account. The lender is funded and ready. The title work is clean. The operating entity is formed and authorized. The closing agent has confirmed the funds, the documents, and the schedule. What remains is the execution, and in a well prepared syndication, the execution is the least dramatic part of the process.

**DAY 75 to  
80**

Final organizational documents delivered to closing agent and lender. Certificate of Formation (LLC) or Certificate of Limited Partnership (LP); EIN confirmation letter; Operating Agreement (LLC) or LPA (LP) demonstrating Manager's or GP's authority to execute and close; GP or Manager incumbency certificate; good standing certificate from formation state (and property state if foreign qualified).

→ *Lenders and title companies require specific organizational documentation to confirm that the person signing is authorized to bind the entity. The requirements vary by lender and title company, and surprises at this stage can cause closing delays. Confirm the specific documentation requirements at the beginning of the lender relationship (Day 7 to 14), not in the final week.*

**DAY 75 to  
82**

Final title commitment review. Confirm no new exceptions have been added since the initial commitment; confirm all title objections have been resolved; order title down date search.

**DAY 78 to  
85**

Final walkthrough of property. Confirm no material change in physical condition since initial due diligence; confirm representations and warranties in PSA remain accurate.

**DAY 80 to  
87**

Closing statement (ALTA Settlement Statement) prepared by title company. Confirms all sources and uses of funds; buyer and lender review and approve.

→ *The closing statement is the final reconciliation of every dollar in the transaction. The sponsor should review it in detail, confirming the acquisition fee calculation, the proration of rents and operating expenses, the earnest money credit, the lender fees, and the payoff of any existing liens. Errors on the closing statement are common and can be costly.*

#### DAY 84 to 88

Wire transfers arranged. Confirm investor capital held in investment entity account is sufficient; confirm lender wire instructions and timing; confirm title company's wire receipt procedure.

→ *Wire fraud targeting real estate closings is a persistent and growing threat. The sponsor should confirm the title company's wire instructions by telephone with the title officer using a number previously verified, not a number obtained from an email. Confirm amounts a second time the morning of closing. A diverted closing wire can be extremely difficult to recover.*

#### DAY 88 to 90

Closing day. Sponsor and seller execute deed and all closing documents; lender funds; title company disburses funds; deed and deed of trust or mortgage recorded with county clerk; possession transferred.

→ *Recording occurs on the closing day or, in some jurisdictions, the business day after closing when the recording office opens. The property does not legally transfer until the deed is recorded. The title company manages recording in all standard commercial transactions.*

#### DAY 90

Post-closing. Investor welcome communications sent; confirmation of final cap table; property management transition; insurance policy effective; lender escrow accounts funded.

## Critical Dates Reference: Deadlines That Cannot Be Missed

The following table identifies every non-negotiable deadline in the syndication process and the specific consequence of missing each. These dates should be entered into the sponsor's compliance calendar at the outset and monitored actively throughout the process.

| Date or Day           | Milestone                                                       | What Happens If Missed                                                                                   |
|-----------------------|-----------------------------------------------------------------|----------------------------------------------------------------------------------------------------------|
| Day 0 (PSA execution) | Earnest money deposit due (typically within 3 business days).   | Breach of PSA; seller may terminate and retain deposit or pursue legal remedies.                         |
| Day 0 plus 3 to 5     | Initial due diligence information requests submitted to seller. | Delays in receiving seller documents compress the available review time within the due diligence period. |

| Date or Day                                | Milestone                                                                                | What Happens If Missed                                                                                                                                                                                      |
|--------------------------------------------|------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Day 1                                      | Securities counsel engaged.                                                              | General solicitation risk accumulates with each investor communication made without confirming the exemption.                                                                                               |
| Day 1 to 7                                 | Entity formation initiated.                                                              | Lender cannot begin underwriting without a confirmed borrower entity; title cannot be prepared without the acquiring entity's name.                                                                         |
| Day 1 to 7                                 | Bad actor questionnaire completed for all covered persons.                               | Cannot rely on Rule 506 exemption if a disqualifying event exists for any covered person; discovery post offering creates rescission exposure.                                                              |
| PSA defined (typically Day 30 to 45)       | Earnest money goes hard (nonrefundable).                                                 | Loss of deposit if deal is terminated after this date; major due diligence findings after the hard date cannot be used to walk away without financial penalty.                                              |
| PSA defined                                | Due diligence period expiration. Buyer must exercise or waive contingencies.             | Failure to timely provide written notice of contingency exercise may constitute automatic waiver.                                                                                                           |
| Day 35 (approximately)                     | Offering documents finalized; capital raise formally opens.                              | Cannot legally begin raising capital through offering documents before they are complete.                                                                                                                   |
| Within 15 days of first sale               | Form D filed with SEC through EDGAR (first sale = first investor irrevocably committed). | Securities violation; enforcement exposure; may provide investors with a colorable claim for rescission in some states.                                                                                     |
| Within 15 days of first sale in each state | Blue sky notice filings in each investor's state of residence.                           | State securities violations; late fees (typically a few hundred to a few thousand dollars per state, depending on the state); potential cease and desist orders; investor rescission rights in some states. |
| Day 45 to 50 (approximately)               | Lender commitment letter received.                                                       | Without a confirmed lender, the closing date cannot be met. Extension negotiations with seller begin, costing additional earnest money.                                                                     |
| PSA defined closing date                   | Acquisition closes; all funds simultaneously disbursed.                                  | Failure to close on the closing date is a default under the PSA; buyer risks earnest money forfeiture and seller's right to pursue specific performance.                                                    |
| Within 15 days of first sale (ongoing)     | Blue sky filings for each additional investor state as new investors are admitted.       | Same consequences as initial filings; ongoing tracking required for rolling closings.                                                                                                                       |

## LLC and LP: How Structure Affects the Timeline

The choice between an LLC and an LP structure does not substantially change the length of the syndication timeline. Both can be formed in 1 to 3 business days and both use the same federal securities exemptions. What the structure choice does affect is the document complexity, the governance framework, and the institutional investor compatibility of the offering. Those differences ripple through the timeline at specific points.

| LLC Timeline Differences                                                                                                                                                     | LP Timeline Differences                                                                                                                                                                                |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Entity formation: Certificate of Formation (simpler than Certificate of LP); no requirement to designate a GP with personal liability.                                       | Entity formation: Certificate of Limited Partnership requires identifying the GP; GP LLC must be fully formed before LP can be properly constituted.                                                   |
| Governing document: Operating Agreement (typically 30 to 60 pages for a syndication versus 60 to 100 pages for an institutional LP); somewhat simpler governance provisions. | Governing document: LPA is typically longer and more complex than an LLC Operating Agreement; includes key person provisions, GP removal, and clawback mechanics that institutional investors require. |
| Manager authority: Manager Managed LLC grants Manager near plenary authority; member voting rights are limited to items specifically reserved in the Operating Agreement.    | GP liability: GP has unlimited personal liability (managed by structuring GP as an LLC); lender's Non-Recourse carveout guaranty is signed by the GP entity and its key principals.                    |
| Institutional investor friction: some institutional investors prefer LP structure; may require side letters to address governance expectations in an LLC structure.          | Institutional investor compatibility: LP structure is the institutional standard; ILPA governance framework (Model LPA, Principles) is built around the LP structure.                                  |
| Transfer restrictions: easier to administer in an LLC using member approval requirement without the LP specific transfer mechanics.                                          | Key person and removal provisions: LP structure has a more developed legal framework for key person events and no fault GP removal; these provisions add to LPA drafting time.                         |
| Timeline impact: slightly faster document preparation (1 to 3 days faster than LP LPA) for comparable transaction complexity.                                                | Timeline impact: LPA drafting typically takes 3 to 7 days longer than a comparable LLC Operating Agreement due to the complexity of institutional grade governance provisions.                         |

## When the Timeline Must Compress: 60 Day and 45 Day Closings

Competitive acquisition environments (broker controlled marketed processes, best and final bid situations, and off market deals where the seller wants speed) sometimes require closings faster than the 90 day baseline. Compressing the timeline to 60 or 45 days is possible, but it changes the risk profile of every phase. The following adjustments are required to close in a compressed timeline.

### 60 Day Closing: What Must Change

**Pre LOI work is critical.**



*Underwriting, investor network assessment, and preliminary lender conversations must all be completed before the LOI is submitted, not after.*

**Documents must be on an accelerated track.**

*Deal structuring call within 24 hours of PSA execution; first draft delivered within 5 business days; two rounds of revision completed within 10 business days.*

**Investor conversations must be ongoing.**

*Through prior relationship outreach consistent with 506(b) requirements, soft commitments should be substantially in place before Day 14, before the documents are issued.*

**Lender application submitted on Day 1.**

*With a complete package. Sponsors who wait for third party reports before engaging the lender cannot close in 60 days.*

**Due diligence period must be front loaded.**

*All major third party reports ordered within 24 hours of PSA execution; Phase I, PCA, and ALTA ordered simultaneously.*

**LLC structure preferred over LP for compressed timelines.**

*Simpler documents with shorter drafting time.*

**Hard earnest money typically larger and earlier.**

*In a competitive process, sponsors must be prepared to commit more capital at risk earlier.*

**⚠ The Compressed Timeline's Biggest Risk: Undercapitalized Equity Raise**

*The constraint in most compressed syndication timelines is not the legal work, the due diligence, or the lender. It is the capital raise. A sponsor who needs to raise \$3 million in equity from private investors in 30 days, starting from the date documents are issued, is relying on an investor network that has been continuously cultivated, that has seen the sponsor's prior deals and results, and that is currently prepared to deploy capital quickly.*

*A sponsor who begins building investor relationships after the PSA is signed and tries to compress the equity raise into 30 days is likely to fail. Not because the deal is bad, but because the relationship infrastructure required to close capital quickly was never built.*

*The sponsors who successfully close in compressed timelines have been continuously investing in investor relationship development during the periods between deals, not just during capital raises. That investment is what makes a compressed timeline possible.*

The timeline described in this appendix reflects the experience of a well prepared sponsor working with experienced securities counsel and real estate transactional counsel, with a warm and maintained investor network, and with a property that does not present unusual due diligence complications. Each of those conditions represents preparation that was done before the timeline began, before the specific deal was identified, and in most cases, long before

**APPENDIX F**

# Fund Formation Timeline

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Forming a blind pool real estate fund is a materially different undertaking from syndicating a specific property. In a single asset syndication, the property anchors the investor presentation. The sponsor can show a specific address, a current rent roll, a lender's term sheet, and a closing date. Investors know exactly what they are buying. In a blind pool fund, none of that exists at the outset. Investors are committing capital to a strategy and a team, trusting that the sponsor will identify, acquire, and manage assets that produce the projected returns over the fund's multi-year life. That difference fundamentally changes the formation process, the document requirements, the investor pitch, and the timeline.

This appendix maps the blind pool real estate fund formation process from strategy development through first investment. The baseline timeline runs six to twelve months from initial planning to first close, with subsequent closings occurring over months twelve through eighteen and the first investment typically following within nine to twenty four months of fund launch. Those ranges are wide because the constraint is almost never the legal or administrative work. It is the capital raise. A fund managed by a sponsor with a deep investor network, an auditable track record, and institutional grade documents can hold a first close within six months. A first time fund manager raising from a cold network is working on a twelve to eighteen month timeline at minimum, and may not reach a meaningful first close at all without a placement agent.

The timeline covers both LLC (Manager Managed) and LP (General Partner and Limited Partners) structures, noting where the two paths diverge and what the structural difference means for document preparation, investor relations, and regulatory compliance. Both structures rely on the same federal securities exemptions (primarily Rule 506(b) or Rule 506(c) under Regulation D) and both require the same sequence of entity formation, document preparation, investor outreach, and regulatory filing. The differences are in governance complexity, institutional investor compatibility, and the internal economics of the sponsor team.

## Fund Formation Timeline: Overview

The table below summarizes the six phases of blind pool fund formation. Each phase is described in detail in the sections that follow.

| Phase                                        | Months                      | Key Milestones                                                                                                                                                                   | Critical Output                                                          |
|----------------------------------------------|-----------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------|
| 1. Strategy and Pre Formation                | Months 1 to 2               | Investment thesis finalized; team assembled; legal counsel engaged; structure decision (LLC or LP); Investment Company Act exclusion decision (3(c)(1), 3(c)(7), or 3(c)(5)(C)). | Term sheet and investment policy statement; structure decision memo.     |
| 2. Entity Formation and Document Preparation | Months 2 to 4               | GP or Manager entity formed; Fund LLC or LP formed; PPM, Operating Agreement or LPA, and subscription documents drafted and finalized.                                           | Completed offering document set ready for investor distribution.         |
| 3. Marketing and Capital Raise               | Months 4 to 10              | PPM and pitch deck distributed; investor meetings conducted; soft commitments converted to signed subscription agreements.                                                       | Initial closing achieved; minimum fund size confirmed.                   |
| 4. First Closing                             | Month 6 to 10 (first close) | First group of investors admitted; capital called; fund officially operational; Form D and blue sky filings made.                                                                | Subscriptions signed and accepted; initial capital in fund bank account. |
| 5. Subsequent Closings and Deal Pipeline     | Months 6 to 18              | Additional investors admitted (up to final closing); equalization payments collected; deal pipeline developed in parallel with continued capital raise.                          | Final closing achieved; first acquisition identified or closed.          |
| 6. First Investment                          | Months 9 to 24              | First property acquisition negotiated and closed through fund SPV; capital called from investors for acquisition; asset management commences.                                    | Fund operational at full scale; first asset under management.            |

### How This Timeline Differs from the Syndication Timeline (Appendix E)

#### No property to anchor the timeline.

*The single asset syndication timeline in Appendix E is anchored to a specific property. Day 0 is LOI acceptance, and every subsequent milestone runs on a clock driven by the purchase agreement's closing date. The fund formation timeline has no such anchor. There is no property, no PSA, no closing date. The fund's timeline is driven instead by the readiness of its infrastructure (documents, entity, compliance program, investor relationships) and by the speed at which committed capital is assembled.*

**Investor urgency must come from the relationship.**

*The fund timeline's most important implication: the capital raise cannot be compressed by a deal deadline the way a syndication capital raise can. A syndication sponsor who is short on equity two weeks before closing has a problem with a specific, near term deadline that creates urgency. A fund manager who is short on committed capital in Month Six has a problem with no external deadline imposing urgency, and investor urgency in a blind pool raise comes entirely from the strength of the relationship and the quality of the pitch.*

**Same exemptions, different dynamics.**

*Both timelines use the same securities exemptions and the same entity structures. The fundamental difference is that in a syndication, the property creates the urgency. In a fund, the sponsor must create it.*

**PHASE 1****Strategy Development and Pre Formation**

*Months 1 to 2. Before any entity is formed or any investor is contacted.*

Everything that happens in Phase 1 precedes the legal work, and everything that happens in Phases 2 through 6 depends on getting Phase 1 right. A fund whose strategy is vague, whose team is incomplete, whose track record is not documented, and whose target investor population is not clearly identified will produce flawed documents, a weak pitch, and a slow capital raise. The work of Phase 1 is foundational. It establishes the answers to the questions that every investor will ask, and it does so before those investors are ever approached.

**1 A. Investment Thesis and Strategy Definition****MONTH 1**

Define the investment strategy with precision. Asset class (multifamily, industrial, retail, office, self-storage, mixed use), geographic target market(s), investment approach (core, core plus, value add, opportunistic), target acquisition size range, target hold period, target returns (preferred return rate, overall equity multiple, IRR).

→ *A fund's investment thesis is not a marketing statement. It is the operational compass that governs every investment decision for the life of the fund. It must be specific enough to guide deal sourcing and evaluation, and broad enough to accommodate the range of opportunities the target market will present. A thesis*

*that says “value add multifamily in the Sun Belt with a 5 year hold targeting 15 percent net IRR” is actionable. One that says “real estate opportunities across asset classes and geographies” is not a thesis. It is a description of a category.*

## MONTH 1

Assess the sponsor’s track record. Compile a complete performance summary of all prior investments under the current strategy: realized exits with documented actual returns; unrealized investments with current marks; comparison of actual versus projected returns for completed deals.

→ *Institutional investors will scrutinize the track record at the individual deal level. A summary table showing “average IRR of 18 percent across 12 deals” without showing each deal individually is insufficient for any investor who conducts real due diligence. Every deal in the track record must be accounted for, including deals that underperformed. An incomplete track record that omits losing investments is a material misrepresentation.*

## MONTH 1

Define the fund’s target size, minimum commitment size, fee structure (management fee rate and basis, carry percentage and preferred return, acquisition and disposition fees), and term (investment period, fund term, extension rights).

→ *Economic terms are the most negotiated elements of a fund raise. Anchoring them before investor conversations begin, rather than allowing them to drift as each investor negotiates individually, is essential for fair treatment across the investor base and for producing coherent fund documents.*

## MONTH 1 to 2

Assess the sponsor team. Identify the key principals; confirm that the individuals who will manage the fund are the same ones who generated the track record; identify any team gaps that must be filled before the fund launch.

→ *Institutional investors evaluate the team as the primary investment decision. A track record built by a team that has since been restructured (where the person responsible for deal sourcing has left, or the operating partner who managed the properties is no longer with the firm) is materially less compelling than one where the same team that produced the results is the one managing the fund.*

## MONTH 1 to 2

Develop the investment policy statement and target market analysis. Specific geographic markets, property type selection criteria, minimum

deal size, maximum concentration limits per property and per market, leverage parameters (target and maximum LTV).

→ *The investment policy statement is what becomes Schedule 2 (Investment Policy) of the ILPA Model LPA for institutional funds. For Regulation D funds, it becomes the detailed investment criteria section of the PPM that sets the parameters within which the manager is authorized to act without investor consent.*

## 1 B. Sponsor Team and Advisor Assembly

**MONTH 1  
to 2**

Engage securities counsel (primary). For PPM, Operating Agreement or LPA, subscription documents, federal exemption election, Investment Company Act analysis (3(c)(1), 3(c)(7), or 3(c)(5)(C)), ERISA plan asset assessment, and blue sky strategy.

→ *Securities counsel engagement should precede any investor communication, any entity formation, and any marketing activity. The exemption election (506(b) or 506(c)) must be made before any investor communication about the specific fund begins. A fund manager who begins talking to investors before engaging securities counsel runs the risk of inadvertent general solicitation that bars 506(b) for the entire offering. The Investment Company Act exclusion is equally consequential. For real estate funds whose strategy fits the 3(c)(5)(C) asset composition tests, structuring under 3(c)(5)(C) eliminates the 100 beneficial owner cap that constrains 3(c)(1) and preserves access to Regulation A+ and Regulation CF for future offerings.*

**MONTH 1  
to 2**

Engage real estate and transactional counsel. For entity formation, property acquisition documents, lender documents, and property level SPV formation when first investments are made.

**MONTH 1  
to 2**

Engage fund administrator or CPA firm with private fund experience. For capital account management, waterfall calculations, K-1 preparation, and financial reporting; begin planning the fund's accounting infrastructure.

→ *Fund administration is one of the most underplanned aspects of fund formation for sponsors transitioning from deal by deal syndications. In a single asset deal, the accounting is straightforward. In a fund that will hold multiple assets through separate SPVs, the fund level accounting (consolidated financial statements, capital account maintenance for potentially dozens of investors, waterfall calculations that aggregate across all assets) requires a purpose built infrastructure that should be designed before the fund launches.*



**MONTH 1  
to 2**

Assess investment adviser registration status. If the fund's regulatory AUM will approach or exceed \$100 million, begin planning for SEC RIA registration (minimum 12 month lead time recommended); for sponsors managing only private fund clients with less than \$150 million in regulatory AUM, the Private Fund Adviser Exemption is generally available with limited annual Form ADV filing requirements as an Exempt Reporting Adviser (ERA).

→ *The regulatory AUM threshold for mandatory SEC registration as a Registered Investment Adviser is \$100 million. Sponsors who anticipate reaching that threshold within the first few years of fund operation should engage counsel on the registration process early, not when the threshold is breached, by which point they are already in violation.*

**MONTH 1  
to 2**

Evaluate placement agent engagement. If the target investor population includes institutional LPs outside the sponsor's existing network, a FINRA registered placement agent may be required to reach them efficiently.

→ *Placement agents for institutional capital raises typically charge 1 to 2 percent of committed capital raised through their introductions. The decision to engage a placement agent should be made in Phase 1, not after the fund launches, because the placement agent relationship affects the investor presentation, the document preparation timeline, and the pay to play compliance analysis for government pension fund solicitation under Rule 206(4)-5 of the Investment Advisers Act.*

**1 C. Structure Decision: LLC and LP**

The structure decision (Manager Managed LLC or General Partner and Limited Partnership) must be made in Phase 1 because it affects entity formation, document preparation, and investor expectations from this point forward. The comparison table below summarizes the key differences.

| Dimension          | LLC Fund (Manager Managed)     | LP Fund (GP and Limited Partners)     |
|--------------------|--------------------------------|---------------------------------------|
| Governing document | Operating Agreement.           | Limited Partnership Agreement (LPA).  |
| Investor role      | Members (passive).             | Limited Partners (passive).           |
| Operator role      | Manager (often a Manager LLC). | General Partner (typically a GP LLC). |

| Dimension                         | LLC Fund (Manager Managed)                                                                               | LP Fund (GP and Limited Partners)                                                                        |
|-----------------------------------|----------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------|
| Sponsor entity formed separately  | Yes. Manager LLC formed separately.                                                                      | Yes. GP LLC formed before the LP entity.                                                                 |
| Formation sequence                | Manager LLC formed first, then Fund LLC.                                                                 | GP LLC formed first, then Fund LP.                                                                       |
| Unlimited liability               | No. Manager LLC has limited liability.                                                                   | Yes in theory; managed by structuring GP as an LLC.                                                      |
| Institutional investor preference | Acceptable; side letters address governance gaps.                                                        | Strongly preferred; ILPA framework built around the LP structure.                                        |
| Key person and removal provisions | Can be included; less developed legal precedent.                                                         | LP statute provides robust framework; ILPA Model LPA governs.                                            |
| Clawback enforceability           | Contractual; works well in practice.                                                                     | Better established legal framework; escrow mechanics more standard.                                      |
| Investment Company Act exclusion  | 3(c)(1), 3(c)(7), or 3(c)(5)(C) (for funds whose portfolio satisfies the real estate composition tests). | 3(c)(1), 3(c)(7), or 3(c)(5)(C) (for funds whose portfolio satisfies the real estate composition tests). |
| Non U.S. investors                | LP structure often preferred by non U.S. investors for familiarity.                                      | Industry standard for non U.S. institutional capital.                                                    |
| Typical legal cost differential   | Baseline.                                                                                                | Add approximately \$3,000 to \$10,000 for LPA complexity versus an Operating Agreement.                  |

## MONTH 1 to 2

Make the LLC or LP structure decision. Confirm with securities counsel; document the decision and its rationale; confirm Investment Company Act exclusion strategy.

→ For funds targeting primarily high net worth accredited investors without significant institutional LP participation, either structure works. For funds targeting family offices, registered investment advisers, and institutional LPs who allocate to private real estate, the LP structure is strongly preferred. Attempting to convert an LLC fund to an LP structure mid raise is costly and disruptive. The Investment Company Act exclusion choice is also a Phase 1 decision: real estate funds whose strategy aligns with the 3(c)(5)(C) asset composition tests (at least 55 percent of total assets in qualifying real estate interests and at least 80 percent in qualifying interests plus real estate type interests) should consider structuring under 3(c)(5)(C) rather than defaulting to 3(c)(1) or 3(c)(7). See Appendix C for the structural decision framework.

**PHASE 2****Entity Formation and Document Preparation***Months 2 to 4. Building the legal infrastructure before the first investor conversation.*

Phase 2 is where the fund's legal infrastructure is built. Both the sponsor entity and the fund entity must be formed before any offering documents are issued. The offering documents (the PPM, the Operating Agreement or LPA, and the subscription agreement) must be complete and internally consistent before the first investor receives them. And the bad actor questionnaire must be completed for every covered person before any offering is made.

**2 A. Sponsor Entity Formation (LLC and LP Tracks)****LLC Structure: Manager LLC.****MONTH 2**

Form Manager LLC in Delaware (or preferred home state). File Certificate of Formation; obtain EIN; open bank account for the Manager LLC.

→ *The Manager LLC is the sponsor's permanent operating company. It signs the Operating Agreement as Manager, earns management fees, holds the carried interest, and continues operating after the Fund LLC is dissolved. It should be treated as the sponsor's primary corporate entity for all fund related activities.*

**MONTH 2**

Draft and execute the Manager LLC's own operating agreement. Governs the sponsor team's internal economics: fee sharing among principals, carried interest allocation and vesting, buy out rights on departure, and key person provisions.

→ *The Manager LLC's internal operating agreement is the most frequently neglected document in a fund formation. It is the legal backbone of the sponsor team relationship. When partners disagree about how carry is distributed, when a principal wants to exit, or when a new team member is brought in, this is the document that governs. Drafting it after the fund launches means these decisions are made under pressure, during a dispute, rather than at arm's length before one exists.*

**LP Structure: GP LLC.****MONTH 2**

Form GP LLC in Delaware. File Certificate of Formation; obtain EIN; open bank account for the GP LLC.

→ *The GP LLC must be formed before the LP entity is constituted, because the Certificate of Limited Partnership must identify the General Partner. A sponsor who tries to form the LP entity before the GP entity has not finished forming the legal structure of the fund.*

## MONTH 2

Draft and execute the GP LLC's own operating agreement. Governs the sponsor team's internal economics with particular attention to: carried interest allocation among principals, clawback obligations and how they are allocated among principals, GP commitment funding, and key person event provisions.

→ *The GP LLC's internal operating agreement in an LP fund must address the clawback allocation specifically. If the fund's LPA requires the GP to return excess carry, who within the GP is responsible for funding that obligation? Allocating the clawback obligation among the GP's principals in the GP LLC's operating agreement, before any carry is distributed, avoids the painful dispute of determining allocation at the moment the obligation arises.*

## 2 B. Fund Entity Formation

### LLC Structure: Fund LLC.

## MONTH 2 to 3

Form Fund LLC in Delaware. File Certificate of Formation; designate Manager LLC as Manager; obtain EIN; open fund bank account.

→ *The Fund LLC's Certificate of Formation is a short document. The substantive governance (the investment policy, the waterfall, the manager authority and limitations, the investor voting rights, the key person and removal provisions) is in the Operating Agreement drafted in Phase 2C.*

## MONTH 2 to 3

LLC: If non U.S. investors are anticipated, assess whether the LLC structure adequately accommodates their tax and regulatory needs; consider whether a parallel offshore entity is needed.

→ *Non U.S. investors in a U.S. LLC fund face FIRPTA withholding on distributions and dispositions and potentially effectively connected income exposure from operating income. Some non U.S. institutional investors prefer an LP structure or an offshore parallel vehicle. This assessment should be made in Phase 1 to 2, not when the first non U.S. investor is identified during the capital raise.*

### LP Structure: Fund LP.

**MONTH 2  
to 3**

Form Fund LP in Delaware. File Certificate of Limited Partnership identifying the GP LLC; obtain EIN; open fund bank account.

→ *The Certificate of Limited Partnership is simpler than the LPA but must be filed before the LPA is executed. In Delaware, the LP is formed on the filing date.*

**2 C. Offering Document Preparation**

The offering documents for a blind pool fund are more complex than the documents for a single asset syndication because they must cover not just the economics of a specific investment but the entire multi-year framework within which the fund will operate. The investment strategy, the criteria for accepting or rejecting deals, the governance structure throughout the fund's life, and the framework for resolving the conflicts that will inevitably arise between the sponsor's interests and the investors' interests across a multi-year, multi asset portfolio.

**MONTH 2**

Deal structuring call with securities counsel. Confirm all economic terms (management fee calculation basis and rate; fee offset provisions; carried interest structure and preferred return rate and accrual basis; catch up if any; acquisition and disposition fees; equalization payment mechanics for subsequent closings; investment period and fund term).

→ *The economic terms established in this call become the operative provisions of both the PPM and the Operating Agreement or LPA. Any discrepancy between how a term is described in the PPM and how it is calculated in the Operating Agreement or LPA (the preferred return rate, the management fee step down at the end of the investment period, the fee offset calculation) is a document deficiency that investors or their counsel will identify and will negotiate against the sponsor.*

**MONTH 2  
to 3**

PPM drafting. Cover and legend; offering summary; management team biographies with complete track record disclosure; investment thesis and strategy; investment criteria and portfolio construction parameters; fund economics and fee disclosure; distribution waterfall; risk factors specific to the blind pool structure (reliance on manager discretion; no pre identified assets); Investment Company Act exclusion disclosure (3(c)(1), 3(c)(7), or 3(c)(5)(C) and the corresponding asset composition monitoring requirements where applicable); ERISA plan asset analysis and 25 percent threshold monitoring disclosure; tax disclosure (pass through treatment; K-1 timeline; depreciation and recapture consequences).

→ *The blind pool structure imposes specific disclosure obligations beyond those in a single asset offering. The risk factors must specifically address: that investors are relying on the manager's discretion and judgment in selecting investments not yet identified; that the specific investments to be made are unknown at the time of the offering; that the manager may face conflicts of interest between the fund and other funds or investments managed by the same team; and that investors have limited ability to evaluate specific investment decisions before capital is called.*

### MONTH 3

LLC: Operating Agreement drafting. Investment policy; manager authority (specifically enumerated actions requiring investor consent versus manager discretion); distribution waterfall; capital account mechanics; transfer restrictions; removal provisions; dissolution.

→ *In a blind pool LLC, the investment policy section of the Operating Agreement is critical. It defines the parameters within which the Manager can act without investor consent. If the Manager invests outside those parameters, it is acting beyond its authority. Parameters should be specific: geographic scope, property type, minimum and maximum deal size, maximum concentration per property and per market, maximum LTV, maximum fund level leverage.*

### MONTH 3

LP: LPA drafting. All the elements of the Operating Agreement plus: key person provisions (automatic suspension of investment period; 90 day remediation vote); GP removal for cause (majority in interest after specified Removal Conduct); GP removal without cause (75 percent in interest, the ILPA market standard); clawback (specific calculation; tax gross up; escrow funding mechanism); LPAC establishment and authority; detailed equalization payment mechanics for subsequent closings.

→ *LP funds targeting institutional capital must be drafted to ILPA standards. Not as an aspiration but as a compliance requirement for receiving institutional commitments. The ILPA Model LPA (October 2019, publicly available at [ilpa.org](http://ilpa.org)) provides the specific language that institutional investors expect. A fund whose LPA falls materially short of ILPA standards on GP removal, clawback, and LPAC authority will face extensive side letter negotiation with every institutional investor, a process that delays closings and creates inconsistent terms across the LP base.*

### MONTH 3

Subscription agreement drafting. For 506(b): self-certification of accredited status (or sophisticated investor, with enhanced disclosure obligations). For 506(c): accredited investor verification per the March 2025 SEC no

|                                       |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
|---------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                       | <p>action guidance (minimum investment amount of \$200,000 with written representations or traditional documentary verification). Entity investor documentation requirements; ERISA plan asset representations; AML and KYC representations and procedures.</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| <b>MONTH 3 to 4</b>                   | <p>Consistency review. Compare every economic term across the PPM, the Operating Agreement or LPA, and the subscription agreement; confirm identical treatment of waterfall, fees, preferred return, management fee step down, and equalization payment.</p> <p>→ <i>The consistency review is not performed automatically by the drafting process. The PPM and the Operating Agreement or LPA are often drafted in parallel by the same attorney, but divergences still occur, particularly in complex multi-page descriptions of the waterfall and fee structure. A side by side comparison of every defined economic term across all three documents should be completed before any investor receives documents.</i></p>                                      |
| <b>MONTH 3 to 4</b>                   | <p>Finalize all state legends for investor states (NASAA jurisdictional legends for each state); confirm state blue sky strategy (initial filing states; states that will be added as investors from new states are identified).</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
| <b>MONTH 3 to 4</b>                   | <p>Complete bad actor questionnaire for all covered persons. Manager or GP principals, 20 percent or greater equity owners, all promoters, and any placement agents, before any investor communication.</p> <p>→ <i>The bad actor questionnaire is not a formality. Rule 506(d) disqualifies the offering from relying on Rule 506 if any covered person has been subject to certain specified adverse regulatory events: SEC orders, criminal convictions, regulatory bars. Discovery of a disqualifying event after the fund has begun its capital raise creates a serious problem for which there is no clean solution. The questionnaire should be completed and the results reviewed by securities counsel before the first investor communication.</i></p> |
| <b>2 D. Compliance Infrastructure</b> |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| <b>MONTH 3 to 4</b>                   | <p>For registered investment advisers: complete Form ADV Part 1 and Part 2 (Brochure); file with the SEC through the IARD system; deliver Part 2 to advisory clients at or before entering the advisory relationship.</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |

→ The RIA registration process takes a minimum of 45 days from submission to approval, and in practice often takes 60 to 90 days. For sponsors approaching the \$100 million regulatory AUM threshold, registration planning should begin in Phase 1, not Phase 2.

### MONTH 3 to 4

Draft written compliance policies and procedures (required for RIAs under Rule 206(4)-7 of the Investment Advisers Act). Designate Chief Compliance Officer; adopt policies on conflicts of interest, advertising, investor communications, recordkeeping, personal trading, AML and KYC, and cybersecurity.

### MONTH 3 to 4

Design investor reporting infrastructure. Quarterly reporting template; K-1 preparation process and timeline; distribution waterfall calculation model; investor portal or reporting platform selection.

→ Investor reporting infrastructure is often not thought about until the first reporting period approaches. Building it before the fund launches (designing the quarterly report template, the distribution notice format, the capital account statement, and the K-1 delivery process) ensures that the first reports to investors are professional and timely. Poor reporting quality in the early months of a fund's life creates a negative investor impression that is difficult to reverse. A range of investor portal platforms is available; the selection depends on the fund's size, the investor base, and the integration requirements with the fund administrator's systems.

## PHASE 3

### Marketing and Capital Raise

*Months 4 to 10. From first investor contact through initial closing.*

The marketing phase is where the distinction between a fund that closes and a fund that does not close is determined. The legal infrastructure is built. The documents are finalized. Everything that follows is relationship work: reaching the right investors, presenting the fund compellingly, addressing their questions and concerns, and converting interest into signed subscription agreements. That work takes longer for a blind pool fund than for any other investment structure, because investors are being asked to trust a team with committed capital before any specific investment has been identified.



### 3 A. Marketing Materials and Investor Pitch

#### MONTH 4

Prepare pitch deck (investor presentation). Fund overview and investment thesis; team track record with specific deal examples and documented returns; market opportunity and investment strategy; fund terms summary; how to invest and contact information.

→ *The pitch deck is a marketing communication subject to the antifraud provisions. Every return projection, every market claim, and every team credential in the pitch deck must be accurate, complete, and consistent with the PPM. Pitch decks that present rosier returns or more impressive track records than the PPM's accurate disclosure are a material misrepresentation even if the PPM is later provided. Courts have held that investor decisions made based on pitch deck representations are protected by the antifraud rules even when the investor later received accurate disclosures.*

#### MONTH 4

506(b) funds: confirm that all marketing materials will be distributed only through private, non-public channels to persons with whom the sponsor has a pre-existing substantive relationship; confirm no social media posts, public webinars, or general advertising.

→ *A 506(b) fund that distributes its pitch deck through a third party platform accessible to persons without a prior relationship, or that posts the fund's returns and strategy on a publicly accessible website, has conducted general solicitation. The contamination runs forward: every investor admitted after the solicitation is in a fund that no longer qualifies under 506(b) for that investor. The rule is clear and unforgiving on this point.*

#### MONTH 4

506(c) funds: launch public marketing. Website, social media, webinars, conferences; confirm all marketing materials reviewed by counsel; confirm verification process is designed and ready before first investor response.

→ *The March 2025 SEC no action letter simplifies 506(c) verification for funds with minimum investments of \$200,000 or more per natural person investor. The two required written representations (the investor is an accredited investor, and the investor has not borrowed the investment amount from a third party for the specific purpose of meeting the minimum) should be incorporated into the subscription agreement from the outset, not added when the first investor raises the question.*

### 3 B. Investor Outreach and Qualification

**MONTH 4  
to 6**

Initial investor outreach. Distribute pitch deck and PPM to prospective investors (506(b): private outreach only; 506(c): through any channel); schedule investor meetings and calls.

**MONTH 4  
to 8**

Investor meetings. Present fund thesis, track record, and terms; address due diligence questions; provide additional information requested (specific deal examples, audited prior fund financials, team background, reference contacts).

→ *Institutional investors will conduct their own independent due diligence that goes well beyond the information the sponsor provides. Reference checks will contact former partners, co investors, and lenders. Background searches will surface regulatory history and litigation. The fund's PPM must disclose all material regulatory and legal history proactively. Discovery of undisclosed adverse history during due diligence is far more damaging than upfront disclosure.*

**MONTH 5  
to 8**

Side letter negotiations. For institutional investors who request customized terms (MFN provisions, enhanced reporting, co-investment rights, ERISA protections, reduced management fees for anchor investors), negotiate and finalize before closing.

→ *Side letters must be disclosed to all other investors who have MFN rights. The mechanism: if LP A negotiates a reduced management fee as an anchor investor, and LP B has MFN rights, LP B is entitled to the benefit of the reduced fee unless the reduction was granted specifically because of LP A's regulatory, tax, or legal situation rather than as a pure economic concession. All side letters should be reviewed by securities counsel before-execution.*

**MONTH 5  
to 9**

Soft commitments. Maintain running log of prospective investors who have expressed a commitment intention but have not yet signed subscription documents; use to project initial closing timing and minimum fund size.

→ *Soft commitments are not legally enforceable. Investors who expressed interest during the marketing phase may decline to close, reduce their commitment, or impose conditions at the subscription stage. A sponsor who plans a first close based entirely on soft commitments with no signed documents is planning based on an optimistic assumption. Budget for 20 to 30 percent of soft commitments not converting to firm subscriptions.*

**3 C. Deal Pipeline Development (Concurrent with Capital Raise)**

One of the structural advantages of a blind pool fund over a single asset syndication is the ability to build a deal pipeline in parallel with the capital raise, without having capital deployed into a specific asset before the raise is complete. But this advantage creates its own tension. Investors want to know that the sponsor has deal flow and can deploy capital efficiently, but disclosing specific deals under evaluation creates confidentiality concerns and potential conflicts between the fund's interest and the deal's timing requirements.

#### MONTH 4 to 10

Build deal pipeline. Identify and underwrite target acquisition candidates in the fund's target markets; maintain a proprietary deal list; develop broker relationships and direct to owner contact programs.

→ *The deal pipeline serves two purposes in the capital raise. It demonstrates operational readiness (the sponsor is not waiting for capital before beginning to look for deals), and it provides the specificity that helps investors understand what the fund's thesis looks like in practice. Sharing a deal example (a real or representative acquisition that fits the fund's criteria) in the investor presentation makes the abstract thesis concrete.*

#### MONTH 4 to 10

Avoid the warehousing problem. If a specific deal is identified and closed before the fund's first closing, it must be warehoused (held on the sponsor's balance sheet or through a bridge vehicle) and transferred to the fund at cost after closing. Warehoused deals create conflicts (was the deal priced fairly? did the sponsor benefit from the timing?) that must be disclosed in detail in the PPM.

→ *Warehoused deals are a valuable tool for jump starting a fund's deployment, but they require careful documentation: the warehouse agreement, the transfer price, the allocation of expenses and income during the warehouse period, and LPAC approval of the transfer terms. Warehousing a deal without these protections creates exactly the kind of conflict of interest that gives investors grounds to question whether the fund manager is acting in their interest.*

### PHASE 4

## First Closing

*Months 6 to 10. Admitting the initial investor group and making the fund operational.*

The first closing is the event that makes the fund legally operational. Before the first closing, the fund entity exists as a legal formation but has no committed capital and no investors. After the first closing, investors are admitted, capital is committed (and perhaps called), the fund's

governance structure is active, and the investment clock is running. The first closing is also the event that triggers the most significant regulatory deadlines in the fund's life.

#### 4 A. Subscription Processing and Closing Mechanics

**MONTH 6  
to 10**

Final subscription document review. For each subscriber, confirm subscription agreement is fully executed; confirm accreditation basis and supporting documentation (506(c)) or reasonable belief documentation (506(b)); confirm entity documentation for non-individual investors; confirm AML and KYC procedures completed and OFAC sanctions screening passed.

→ *The subscription review process should be completed by securities counsel for the first closing of any fund. This review (confirming that each investor's subscription is complete, accurate, and consistent with the applicable exemption's requirements) is what produces the legal conclusion that the closing was conducted in compliance with securities law. For subsequent closings, the sponsor's internal team can manage the process with counsel reviewing any atypical situations.*

**MONTH 6  
to 10**

Investor capital call (if applicable). For funds with a capital call structure (committed capital drawn as investments are made), issue formal capital call notices per the fund agreement mechanics (typically 10 business days' notice). For funds with immediate capital call (all committed capital contributed at closing), confirm wire transfer details and timing.

→ *The distinction between a capital call fund (committed capital called as needed) and an immediate contribution fund (all capital contributed at closing) is a fundamental structural choice that affects the fund's J curve, the management fee calculation, and the investor experience. Capital call structures are standard for larger funds and institutional investors. Immediate contribution is more common in smaller retail facing funds where investors prefer not to have unfunded commitments.*

**MONTH 6  
to 10**

LLC: Execute Operating Agreement (Manager and all Members execute or deliver counterpart signature pages); update fund's membership register to reflect all admitted Members.

**MONTH 6  
to 10**

LP: Execute LPA (GP and all Limited Partners execute or deliver counterpart signature pages); update the fund's LP register to reflect all

admitted Limited Partners; confirm LPAC formation if initial closing includes investors entitled to LPAC representation.

→ *The LPAC formation at the first closing is a governance milestone that institutional investors will track. The LPAC's first formal meeting (which may occur contemporaneously with or shortly after the first closing) should be documented with minutes.*

#### 4 B . Post First Closing Regulatory Filings

**WITHIN  
15 DAYS**

File Form D with SEC through EDGAR within 15 calendar days of first sale. Complete all required sections: issuer information, federal exemption claimed (506(b) or 506(c)), Investment Company Act exclusion claimed (3(c)(1), 3(c)(7), or 3(c)(5)(C)), number and aggregate amount of investors, date of first sale.

→ *Under the SEC's Form D guidance, the date of first sale is the date on which the first investor is irrevocably contractually committed to invest, which depending on the terms of the subscription agreement may be the date the issuer accepts the investor's subscription. For a capital call fund, the first sale generally occurs when the first subscription is accepted by the fund, not when capital is first called or wired. The 15 day clock runs from the date of irrevocable commitment.*

**WITHIN  
15 DAYS**

File blue sky notice filings in each investor's state of residence within 15 days of first sale in that state. Use NASAA EFD for electronic filings; track each state separately; identify any states that require paper filings rather than EFD submission; pay required state filing fees.

→ *The ongoing blue sky compliance obligation for a fund with rolling closings means the sponsor must track not just the initial states but every new state added as each new investor's home state is identified. A fund that admitted 12 investors in Month 6 from 8 states and then admits 6 more investors in Month 10 from 3 additional states has new blue sky filings due in those 3 new states within 15 days of the Month 10 closing. NASAA EFD covers most states; a few state securities regulators require paper filings or accept only certain filing types through EFD.*

### PHASE 5

## Subsequent Closings and Deal Pipeline

*Months 10 to 18. Adding investors and identifying first investments.*

Subsequent closings admit additional investors to the fund after the first closing date. Most fund documents permit subsequent closings through a final closing date, typically 12 months after the initial closing. Investors admitted in subsequent closings are economically treated as if they had been admitted at the initial closing, meaning they must make equalization payments to catch up with earlier investors and pay interest on those equalization amounts at the preferred return rate.

### 5 A. Subsequent Closing Mechanics

#### MONTH 10 to 18

Subsequent closing investor onboarding. Complete all subscription review and AML and KYC steps; collect new blue sky notice filings for any new investor states; process subscription documents.

#### MONTH 10 to 18

Equalization payment calculation. For each subsequent closing investor, calculate the equalization payment, the amount that would have been called from that investor if they had been admitted at the initial closing; bill the equalization amount plus interest at the preferred return rate for the period since the initial closing.

→ *Equalization payment calculation errors are among the most frequently disputed issues in fund accounting. The calculation requires knowing the aggregate capital called from initial closing investors as a percentage of their commitments, the pro rata share of each prior investment allocable to the new investor's commitment, and the preferred return accrual on the equalization amount from the initial closing date through the subsequent closing date. This calculation should be performed by the fund administrator and confirmed by counsel before it is billed to the new investor.*

#### MONTH 10 to 18

Update fund register. Amend Operating Agreement or LPA to reflect new Members or LPs (or, if Operating Agreement or LPA permits, use the register update mechanism without formal amendment); update cap table.

#### MONTH 10 to 18

Final closing. On the date specified in the fund documents as the final closing date, no additional investors may be admitted; confirm total committed capital; update fund register and cap table for the final time.

→ *The final closing date is the hard deadline after which the fund's investor base is fixed. Sponsors who want to extend the final closing date (to admit a late arriving institutional investor, for example) must amend the fund documents,*

*which requires the consent threshold specified in the Operating Agreement or LPA and notification to all existing investors.*

## 5 B. Deal Pipeline and Pre Investment Activities

### MONTH 6 to 18

Active deal sourcing. Develop broker relationships in target markets; build direct to owner contact program; review proprietary acquisition opportunities; maintain deal pipeline log with underwriting model for each candidate.

→ *Fund investors are watching the capital deployment pace as closely as they watch returns. A fund that sits on committed capital for 18 months without making an investment is paying management fees while generating no investment level returns for investors, a dynamic that produces investor impatience and erodes trust. Active deal sourcing that begins concurrently with the capital raise positions the fund to deploy capital quickly after each closing.*

### MONTH 6 to 18

Investment committee process. Establish the investment committee review process for acquisition candidates; define the information package required for IC review; define the approval threshold; document IC decisions.

→ *A documented investment committee process is both a governance requirement and a regulatory expectation. For funds managed by registered investment advisers, the investment committee process is a key element of the compliance program that the SEC may examine. For institutional funds, LPAC disclosure obligations require notification of the LPAC of certain conflicts of interest that arise in the investment decision process.*

### MONTH 10 to 18

First LOI submitted on fund's behalf. The fund enters into a non-binding LOI for a specific acquisition; fund documents authorize the Manager or GP to execute and close acquisitions within the investment policy parameters without investor approval.

→ *The first acquisition is a significant milestone for the fund's investor relations. Investors who have committed to a blind pool have been waiting, for months, to see the first application of the investment thesis. The first deal's alignment with the stated strategy, pricing, and return projections is scrutinized by investors as validation of, or grounds for concern about, the fund's approach.*



**PHASE 6****First Investment and Fund Operational Scale**

*Months 9 to 24. From first acquisition LOI through closing and asset management.*

The first investment is the moment the blind pool becomes a real estate investment. Every step from this point follows the single asset syndication timeline described in Appendix E, with one critical difference: the buyer is the Fund LLC or Fund LP, not a newly formed deal specific entity. The fund acquires each property through a separate subsidiary SPV, a new LLC formed to hold each specific property, with the Fund as the SPV's sole member or as the limited partner of a property level LP.

**6 A. SPV Formation for Each Acquisition****MONTH  
9+**

Form property level SPV LLC or LP for each acquisition. Separate entity from the Fund; Fund serves as sole member (LLC) or limited partner (LP) of the SPV.

→ *The property level SPV serves two essential functions: it isolates each property's liabilities from the Fund and from other properties in the portfolio (a judgment against one property cannot reach the Fund's other assets or the investors' interests in the Fund), and it satisfies lenders' requirement that the borrowing entity be a clean, single purpose entity with no prior operations or liabilities.*

**MONTH  
9+**

Obtain separate EIN for each SPV; open separate bank account for each SPV; confirm SPV is authorized to execute loan documents and purchase agreement.

**MONTH  
9+**

Document the fund's investment in the SPV. Intercompany loan or equity contribution from Fund to SPV; confirm the accounting treatment is consistent with the fund's financial reporting framework.

**6 B. Capital Call for First Acquisition****MONTH  
9+**

Issue formal capital call notice for the acquisition equity. Specify the call amount per investor (based on each investor's pro rata share of



|  |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
|--|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|  | <p>commitments); specify the due date (minimum 10 business days under the ILPA standard); confirm wire instructions.</p> <p>→ <i>For a capital call fund structure, the capital call notice is the first time investors actually wire money to the Fund. The notice must comply precisely with the fund agreement's mechanics, using the defined notice method, the minimum advance notice period, and the specified calculation methodology. A capital call notice that does not comply with the fund agreement's mechanics gives investors grounds to dispute the call.</i></p> |
|--|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

|                                   |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|-----------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p><b>MONTH</b><br/><b>9+</b></p> | <p>Track funding. Confirm each investor funds their allocated amount by the due date; address any investors who fail to fund on time per the defaulting partner provisions of the Operating Agreement or LPA.</p> <p>→ <i>A defaulting investor at the first capital call is a difficult situation. The defaulting investor provisions of the Operating Agreement or LPA specify the remedies (typically suspension of distribution rights, forced transfer at a discount, or forfeiture), but exercising those remedies against an early investor creates a hostile dynamic that affects the fund's broader investor relations. Securities counsel should be involved in any first capital call default situation.</i></p> |
|-----------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

## 6 C . Acquisition Closing and Post-closing

|                                   |                                                                                                                                                                                                          |
|-----------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p><b>MONTH</b><br/><b>9+</b></p> | <p>Follow single asset syndication timeline from PSA through closing (see Appendix E, Phase 2 through Phase 6). PSA execution; due diligence; lender underwriting; closing preparation; closing day.</p> |
|-----------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

|                                   |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|-----------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p><b>MONTH</b><br/><b>9+</b></p> | <p>Post-closing investor reporting. Send acquisition notification to all fund investors (name of property, acquisition price, capital deployed, debt terms, business plan summary); update fund level reporting to reflect the new asset.</p> <p>→ <i>Fund investors in a blind pool have been waiting to see the first deployment of their capital. The first post-acquisition investor report should be comprehensive, more detailed than the standard quarterly report, to demonstrate that the first investment aligns with the stated strategy and that the fund's deployment is on track. This report establishes the reporting tone and standard for the entire fund's life.</i></p> |
|-----------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

**MONTH**  
**9+**

LPAC notification of first acquisition. Provide LPAC with full investment information; confirm no conflicts of interest requiring LPAC approval in connection with the acquisition.

## The Fund's Life Beyond Formation: Key Milestones Through Wind Down

Fund formation is the beginning of a relationship with investors that spans years. The milestones below are not part of the formation timeline but represent the key events in the fund's operational life that require proactive planning from the moment the fund launches.

### Year by Year Fund Lifecycle Milestones

#### Year 1.

*Initial close and first investment; team and reporting infrastructure fully operational; continued capital raise through final close; second and third acquisitions in pipeline.*

#### Years 2 to 3.

*Final close achieved; investment period in full deployment; value add execution on early acquisitions; LPAC annual meeting; audited Year 1 financials delivered; first K-1s distributed to investors.*

#### Years 3 to 5.

*Investment period expires (typically 3 to 5 years from initial close); only follow on investments and commitments made before-expiration may be completed; management fee steps down to invested capital basis; deal pipeline shifts from new acquisitions to asset management and exit planning.*

#### Years 4 to 7.

*First disposition events (sales or refinancings); distribution of proceeds per the waterfall; investor realized return reporting; clawback calculation assessment after each full fund cycle realization event.*

#### Years 6 to 8.

*Majority of portfolio realized; wind down planning commences; extension discussions with LPs if remaining assets require additional time; term extension vote (if required by Operating Agreement or LPA).*

#### Years 8 to 10.

*Final disposition events; final distribution to investors; final K-1s delivered; clawback final calculation; escrow release (if escrow mechanism was used); GP carry distributed net of any clawback obligation.*

#### **Year 10 and beyond.**

*Fund entity dissolved; GP entity dissolved (or transitioned to successor fund management); records retained per applicable regulatory recordkeeping requirements. SEC RIA recordkeeping rules under Rule 204-2 generally require 5 years; many sponsors retain offering and investor records for 7 to 10 years as a conservative best practice.*

## **Fund Formation and Ongoing Compliance Calendar**

The table below identifies every mandatory compliance action triggered during the fund formation process and the ongoing fund life, the specific deadline, and the consequence of missing each. This table should be the basis of the fund's compliance calendar, maintained and monitored throughout the fund's life.

| Trigger or Date                            | Required Action                                                                                                                                    | Consequence of Missing                                                                                       |
|--------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------|
| Before any investor communication          | Confirm federal exemption (506(b) or 506(c)); complete bad actor questionnaire for all covered persons.                                            | General solicitation violations; exemption unavailability; rescission exposure for all subsequent investors. |
| Before PPM issuance                        | Entity formation complete; Investment Company Act exclusion analysis done (3(c)(1), 3(c)(7), or 3(c)(5)(C)); ERISA plan asset assessment complete. | Investors admitted into a legally incomplete structure; documents may need to be redone.                     |
| Within 15 days of first sale               | File Form D with SEC through EDGAR.                                                                                                                | Securities violation; state enforcement exposure; investor rescission rights in some states.                 |
| Within 15 days of first sale in each state | File blue sky notice in each investor's state of residence.                                                                                        | State securities violations; late fees; cease and desist risk; investor rescission rights.                   |
| Annual (if offering remains open)          | File Form D annual amendment.                                                                                                                      | Technical violation; pattern of non-compliance adverse in any enforcement proceeding.                        |
| 90 days after fiscal year end              | Deliver audited annual financial statements to investors.                                                                                          | Breach of fund agreement; institutional LP default notice possible.                                          |

| Trigger or Date                                                                                         | Required Action                                                                             | Consequence of Missing                                                                                 |
|---------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------|
| By the later of 90 days after fiscal year end or the date reasonably necessary for investor tax returns | Deliver Form 1065 and Schedule K-1s to all investors.                                       | Investor tax return delays; investor complaints; possible fund agreement breach.                       |
| Annual (RIA funds over \$100M AUM)                                                                      | File Form ADV annual amendment within 90 days of fiscal year end.                           | Investment Advisers Act violation; SEC examination deficiency.                                         |
| Annual                                                                                                  | Annual blue sky renewals in states requiring renewal.                                       | State securities violations in states where filings lapse.                                             |
| Before each capital call                                                                                | Deliver formal capital call notice per fund agreement (typically 10 business days minimum). | Defaulting partner dispute; lender covenant violation if LP structure capital call rights are pledged. |
| Each new investor state                                                                                 | New blue sky filing before first sale in previously unfiled state.                          | State securities violation; bars the sponsor from accepting that investor until a cure filing is made. |
| Each new investor admission (after initial close)                                                       | Equalization payment calculation and billing; admit to fund register; update cap table.     | Inequity among LP classes; investor disputes over pro rata sharing of pre-admission investments.       |

Fund formation is the most consequential legal undertaking in a real estate sponsor's career, more consequential than any single acquisition, because the fund's documents govern not one transaction but every transaction the fund makes over its multi-year life. The Operating Agreement or LPA that is poorly drafted in Month 3 creates problems in Month 48 when an investor disputes a waterfall calculation, a key principal departs, or a deal underperforms and investors want to assess the manager's accountability. The documents that are right from inception are the ones that work under pressure without litigation.

### **Question 3: Does the waterfall apply to operating distributions and sale proceeds the same way?**

Some offerings use different waterfall mechanics for quarterly operating cash flow distributions versus sale or refinancing proceeds. For example, operating distributions might be paid pro rata without a pref calculation, while the full waterfall — including cumulative preferred return reconciliation — is applied only at the final sale.

This is not inherently wrong, but investors need to understand it: they may receive quarterly cash flow that looks like a return but is actually a return of capital, with the real pref calculation deferred to sale. The tax treatment of those distributions differs significantly from a true preferred return.

**Question 4: Is there a clawback, and can the sponsor actually fund it?**

Under an American waterfall, the clawback is the primary investor protection against overpayment of promote on early strong deals that are later offset by poor-performing ones. A clawback clause that is not backed by an escrow or a sponsor with genuine financial resources is a paper protection only.

Ask the sponsor: Is there a clawback escrow? If not, what is the sponsor's plan for funding a clawback obligation if it arises? The answer tells you a lot about how seriously the sponsor has thought about alignment with their investors.

The waterfall calculation is not a back-office accounting exercise. It is the legal mechanism that determines how your investment converts into cash in your account. Understanding it before you invest — not after the distribution statement arrives — is the difference between being an informed participant in a transaction and being a passive recipient of a number someone else calculated.

The examples in this appendix used simple numbers to make the logic visible. Real deals use the same logic but with more complexity: quarterly distributions that affect IRR calculations, capital calls that are timed differently across multiple investors, equalization payments for late-entering investors in a fund, and refinancing proceeds that partially reset the waterfall midway through the hold. None of that changes the underlying structure — return capital first, preferred return second, catch-up third, profit split fourth — but it does change the math at each step.

Sponsors who want their waterfall provisions to be airtight under pressure — and investors who want to understand exactly what they are agreeing to — both benefit from the same thing: a waterfall that is drafted precisely, reviewed carefully for internal consistency with the PPM, and explained clearly in plain language before any money is committed.

## APPENDIX G

# Waterfall Distribution Calculation Examples

The waterfall is the single most consequential economic provision in any private real estate offering. It determines how every dollar of profit is divided between investors and the sponsor. It establishes the sponsor's incentive structure for the entire life of the deal. And, in our experience, it generates more investor disputes, more PPM-to-operating-agreement inconsistencies, and more post-closing calculation errors than any other provision in a real estate offering.

Despite that importance, waterfall provisions are frequently described in offering documents using abstract terminology that leaves investors unsure of what they will actually receive in different outcome scenarios. This appendix takes a different approach. Each of the four examples below uses concrete numbers to walk the entire calculation from start to finish, showing exactly where each dollar goes at each step. The math is intentionally simple. The goal is not to replicate a full financial model. The goal is to make the logic of each waterfall structure transparent.

The four examples are: (1) a basic preferred return waterfall with a GP catch-up, which is the most common structure in single asset real estate syndications; (2) a tiered IRR hurdle waterfall with two promote levels, which is common in value add and opportunistic funds; (3) a side by side comparison of the American (deal by deal) and European (whole fund) waterfall using the same two deal scenario, demonstrating how dramatically the two structures can produce different outcomes for investors and sponsors; and (4) a clawback example showing what happens under an American waterfall when one deal performs well and later deals underperform.

## Key Terms Used Throughout This Appendix

The four examples that follow use a common vocabulary. Each of the terms below appears repeatedly across the examples, and a precise understanding of each is necessary to follow the calculations.

### Vocabulary of the Waterfall

*Invested Capital (or Contributed Capital).* The total amount investors put into the deal.

*Preferred Return (Pref).* The minimum annual return investors must receive before the sponsor earns any promote. Common rates are 6 percent, 7 percent, or 8 percent per year.

*Promote (or Carried Interest).* The sponsor's disproportionate share of profits above the preferred return. Common rates are 20 percent, 25 percent, or 30 percent.

*GP Catch-Up.* A tier where the sponsor receives 100 percent of distributions until the sponsor has caught up to the agreed promote percentage on cumulative profits.

*IRR (Internal Rate of Return).* A time weighted measure of annualized return that accounts for when money goes in and when it comes back. The IRR is higher when investors receive their money back earlier.

*Equity Multiple.* Total distributions received divided by total capital invested. A 2.0x equity multiple means an investor received back twice what they put in.

*Distributable Cash.* Cash available to distribute after all operating expenses, debt service, and required reserves have been paid.

*American Waterfall (Deal by Deal).* The sponsor earns promote on each deal individually, without waiting for the whole fund to return all capital.

*European Waterfall (Whole Fund).* The sponsor earns no promote until all invested capital and preferred returns have been returned across the entire fund.

*Clawback.* A mechanism requiring the sponsor to return previously received promote if, at the end of the fund, total promote payments exceeded what the waterfall calculation justifies.

## EXAMPLE 1

### Basic Preferred Return Waterfall with GP Catch-Up

*The most common structure in single asset real estate syndications.*

A sponsor acquires an apartment building using \$1,000,000 of investor equity. The sponsor contributes a small co-invest alongside the investors, but for simplicity this example focuses on the investor equity. Five years later the property is sold, and after paying off the mortgage and all costs, \$1,400,000 of distributable cash is available to split between the investors and the sponsor.

## Waterfall Terms

- 8 percent preferred return, paid annually on invested capital, simple interest (not compounding).
- After investors receive back their capital plus all accrued preferred return, the sponsor receives a GP catch-up at 100 percent until the sponsor has received 20 percent of total profits distributed to date.
- After the catch-up, remaining profits split 80 percent to investors and 20 percent to the sponsor.

## Setting the Preferred Return

The investors put in \$1,000,000. The preferred return is 8 percent per year. The hold period is 5 years. The preferred return that must be paid before any promote is earned:

$$\text{\$1,000,000} \times 8\% \times 5 \text{ years} = \text{\$400,000 in total preferred return}$$

So the investors need to receive back their \$1,000,000 of capital plus \$400,000 of preferred return, a total of \$1,400,000, before the sponsor earns anything beyond their own invested share.

### 1 A. Step-by-Step Calculation, \$1,400,000 Distributable Cash

|               |                                                                                                                                                                                                                                                                                                                                                                                                                         |
|---------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>STEP 1</b> | <p>Return investors' capital. The first tier of every waterfall returns the investors' original investment. \$1,000,000 goes to investors. Remaining distributable cash: \$1,400,000 minus \$1,000,000 equals \$400,000.</p> <p>→ Investors have received back their full capital contribution.</p>                                                                                                                     |
| <b>STEP 2</b> | <p>Pay the preferred return. The second tier pays the 8 percent annual preferred return that has accumulated over 5 years. Total preferred return owed: \$1,000,000 x 8 percent x 5 = \$400,000. Available cash after Step 1: \$400,000. \$400,000 goes to investors. Remaining distributable cash: \$0.</p> <p>→ Investors have received their full preferred return. No cash remains for the catch-up or promote.</p> |

### Example 1A: Final Distribution (No Excess Profit)

| Description       | Investors (LP) | Sponsor (GP) | Total       |
|-------------------|----------------|--------------|-------------|
| Return of capital | \$1,000,000    | \$0          | \$1,000,000 |



| Description                     | Investors (LP)     | Sponsor (GP) | Total              |
|---------------------------------|--------------------|--------------|--------------------|
| Preferred return (8% x 5 years) | \$400,000          | \$0          | \$400,000          |
| GP catch-up                     | \$0                | \$0          | \$0                |
| Residual profit split (80 / 20) | \$0                | \$0          | \$0                |
| <b>TOTAL</b>                    | <b>\$1,400,000</b> | <b>\$0</b>   | <b>\$1,400,000</b> |
| Equity multiple                 | 1.4x               |              |                    |

### Reading Example 1A

*In this scenario, the total distributable cash exactly covers the investors' capital and preferred return, with nothing left over. The sponsor receives no promote.*

*From an investment standpoint, this is a reasonable result. The investors received their full 8 percent annual return over 5 years. The sponsor earns money through the fees paid during the hold period (acquisition fee, asset management fee, disposition fee), but the waterfall's promote tier is never reached.*

*The next sub-section runs the same example with better performance. Instead of \$1,400,000 of distributable cash, the property sells for enough to leave \$1,700,000 in distributable cash.*

### 1 B. Same Deal, Better Outcome, \$1,700,000 Distributable Cash

Now there is an extra \$300,000 above the amount needed to pay back capital and preferred return. The catch-up and profit split tiers come into play.

|               |                                                                                                                                                                                                                                                  |
|---------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>STEP 1</b> | <p>Return investors' capital. \$1,000,000 goes to investors. Remaining: \$1,700,000 minus \$1,000,000 equals \$700,000.</p> <p>→ <i>Capital fully returned.</i></p>                                                                              |
| <b>STEP 2</b> | <p>Pay the preferred return. \$400,000 goes to investors (8 percent x \$1,000,000 x 5 years). Remaining: \$700,000 minus \$400,000 equals \$300,000.</p> <p>→ <i>Investors have received \$1,400,000 total. \$300,000 remains as profit.</i></p> |

**STEP 3**

GP catch-up. The catch-up allows the sponsor to receive 100 percent of remaining cash until the sponsor has received 20 percent of total profits. Total profits distributed so far: \$400,000 (the preferred return is the first block of profit above return of capital). The catch-up ends when the sponsor has received 20 percent of total cumulative profits (pref plus catch-up combined). If pref equals \$400,000 and catch-up equals X, then X divided by (\$400,000 plus X) equals 20 percent, which gives X equals \$100,000. \$100,000 goes to the sponsor. Remaining: \$300,000 minus \$100,000 equals \$200,000.

→ *Catch-up complete. Sponsor has \$100,000. Investors have \$1,400,000. Combined profits equal \$500,000, split \$400,000 (80 percent) and \$100,000 (20 percent).*

**STEP 4**

Residual 80 / 20 split. \$200,000 remains. Investors receive \$200,000 x 80 percent = \$160,000. Sponsor receives \$200,000 x 20 percent = \$40,000.

→ *Final tier complete.*

**Example 1B: Final Distribution (\$1,700,000 Distributable Cash)**

| Description                       | Investors (LP)     | Sponsor (GP)     | Total              |
|-----------------------------------|--------------------|------------------|--------------------|
| Return of capital                 | \$1,000,000        | \$0              | \$1,000,000        |
| Preferred return (8% x 5 years)   | \$400,000          | \$0              | \$400,000          |
| GP catch-up                       | \$0                | \$100,000        | \$100,000          |
| Residual profit split (80% / 20%) | \$160,000          | \$40,000         | \$200,000          |
| <b>TOTAL</b>                      | <b>\$1,560,000</b> | <b>\$140,000</b> | <b>\$1,700,000</b> |
| Investor equity multiple          | 1.56x              |                  |                    |
| Sponsor total (incl. catch-up)    |                    | \$140,000        |                    |

**EXAMPLE 2****Tiered IRR Hurdle Waterfall**

*Two promote tiers that reward the sponsor more as investor returns improve.*

A value-add fund raises \$5,000,000 from investors and acquires three properties over its investment period. At the end of the fund's 5-year life, all properties are sold, and the fund has

\$8,500,000 of total distributable cash to return to investors and the sponsor. The fund invested \$5,000,000 of investor capital, so total profits are \$3,500,000.

## Waterfall Terms

- Tier 1: 100 percent to investors until all \$5,000,000 of capital is returned.
- Tier 2: 100 percent to investors as 8 percent preferred return, paid on capital for the full 5-year hold.
- Tier 3: GP catch-up at 100 percent until sponsor has received 20 percent of the Tier 2 preferred return.
- Tier 4: 80 percent to investors and 20 percent to sponsor until investors reach a 15 percent IRR.
- Tier 5: 70 percent to investors and 30 percent to sponsor on all additional cash above the 15 percent IRR hurdle.

### A Note on IRR Versus Simple Preferred Return

*In a real fund, whether the next tier kicks in is determined by whether the investors' actual IRR at the time of distribution has reached the stated hurdle. IRR depends on the timing of every cash flow, not just the cumulative dollars returned, and a precise calculation requires modeling each distribution.*

*For this example, the dollar amounts in each tier work out cleanly assuming all profits are distributed at the end of year 5 and the cumulative cash returned (\$8,500,000 on a \$5,000,000 investment held for 5 years) falls short of the dollar threshold a 15 percent annualized return would require. Tier 4 absorbs all remaining cash; Tier 5 is never reached.*

## 2 A. Step-by-Step Calculation, \$8,500,000 Distributable Cash

### TIER 1

Return of capital. \$5,000,000 goes to investors. Remaining: \$8,500,000 minus \$5,000,000 equals \$3,500,000.

→ All investor capital returned.

### TIER 2

Preferred return, 8 percent x 5 years. Preferred return owed: \$5,000,000 x 8 percent x 5 years = \$2,000,000. \$2,000,000 goes to investors. Remaining: \$3,500,000 minus \$2,000,000 equals \$1,500,000.

→ Preferred return fully paid.

|               |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|---------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>TIER 3</b> | <p>GP catch-up. The sponsor is entitled to 20 percent of the preferred return as a catch-up. Catch-up amount: <math>\\$2,000,000 \times (20 / 80) = \\$500,000</math>. Available cash is \$1,500,000, more than enough for the full catch-up. \$500,000 goes to the sponsor. Remaining: \$1,500,000 minus \$500,000 equals \$1,000,000.</p> <p>→ Catch-up complete. Investors have received \$7,000,000; sponsor has received \$500,000.</p>                                                                                                                   |
| <b>TIER 4</b> | <p>80 / 20 split until 15 percent IRR. The 15 percent IRR hurdle is not met by the \$8,500,000 total distribution on a \$5,000,000 investment held for 5 years, so Tier 4 absorbs all remaining cash without triggering Tier 5. Remaining cash: \$1,000,000. Investors receive <math>\\$1,000,000 \times 80 \text{ percent} = \\$800,000</math>. Sponsor receives <math>\\$1,000,000 \times 20 \text{ percent} = \\$200,000</math>.</p> <p>→ Tier 4 distributes the remaining cash. Tier 5 is never reached because the 15 percent IRR hurdle was not met.</p> |

### Example 2: Tiered IRR Waterfall Summary

| Description                           | Investors (LP)     | Sponsor (GP)     | Total              |
|---------------------------------------|--------------------|------------------|--------------------|
| Tier 1: Return of capital             | \$5,000,000        | \$0              | \$5,000,000        |
| Tier 2: 8% preferred return (5 years) | \$2,000,000        | \$0              | \$2,000,000        |
| Tier 3: GP catch-up (20% of pref)     | \$0                | \$500,000        | \$500,000          |
| Tier 4: 80 / 20 split (up to 15% IRR) | \$800,000          | \$200,000        | \$1,000,000        |
| Tier 5: 70 / 30 split (above 15% IRR) | \$0                | \$0              | \$0                |
| <b>TOTAL</b>                          | <b>\$7,800,000</b> | <b>\$700,000</b> | <b>\$8,500,000</b> |
| Investor equity multiple              | 1.56x              |                  |                    |
| Sponsor promote earned                |                    | \$700,000        |                    |

### The Logic Behind Multiple IRR Hurdles

*The tiered IRR structure rewards the sponsor progressively as investor returns improve. If this fund had returned more cash above the 15 percent IRR hurdle, the Tier 5 split (70 / 30) would have applied to the excess. The sponsor's promote on that additional cash*

*would have risen from 20 percent to 30 percent, a meaningful increase that rewards superior performance.*

*This structure aligns incentives effectively. When returns are modest, the sponsor earns a 20 percent promote. When returns are exceptional, the sponsor earns a 30 percent promote on the incremental gain. Investors participate in that upside as well. They take 70 percent of the above-hurdle cash rather than 80 percent, but they take it on returns above 15 percent IRR, which represents strong performance.*

*From the investor's perspective, a tiered structure means the sponsor remains motivated to push for better returns. A sponsor who is satisfied with a middling outcome has not maxed out the available promote. The next IRR hurdle is worth more in promote dollars than staying just above the pref, and the sponsor knows it.*

### EXAMPLE 3

## American versus European Waterfall, Same Two Deals, Very Different Results

*Why the waterfall structure matters as much as the economic terms.*

A fund raises \$4,000,000 from investors and makes two investments. The waterfall terms are the same in both cases: 8 percent preferred return, then 20 percent promote. The only difference is whether the waterfall is applied deal by deal (American) or across the whole fund (European).

### The Two Deals

- Deal 1: the fund invests \$2,000,000 and sells the property after 3 years for \$2,800,000 in distributable cash (a 40 percent profit on capital).
- Deal 2: the fund invests \$2,000,000 and sells the property after 5 years for \$1,800,000 in distributable cash (a 10 percent principal loss).
- Total cash returned across both deals: \$2,800,000 plus \$1,800,000 equals \$4,600,000.
- Total investor capital: \$4,000,000. Total profit across both deals: \$600,000.

### 3 A. American Waterfall, Deal by Deal Calculation

Under the American waterfall, each deal's profits are distributed independently. The sponsor earns a promote on Deal 1 without waiting to see how Deal 2 turns out.

### Deal 1, American Waterfall

|               |                                                                                                                                                                                                                                                                                      |
|---------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>STEP 1</b> | Return of capital for Deal 1. \$2,000,000 invested. \$2,000,000 returned to investors first. Remaining from Deal 1: \$2,800,000 minus \$2,000,000 equals \$800,000.                                                                                                                  |
| <b>STEP 2</b> | Preferred return on Deal 1. \$2,000,000 x 8 percent x 3 years = \$480,000 owed as preferred return. Available cash is \$800,000, so the full preferred return can be paid. \$480,000 goes to investors. Remaining: \$320,000.                                                        |
| <b>STEP 3</b> | GP catch-up on Deal 1. Catch-up: $\$480,000 \times (20 / 80) = \$120,000$ goes to sponsor. Remaining: \$200,000.                                                                                                                                                                     |
| <b>STEP 4</b> | 80 / 20 profit split on Deal 1. Investors: $\$200,000 \times 80 \text{ percent} = \$160,000$ . Sponsor: $\$200,000 \times 20 \text{ percent} = \$40,000$ . Remaining: \$0.<br>→ Deal 1 complete. Sponsor earned \$120,000 (catch-up) plus \$40,000 (split) for \$160,000 in promote. |

### Deal 2, American Waterfall

|               |                                                                                                                                                                                                                                                                                                                                 |
|---------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>STEP 1</b> | Return of capital for Deal 2. \$2,000,000 invested. Only \$1,800,000 came back. \$1,800,000 goes to investors. Investors are short \$200,000 on return of capital. No preferred return is paid. No promote is paid. Remaining: \$0.<br>→ Deal 2 complete. Investors lost \$200,000 on this deal. Sponsor earned \$0 in promote. |
|---------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

### American Waterfall: Combined Results for Both Deals

| Description                       | Investors (LP) | Sponsor (GP) | Total       |
|-----------------------------------|----------------|--------------|-------------|
| Deal 1, return of capital         | \$2,000,000    | \$0          | \$2,000,000 |
| Deal 1, preferred return          | \$480,000      | \$0          | \$480,000   |
| Deal 1, GP catch-up               | \$0            | \$120,000    | \$120,000   |
| Deal 1, 80 / 20 profit split      | \$160,000      | \$40,000     | \$200,000   |
| Deal 2, partial return of capital | \$1,800,000    | \$0          | \$1,800,000 |

| Description               | Investors (LP)     | Sponsor (GP)     | Total              |
|---------------------------|--------------------|------------------|--------------------|
| Deal 2, preferred return  | \$0                | \$0              | \$0                |
| <b>TOTAL</b>              | <b>\$4,440,000</b> | <b>\$160,000</b> | <b>\$4,600,000</b> |
| Investor net gain or loss | + \$440,000        |                  |                    |
| Sponsor promote earned    |                    | \$160,000        |                    |

### 3 B. European Waterfall, Whole-Fund Calculation

Under the European waterfall, all cash from all deals is pooled together, and the sponsor earns no promote until all investor capital and all preferred returns are paid across the entire fund.

Total distributable cash from both deals: \$4,600,000.

|               |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|---------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>STEP 1</b> | Return of all capital, whole fund. Investors put in \$4,000,000 total across both deals. \$4,000,000 goes to investors first. Remaining: \$4,600,000 minus \$4,000,000 equals \$600,000.                                                                                                                                                                                                                                                                                       |
| <b>STEP 2</b> | Preferred return, whole fund. Deal 1 pref: \$2,000,000 x 8 percent x 3 years = \$480,000. Deal 2 pref: \$2,000,000 x 8 percent x 5 years = \$800,000. Total preferred return owed: \$1,280,000. Available cash: only \$600,000, not enough to pay the full preferred return. \$600,000 goes to investors as a partial preferred return. Investors are still owed \$680,000 in unpaid pref. Remaining: \$0.<br>→ No cash remains for GP catch-up or promote. Sponsor earns \$0. |

### European Waterfall: Combined Results for Both Deals

| Description                                    | Investors (LP)     | Sponsor (GP) | Total              |
|------------------------------------------------|--------------------|--------------|--------------------|
| Return of all capital, whole fund              | \$4,000,000        | \$0          | \$4,000,000        |
| Preferred return (partial, all available cash) | \$600,000          | \$0          | \$600,000          |
| GP catch-up                                    | \$0                | \$0          | \$0                |
| 80 / 20 profit split                           | \$0                | \$0          | \$0                |
| <b>TOTAL</b>                                   | <b>\$4,600,000</b> | <b>\$0</b>   | <b>\$4,600,000</b> |

| Description             | Investors (LP) | Sponsor (GP) | Total |
|-------------------------|----------------|--------------|-------|
| Unpaid preferred return | (\$680,000)    |              |       |
| Sponsor promote earned  |                | \$0          |       |

### 3 C. Side by Side Comparison

Same two deals. Same economic terms. Dramatically different results for both investors and the sponsor.

| Distribution Tier                           | Deal 1 Cash              | Deal 2 Cash           | Total Cash               | Who Gets It |
|---------------------------------------------|--------------------------|-----------------------|--------------------------|-------------|
| American: Deal 1, return of capital         | \$2,000,000              |                       | \$2,000,000              | 100% LP     |
| American: Deal 1, preferred return          | \$480,000                |                       | \$480,000                | 100% LP     |
| American: Deal 1, catch-up + split          | \$320,000                |                       | \$320,000                | 80 / 20     |
| American: Deal 2, return of cap. (partial)  |                          | \$1,800,000           | \$1,800,000              | 100% LP     |
| <b>American: Investor / Sponsor totals</b>  | <b>\$2,640K / \$160K</b> | <b>\$1,800K / \$0</b> | <b>\$4,440K / \$160K</b> |             |
| European: All capital returned              |                          |                       | \$4,000,000              | 100% LP     |
| European: Partial pref (only \$600K avail.) |                          |                       | \$600,000                | 100% LP     |
| <b>European: Investor / Sponsor totals</b>  |                          |                       | <b>\$4,600K / \$0</b>    |             |

#### What This Comparison Reveals

*Under the American waterfall, the sponsor earned \$160,000 in promote from Deal 1, even though the fund as a whole only returned \$600,000 more than the investors' capital, and investors never received their full preferred return when both deals are considered together.*

*Under the European waterfall, investors received every dollar of distributable cash and the sponsor earned nothing, because there was not enough total cash to pay both the return of capital and the preferred return across all investments.*



*The difference is \$160,000 out of investors' pockets and into the sponsor's pocket, depending entirely on how the waterfall is structured. Both structures are legal. Both are disclosed in the PPM and governing documents. But investors who do not understand which waterfall they are in cannot accurately predict what they will receive.*

*This is why reading the waterfall provisions in the PPM and operating agreement carefully, before investing matters.*

#### EXAMPLE 4

### The Clawback, When the Sponsor Has to Give Money Back

*What happens under an American waterfall when later deals underperform.*

A fund uses an American (deal by deal) waterfall. The fund makes three investments. The clawback provision requires the sponsor to return any promote received in excess of what the European (whole fund) calculation would have entitled them to.

#### The Three Deals

- Deal A: invests \$3,000,000 and returns \$4,500,000 after 3 years (a strong performer). Sponsor earns \$300,000 in promote under the deal by deal calculation.
- Deal B: invests \$2,000,000 and returns \$2,160,000 after 4 years (a small gain that does not even cover the preferred return). Sponsor earns \$0 in promote.
- Deal C: invests \$1,000,000 and returns \$700,000 after 5 years (a \$300,000 principal loss). Sponsor earns \$0 in promote.

Total capital invested: \$6,000,000. Total cash returned: \$7,360,000. Sponsor promote received during the fund's life: \$300,000 (from Deal A only).

#### How Deal A Produces a \$300,000 Promote

*Deal A: \$3,000,000 invested, \$4,500,000 returned over 3 years.*

*Return of capital: \$3,000,000 to investors.*

*Preferred return (8 percent x 3 years):  $\$3,000,000 \times 8 \text{ percent} \times 3 = \$720,000$  to investors.*

*Remaining:  $\$4,500,000 \text{ minus } \$3,000,000 \text{ minus } \$720,000 = \$780,000$ .*

*GP catch-up to reach 20 percent of profits:  $\$720,000 \times (20 / 80) = \$180,000$  to sponsor.*

*Remaining after catch-up:  $\$780,000$  minus  $\$180,000 = \$600,000$ .*

*Final 80 / 20 split:  $\$480,000$  to investors and  $\$120,000$  to sponsor.*

*Sponsor's total promote on Deal A:  $\$180,000$  plus  $\$120,000 = \$300,000$ .*

#### 4 A. The Clawback Calculation

At the end of the fund, we ask the same question every clawback provision asks: if the European waterfall had been used all along, how much promote would the sponsor have been entitled to? We then compare that figure to what the sponsor actually received.

|               |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|---------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>STEP 1</b> | <p>Calculate what investors were owed (European or whole fund basis). Return of all capital: \$6,000,000. Preferred return (8 percent per year, weighted by deal hold period): Deal A, <math>\\$3,000,000 \times 8 \text{ percent} \times 3 \text{ years} = \\$720,000</math>; Deal B, <math>\\$2,000,000 \times 8 \text{ percent} \times 4 \text{ years} = \\$640,000</math>; Deal C, <math>\\$1,000,000 \times 8 \text{ percent} \times 5 \text{ years} = \\$400,000</math>. Total preferred return owed: \$1,760,000. Total owed to investors before any promote: \$7,760,000.</p> |
| <b>STEP 2</b> | <p>Compare total cash available to what investors were owed. Total cash available from all three deals: \$7,360,000. Total owed to investors: \$7,760,000. The fund came up \$400,000 short of paying investors back their full capital and preferred return. Under the European waterfall, investors would receive all \$7,360,000 and the sponsor would receive \$0 in promote. Under the American waterfall, the sponsor already received \$300,000 in promote from Deal A.</p>                                                                                                    |
| <b>STEP 3</b> | <p>Calculate the clawback. Sponsor earned under American waterfall: \$300,000. Sponsor entitled to under European calculation: \$0. Clawback amount: <math>\\$300,000</math> minus <math>\\$0</math> equals <math>\\$300,000</math>. The sponsor must return \$300,000 to investors.</p> <p>→ <i>The full \$300,000 of previously distributed promote must be returned.</i></p>                                                                                                                                                                                                       |

#### 4 B. The Tax Gross-Up Problem

In practice, a clawback creates a tax complication that sponsors and investors both need to understand. When the sponsor received the \$300,000 in promote from Deal A, they paid income tax on it. At a long-term capital gains rate of 20 percent, the tax bill would be \$60,000, leaving the sponsor with \$240,000 after tax. A clawback that requires the sponsor to return the full \$300,000 demands more cash than the sponsor ever actually kept from that distribution.

This is why well-drafted clawback provisions include a tax gross-up provision. The sponsor's obligation to return promote is reduced to account for taxes already paid, so the sponsor is not required to return more cash than they actually received after tax. A clawback provision without a tax gross-up can leave a sponsor on the hook for cash they no longer have.

The practical lesson is straightforward. When a fund uses an American waterfall, the sponsor should either maintain a clawback escrow (setting aside a portion of each promote distribution in a segregated account) or have the personal financial resources to fund the clawback obligation if it arises. A clawback clause that exists on paper but cannot actually be funded provides investors with no meaningful protection.

#### Example 4: Clawback Summary

| Description                                      | Investors (LP) | Sponsor (GP) | Total       |
|--------------------------------------------------|----------------|--------------|-------------|
| Promote earned from Deal A (American waterfall)  |                | \$300,000    | \$300,000   |
| Promote earned from Deal B                       |                | \$0          | \$0         |
| Promote earned from Deal C                       |                | \$0          | \$0         |
| Total promote received during fund life          |                | \$300,000    | \$300,000   |
| Promote entitled to (European, whole-fund basis) |                | \$0          | \$0         |
| Clawback, sponsor must return                    |                | (\$300,000)  | (\$300,000) |
| <b>Net sponsor promote after clawback</b>        |                | <b>\$0</b>   | <b>\$0</b>  |

## The Four Waterfall Questions Every Investor Should Ask

The four examples above illustrate that a waterfall's economic outcome turns on four variables that may not be obvious from a deal summary or pitch deck. Before committing capital to any private real estate offering, investors should get clear answers to all four.

### **Question 1. Is the preferred return simple or cumulative?**

*Simple preferred return. If the sponsor does not pay the full 8 percent in Year 1, that shortfall is not added to the following year's obligation. The unpaid amount is lost.*

*Cumulative preferred return. If the sponsor pays only 4 percent in Year 1, the remaining 4 percent carries forward and must be paid before any promote is earned. This is significantly more protective for investors.*

*Most well-structured offerings use a cumulative preferred return. If the operating agreement or LPA does not specifically say cumulative, ask the sponsor and read the document carefully.*

### **Question 2. Is the preferred return calculated on contributed capital or unreturned capital?**

*Contributed capital basis. The preferred return is calculated on the full original investment amount throughout the entire hold period. A \$1,000,000 investment earns 8 percent on \$1,000,000 every year, even in Year 4 when the sale is approaching.*

*Unreturned capital basis. If the property generated early cash distributions that were characterized as return of capital (reducing the investor's invested capital balance), the preferred return calculation shrinks as those distributions are made. Investors receive less preferred return in total.*

*These two approaches produce meaningfully different dollar amounts. The operating agreement or LPA must specify which basis applies.*

### **Question 3. Does the waterfall apply to operating distributions and sale proceeds the same way?**

*Some offerings use different waterfall mechanics for quarterly operating cash flow distributions versus sale or refinancing proceeds. For example, operating distributions might be paid pro rata without a pref calculation, while the full waterfall (including cumulative preferred return reconciliation) is applied only at the final sale.*

*This is not inherently wrong, but investors need to understand it. They may receive quarterly cash flow that looks like a return but is actually a return of capital, with the real*

*pref calculation deferred to sale. The tax treatment of those distributions differs significantly from a true preferred return.*

#### **Question 4. Is there a clawback, and can the sponsor actually fund it?**

*Under an American waterfall, the clawback is the primary investor protection against overpayment of promote on early strong deals that are later offset by poor performing ones. A clawback clause that is not backed by an escrow or a sponsor with genuine financial resources is a paper protection only.*

*Ask the sponsor: is there a clawback escrow? If not, what is the sponsor's plan for funding a clawback obligation if it arises? The answer reveals a great deal about how seriously the sponsor has thought about alignment with investors.*

## **Why Waterfall Drafting Matters**

The waterfall calculation is not a back-office accounting exercise. It is the legal mechanism that determines how an investment converts into cash in an investor's account. Understanding it before the deal closes, rather than after the distribution statement arrives, is the difference between being an informed participant in a transaction and being a passive recipient of a number someone else calculated.

The examples in this appendix used simple numbers to make the logic visible. Real deals use the same logic but with more complexity: quarterly distributions that affect IRR calculations, capital calls timed differently across multiple investors, equalization payments for late-entering investors in a fund, and refinancing proceeds that partially reset the waterfall midway through the hold. None of that changes the underlying structure (return capital first, preferred return second, catch-up third, profit split fourth), but it does change the math at each step.

In our practice, the most common waterfall failure mode is not bad drafting in isolation. It is three documents (the pitch deck, the PPM, and the operating agreement or LPA) describing the waterfall using slightly different language because they were not reviewed together as a unified set. The pitch deck says one thing in plain English. The PPM uses defined terms that nearly, but not quite, track the deck. The operating agreement uses a third set of defined terms drafted by a different attorney at a different time. When the property sells and the cash needs to be split, the inconsistencies surface in a context where there is real money at stake and no time to fix them.

Sponsors who want their waterfall provisions to hold up under pressure, and investors who want to understand what they are actually agreeing to, both benefit from the same thing: a waterfall drafted precisely, modeled before launch with multiple performance scenarios, and reconciled across every document an investor will see.

### **A Note from Counsel**

*Waterfall provisions are where economic intent meets legal drafting, and where the two most often diverge. The work we do for clients on these provisions typically falls into four categories: (1) sponsors structuring a first deal or first fund who need a waterfall that matches their economic deal with their investors and is internally consistent across the PPM, operating agreement or LPA, and subscription documents; (2) sponsors moving from single asset syndications to a fund model and adapting their familiar deal by deal waterfall to a structure that institutional and sophisticated LPs will accept; (3) sponsors with an existing portfolio whose original waterfall provisions need to be revised because the deal evolved (refinancing, equity recapitalization, partner buyout, addition of a co-investor) and the original document no longer cleanly governs the actual cash flows; and (4) investors evaluating a sponsor's offering documents before committing capital who want a second pair of eyes on the waterfall mechanics, the preferred return mechanics, and the clawback provisions.*

*If any of those scenarios describes your situation, we would be glad to talk. You can reach us through [crowdfundlawyer.com](http://crowdfundlawyer.com).*

## APPENDIX H

# State Blue Sky Filing Reference Guide

When a sponsor closes the first investor in a private real estate offering under Regulation D, two clocks start running simultaneously. The federal Form D must be filed with the SEC through EDGAR within 15 days. A state notice filing must be made in that investor's home state within 15 days as well. The federal filing gets most of the attention. The state filings, more numerous and more procedurally varied, get less, and that asymmetry produces a category of compliance failure that is both common and entirely avoidable.

This appendix provides a working reference for the state-level blue sky notice filing obligations that attach to every Regulation D Rule 506 offering. It covers the legal framework that creates these obligations, the mechanics of how filings are made, the states that require special handling, and a jurisdiction-by-jurisdiction reference table showing each state's regulator, fee, filing method, and deadline. It also profiles the states that require attention beyond the standard process, including New York, California, and a handful of others where the mechanics, fees, or enforcement posture make the standard approach insufficient.

One caveat before using any reference in this appendix. State securities requirements change. Fees are updated, filing procedures shift between paper and electronic systems, and regulatory agencies occasionally add or modify requirements. The information here reflects the regulatory environment as of early 2026 and is accurate to the best of the author's knowledge at that time, but it should be verified against each state's current published requirements before any filing is made. The NASAA Electronic Filing Depository at [nasaaefd.org](https://nasaaefd.org) and each state's securities regulator website are the authoritative sources.

## PART ONE

## The Legal Framework

*Why state filings are required even when registration is not.*

The National Securities Markets Improvement Act of 1996, known as NSMIA, established the concept of “covered securities,” a category of securities that is preempted from state registration and qualification requirements. Securities sold under Rule 506 of Regulation D are covered securities. States cannot require issuers to register covered securities offerings with state regulators, cannot require state merit review of covered securities offerings, and cannot impose state-level investor eligibility requirements more restrictive than the federal accredited investor standard.

What NSMIA did not do is eliminate state authority entirely. States retained two powers that remain fully operative for every covered securities offering. First, the authority to require notice filings and to collect filing fees. Second, the authority to enforce state antifraud laws against any misrepresentation or omission in connection with the offer or sale of securities in that state, regardless of the federal exemption.

The notice filing obligation is the one that catches sponsors off guard. Because the federal exemption eliminates state registration, many sponsors assume, incorrectly, that the state compliance obligation is also eliminated. It is not. Every U.S. state except Florida requires a notice filing for Regulation D Rule 506 offerings to its residents. Florida is the only state that has affirmatively elected to impose no notice filing requirement on Rule 506 offerings. Every other jurisdiction, including the District of Columbia, Puerto Rico, and the U.S. Virgin Islands, requires a notice filing of some kind. The notice filing does not involve state review of the offering's merits. The state is simply being informed that a covered securities offering has been made to its residents. But failure to file the notice, or filing it late, can constitute a state securities violation with real consequences.

### **What a Blue Sky Notice Filing Is, and What It Is Not**

*What it is: a notification to the state that a Rule 506 offering has been made to one or more of its residents; a copy of the federal Form D, plus any required state-specific forms; payment of a state-specific filing fee; and a consent to service of process form in many states, agreeing that the state can serve the issuer with legal process.*

*What it is not: a registration of the securities offering with the state; a merit review of the offering's fairness or adequacy of disclosure; state approval of the offering; or a guarantee of compliance. The state can still bring an antifraud enforcement action regardless of a timely notice filing.*

*The filing tells the state that the issuer sold securities to someone who lives there under Rule 506. The state responds, in effect, by acknowledging receipt and keeping the filing on record. That is the entire transaction for most states. But failing to make it triggers consequences that are disproportionate to the simplicity of the filing itself.*

## **PART TWO**

### **How Blue Sky Notice Filings Work**

*The mechanics, from federal Form D to state notice to ongoing tracking.*



## **2 A. File the Federal Form D First**

The NASAA Electronic Filing Depository, known as EFD, pulls Form D information from the SEC's EDGAR system. This means an issuer cannot file through EFD until the Form D already exists in EDGAR. The sequence is mandatory. File Form D with the SEC through EDGAR first; then file state blue sky notices through EFD.

The Form D must be filed through EDGAR's electronic system within 15 calendar days of the date of first sale. The date of first sale is defined as the date the first investor signs a subscription agreement, not the date capital is wired. If the subscription agreement is signed on June 1 and the wire arrives June 5, the 15-day clock started on June 1. The Form D filing deadline is June 16.

## **2 B. Identify Each Investor's State of Residence**

The blue sky filing obligation is triggered by investor residency. One filing must be made in each state where at least one investor resides. A single filing covers all investors from that state in the same offering, regardless of how many investors reside there. An issuer does not file one notice per investor. The issuer files one notice per state.

For a rolling offering with closings over 6 to 18 months, the state filing obligation tracks each investor as they are admitted. If the first 10 investors are all from Texas, only a Texas filing is required. If investor 11 is from Colorado, a Colorado filing is required within 15 days of that investor's subscription. Tracking investor state residency throughout the offering period, not just at the initial closing, is an ongoing compliance task.

## **2 C. Use the NASAA EFD for Most States**

The NASAA Electronic Filing Depository is a centralized online system that allows issuers to file state blue sky notices and pay state filing fees for Regulation D Rule 506 offerings to participating states simultaneously. EFD launched in 2014 and has significantly streamlined the state filing process. Effective January 6, 2025, the system moved to a new website at [nasaaefd.org](https://nasaaefd.org). The older URL at [efdnasaa.org](https://efdnasaa.org) was retired at the end of 2024.

EFD charges a one-time enrollment fee of \$150 to use the system. After enrollment, filing through EFD requires selecting the states where filings are needed, confirming that the Form D is already on file in EDGAR (EFD pulls it automatically), and paying each state's required fee through the system. Electronic receipts are generated as proof of filing.

### States That Require Special Handling

*Most jurisdictions accept Reg D Rule 506 notice filings through EFD, but several deviate from the standard process and require attention before filing.*

*Arizona: Requires paper filing by mail to the Arizona Corporation Commission, Securities Division. See [azcc.gov](http://azcc.gov) for forms and the mailing address.*

*New York: Joined EFD in December 2020 for most Regulation D offerings, but offerings of “real estate securities” within the meaning of New York General Business Law section 352-e are still required to file Form 99 manually through the Attorney General's Real Estate Finance Bureau. See the New York profile in Part Four.*

*Florida: No filing required at all. See the Florida profile in Part Four.*

*Other states: A handful of states, including Indiana and Utah, charge no filing fee for smaller offerings but still require the notice itself to be filed through EFD.*

*The current EFD participation list and per-state requirements are maintained at [nasaaefd.org](http://nasaaefd.org) and at [nasaa.org](http://nasaa.org). Confirm current status before each filing.*

## 2 D . Track Deadlines and Renewals

The standard deadline for blue sky notice filings is 15 calendar days after the first sale of securities to an investor in that state. “First sale” means the date the subscription agreement is signed and accepted, the same definition used for the federal Form D. Most states enforce this deadline, and late filings, even by a few days, can expose the issuer to late fees, enforcement actions, or, in some states, the investor's right to rescind the investment.

Most states do not require annual renewal of the blue sky notice. Once the notice is filed, it covers the offering until completion for most states. A few states do require renewal or amendment when the offering remains open beyond 12 months. Nevada, for example, treats its notice filing as effective for one year, after which the issuer must refile and pay the fee again if the offering continues. Separately, all states require that the notice be updated if material information on the Form D changes. A change in the total offering amount, a change in the number of investors, or a change in the issuer's contact information may require an amended filing. The annual amendment obligation for the federal Form D, when an offering remains open beyond one year, is separate from the state renewal question and must be addressed independently.

## The Antifraud Foundation Beneath Every Filing

Filing the blue sky notice does not create immunity from state enforcement. Every state retains antifraud authority over securities transactions within its borders, regardless of whether a notice was timely filed. A state can investigate and prosecute misrepresentations or omissions in connection with any securities offering, including fully compliant Regulation D offerings, at any time. The notice filing tells the state the issuer was there. It does not insulate the issuer from consequences if the offering itself involved material misstatements.

Blue sky compliance and antifraud compliance are not the same thing. Getting the filing mechanics right is necessary. Getting the disclosures right, in the PPM, in investor communications, and in marketing materials, is what actually protects against state enforcement, investor rescission claims, and the regulatory exposure that follows from a material misrepresentation, regardless of how promptly the Form D was filed.

### PART THREE

## Consequences of Late or Missing Filings

*What state regulators can do when the notice is not made on time.*

The consequences of missing a state blue sky filing range from a modest late fee to enforcement actions that can disrupt the offering and create investor rescission rights. The specific consequences vary by state, but the range of outcomes is consistent enough to describe in general terms.

- **Late filing fees.** Most states assess a penalty fee for filings made after the deadline, typically ranging from \$50 to \$2,500 depending on the state and the length of the delay. Some states impose tiered late fees that escalate over time. The financial cost of a late fee is not the primary concern. The problem is what the late filing signals to the state regulator about the issuer's compliance posture.
- **Cease-and-desist orders.** State securities regulators can issue orders requiring the issuer to stop accepting additional investor funds from that state's residents until compliance is achieved. A cease-and-desist order during an active capital raise can disrupt closing timelines, require notification to lenders, and create investor relations problems that are difficult to manage.
- **Investor rescission rights.** Some states treat a failure to file a timely blue sky notice as a violation that gives investors from that state a right of rescission, the legal right to demand return of their investment plus statutory interest, regardless of how the

investment has performed. In a successful real estate offering, rescission exposure on even a few investors can significantly exceed the cost of the filing that was missed.

- Bar from future offerings in the state. Repeated or willful failure to make required state filings can result in a regulatory bar preventing the issuer from making future securities offerings to residents of that state. For sponsors who anticipate repeat offerings, this consequence has long-term effects that extend beyond the current deal.
- Criminal referral. Willful violation of state securities laws, including willful failure to make required filings, can result in criminal referral to state prosecutors. This outcome is rare for inadvertent filing failures, but it applies when a pattern of non-compliance suggests intentional avoidance.

### **The Most Common Filing Mistake: Treating Blue Sky Filings as a Post-Closing Task**

*The most frequent blue sky compliance failure is straightforward in its mechanics. The sponsor treats blue sky filings as a task to address after the property closes, rather than as a concurrent compliance obligation that runs alongside the capital raise.*

*The 15-day clock runs from the date of first sale in each state, which is typically weeks before the property acquisition closes. An investor who signs a subscription agreement on October 1 and wires capital on October 8 triggers a blue sky filing deadline of October 16 in that investor's state. The property may not close until November 15. The filing deadline does not wait for the deal to close.*

*The practical fix is straightforward. Maintain a running investor log with each investor's state of residence and the date the subscription agreement was signed. Every time a new state appears in the log, that state's filing deadline should be calendared and actioned within a few days. Waiting until all investors are admitted before beginning the state filing process guarantees late filings for investors who signed early.*

## **PART FOUR**

### **States That Require Special Handling**

*Four jurisdictions where the standard process is insufficient.*

For most states, the blue sky notice filing process is straightforward. A Form D is filed through EFD with a flat fee, within 15 days of first sale, and no further action is required until the offering closes. Several states deviate from this pattern in ways that materially affect the compliance process. These states warrant specific attention before the offering begins.

## New York

*The most complex blue sky jurisdiction in the country for real estate offerings.*

**Regulator:** New York Attorney General, Investor Protection Bureau and Real Estate Finance Bureau. Website: [ag.ny.gov](http://ag.ny.gov).

**Standard Reg D offerings:** Since December 2020, most Regulation D Rule 506 offerings to New York investors are filed through EFD like other states. New York's filing fee for these offerings is variable, ranging from approximately \$300 to \$2,135 depending on offering size.

**Real estate securities:** Offerings of "real estate securities" within the meaning of New York General Business Law section 352-e, including most LLC and limited partnership interests that own, operate, or develop real property, are subject to a separate regime. They are not filed through EFD. They are filed through the New York Attorney General's Real Estate Finance Bureau using Form 99 (a notification filing for Rule 506 issuers) plus a consent to service of process form (Form U-2). Larger real estate offerings may instead require a full filing under section 352-e using Form RS-1 with an offering statement (CPS-1 or CPS-7).

**Annual report:** Real estate syndications filed in New York require an annual report to be filed with the Attorney General's office, including a balance sheet and profit-and-loss statement certified by an independent CPA, within four months of the syndicate's fiscal year end.

**Enforcement posture:** The New York Attorney General's office has historically been one of the most active state securities enforcement programs in the country, with a particular focus on investor protection in real estate transactions. Penalties for unregistered offerings of real estate securities under the Martin Act are substantial.

**Practical guidance:** If any prospective investor resides in New York and the offering involves a real estate syndication, engage securities counsel familiar with section 352-e and the Real Estate Finance Bureau's filing requirements before accepting that investor. The pre-clearance and ongoing reporting obligations make New York distinctly more burdensome than any other state in the country for real estate offerings.

## California

*High-volume investor market, active enforcement, now an EFD participant.*

**Regulator:** California Department of Financial Protection and Innovation (DFPI). Website: [dfpi.ca.gov](http://dfpi.ca.gov).

**Filing mechanics:** California now participates in NASAA EFD for Regulation D Rule 506 notice filings, having joined the system in recent years. Filings may also be made directly to DFPI by mail, but electronic filing through EFD is the practical default.

**Fee:** California's current fee for a Rule 506 notice filing is \$300, a fixed amount rather than a percentage of the offering size as it was structured in some prior years.

**Deadline:** 15 calendar days after the first sale to a California investor. California enforces this deadline actively.

**No merit review for 506 offerings:** Because Rule 506 securities are covered securities under NSMIA, California cannot conduct a merit review of the offering. The DFPI's filing is administrative, a notice and not an approval.

**Enforcement posture:** The DFPI is a well-resourced regulatory agency that has pursued enforcement actions against issuers who fail to file, file late, or file inaccurately. California's rescission remedy, available to investors when the issuer violated California securities law in connection with the sale, is a particularly powerful tool in enforcement actions against non-compliant issuers.

**Practical guidance:** Given the size of California's investor market and the DFPI's active enforcement posture, California should always be treated as a priority filing state. If any investor resides in California, file promptly rather than waiting until the 14th day.

## Florida

*The only state in the country that does not require a notice filing.*

**Regulator:** Office of Financial Regulation (OFR), Division of Securities. Website: [flofr.gov](http://flofr.gov).

**Filing requirement:** Florida does not require a blue sky notice filing for Regulation D Rule 506 offerings. There is no state form to file, no filing fee, and no deadline. Florida's exemption from the notice filing requirement is statutory under Chapter 517.071(1) of the Florida Statutes; the Florida Securities and Investor Protection Act does not impose a notice filing obligation on covered securities offerings.

**Antifraud authority intact:** This does not mean that Florida's securities laws do not apply. Florida retains full antifraud enforcement authority and can investigate and

prosecute misrepresentations in connection with securities offered to Florida investors regardless of the lack of a notice filing requirement.

**Dealer registration considerations:** Florida statutes do require that sales of securities in the state be made by a properly registered dealer or by someone using a dealer-registration exemption. For issuer-direct offerings under Rule 506, two issuer-employee exemptions are available under Chapter 517.12(3) of the Florida Statutes. These exemptions should be reviewed before a sponsor uses non-dealer employees to solicit Florida investors.

**Practical guidance:** Do not file anything with the Florida OFR for a Rule 506 offering. There is no form, no fee, and no process. Maintain accurate records of Florida investors in case of any future inquiry. The antifraud obligation is unchanged.

## Texas

*High-volume state for private real estate; standard EFD process.*

**Regulator:** Texas State Securities Board (SSB). Website: [ssb.texas.gov](http://ssb.texas.gov).

**Filing mechanics:** EFD, through the NASAA system at [nasaaefd.org](http://nasaaefd.org).

**Fee:** The Texas fee for a Rule 506 notice filing is calculated as one-tenth of one percent of the aggregate amount of the offering, with a \$500 cap. For most real estate syndications, the fee is the \$500 maximum.

**Deadline:** 15 calendar days after the first sale to a Texas investor.

**No annual renewal:** Texas does not require annual renewal of the notice filing.

**Intrastate exemption note:** Texas has its own intrastate offering exemption under the Texas Securities Act that applies to all-Texas offerings with no more than 35 sophisticated investors or an unlimited number of accredited investors. This is a separate and distinct offering structure from a Regulation D offering and requires a different analysis. Sponsors using intrastate exemptions must separately satisfy Texas state-law requirements.

**Practical guidance:** Texas is a routine EFD filing. For sponsors based in Texas who run primarily Texas-investor offerings, the primary compliance consideration is maintaining accurate investor logs to ensure that every new Texas investor's 15-day filing clock is tracked.

## Arizona

*Paper filing required; not an EFD participant.*

**Regulator:** Arizona Corporation Commission (AZCC), Securities Division. Website: [azcc.gov](http://azcc.gov).

**Filing mechanics:** Arizona does not participate in the NASAA EFD system. All blue sky notice filings for Regulation D Rule 506 offerings in Arizona must be made by paper mail to the Arizona Corporation Commission.

**What to send:** A copy of the Form D as filed with the SEC, a completed consent to service of process form (Form U-2 or Arizona's equivalent), and the filing fee payment by check or money order payable to the Arizona Corporation Commission.

**Mailing address:** Arizona Corporation Commission, Securities Division, 1300 West Washington Street, Phoenix, Arizona 85007.

**Fee:** \$250 flat fee for Rule 506 offerings.

**Deadline:** 15 calendar days after the first sale to an Arizona investor. The filing date is typically the date the envelope is postmarked, but confirm current requirements with the AZCC.

**Processing time:** Allow additional lead time when mailing. The AZCC's Securities Division processes paper filings, and the turnaround time is not immediate. Filing on Day 14 of the 15-day window by regular mail creates delivery risk.

**Practical guidance:** If any investor resides in Arizona, prepare the paper filing package immediately upon admitting the investor and send it by certified mail, return receipt requested. The delivery confirmation documents compliance.

## PART FIVE

### Jurisdiction-by-Jurisdiction Reference

*Regulator, fee, filing method, deadline, and renewal status for every U.S. jurisdiction.*

The table below provides a jurisdiction-by-jurisdiction reference for Regulation D Rule 506 blue sky notice filings. All information is current as of early 2026 and should be verified against each state's current published requirements before filing. Fees are approximate and subject to change without notice. Fees shown are government filing fees only. Service fees, EFD system fees, and counsel fees are additional.



## Table Key

- EFD = filing made through the NASAA Electronic Filing Depository at [nasaaefd.org](http://nasaaefd.org).
- Paper = filing made by paper submission to the state regulator (not EFD).
- Variable = fee depends on offering size or amount sold in the state; the range shown reflects typical figures.
- ✓ = no notice filing required (Florida only).
- Real Estate = state has special handling for real estate securities; review profile before filing.

| State              | Regulator / Website                                                              | Fee              | Filing       | Deadline | Renewal |
|--------------------|----------------------------------------------------------------------------------|------------------|--------------|----------|---------|
| <b>Alabama</b>     | ASC, <a href="http://asc.alabama.gov">asc.alabama.gov</a>                        | \$300            | EFD          | 15 days  | No      |
| <b>Alaska</b>      | Div. of Banking, <a href="http://commerce.alaska.gov">commerce.alaska.gov</a>    | \$600            | EFD          | 15 days  | No      |
| <b>Arizona</b>     | AZCC, <a href="http://azcc.gov">azcc.gov</a>                                     | \$250            | Paper        | 15 days  | No      |
| <b>Arkansas</b>    | Sec. Dept., <a href="http://securities.arkansas.gov">securities.arkansas.gov</a> | \$100 to \$500   | EFD          | 15 days  | No      |
| <b>California</b>  | DFPI, <a href="http://dfpi.ca.gov">dfpi.ca.gov</a>                               | \$300            | EFD          | 15 days  | No      |
| <b>Colorado</b>    | Div. of Securities, <a href="http://dora.colorado.gov">dora.colorado.gov</a>     | \$50             | EFD          | 15 days  | No      |
| <b>Connecticut</b> | Banking Dept., <a href="http://portal.ct.gov">portal.ct.gov</a>                  | \$150            | EFD          | 15 days  | No      |
| <b>Delaware</b>    | Sec. Dept., <a href="http://securities.delaware.gov">securities.delaware.gov</a> | \$200 to \$1,000 | EFD          | 15 days  | No      |
| <b>D.C.</b>        | DISB, <a href="http://disb.dc.gov">disb.dc.gov</a>                               | \$250            | EFD          | 15 days  | No      |
| <b>Florida ✓</b>   | OFR, <a href="http://flofr.gov">flofr.gov</a>                                    | None             | Not required | N/A      | N/A     |
| <b>Georgia</b>     | Sec. of State, <a href="http://sos.ga.gov">sos.ga.gov</a>                        | \$250            | EFD          | 15 days  | No      |
| <b>Hawaii</b>      | DCCA, <a href="http://cca.hawaii.gov">cca.hawaii.gov</a>                         | \$100            | EFD          | 15 days  | No      |
| <b>Idaho</b>       | Dept. of Finance, <a href="http://finance.idaho.gov">finance.idaho.gov</a>       | \$50             | EFD          | 15 days  | No      |
| <b>Illinois</b>    | Sec. Dept., <a href="http://idfpr.illinois.gov">idfpr.illinois.gov</a>           | \$100            | EFD          | 15 days  | No      |
| <b>Indiana</b>     | Sec. of State, <a href="http://sos.in.gov">sos.in.gov</a>                        | \$0              | EFD          | 15 days  | No      |
| <b>Iowa</b>        | Insurance Div., <a href="http://iid.iowa.gov">iid.iowa.gov</a>                   | \$100            | EFD          | 15 days  | No      |
| <b>Kansas</b>      | OSC, <a href="http://ksc.ks.gov">ksc.ks.gov</a>                                  | \$250            | EFD          | 15 days  | No      |
| <b>Kentucky</b>    | DFI, <a href="http://kfi.ky.gov">kfi.ky.gov</a>                                  | \$250            | EFD          | 15 days  | No      |
| <b>Louisiana</b>   | OFI, <a href="http://ofi.la.gov">ofi.la.gov</a>                                  | \$300            | EFD          | 15 days  | No      |
| <b>Maine</b>       | Office of Sec., <a href="http://maine.gov/securities">maine.gov/securities</a>   | \$300            | EFD          | 15 days  | No      |

| State                 | Regulator / Website                                                                              | Fee              | Filing        | Deadline | Renewal |
|-----------------------|--------------------------------------------------------------------------------------------------|------------------|---------------|----------|---------|
| <b>Maryland</b>       | Div. of Securities, <a href="http://marylandattorneygeneral.gov">marylandattorneygeneral.gov</a> | \$100            | EFD           | 15 days  | No      |
| <b>Massachusetts</b>  | Sec. Div., <a href="http://sec.state.ma.us">sec.state.ma.us</a>                                  | \$250 to \$750   | EFD           | 15 days  | No      |
| <b>Michigan</b>       | LARA, <a href="http://michigan.gov/lara">michigan.gov/lara</a>                                   | \$100            | EFD           | 15 days  | No      |
| <b>Minnesota</b>      | Commerce, <a href="http://mn.gov/commerce">mn.gov/commerce</a>                                   | \$100 to \$300   | EFD           | 15 days  | No      |
| <b>Mississippi</b>    | Sec. of State, <a href="http://sos.ms.gov">sos.ms.gov</a>                                        | \$300            | EFD           | 15 days  | No      |
| <b>Missouri</b>       | Sec. of State, <a href="http://sos.mo.gov">sos.mo.gov</a>                                        | \$100            | EFD           | 15 days  | No      |
| <b>Montana</b>        | CSI, <a href="http://csimt.gov">csimt.gov</a>                                                    | \$200 to \$1,000 | EFD           | 15 days  | No      |
| <b>Nebraska</b>       | Banking Dept., <a href="http://ndbf.nebraska.gov">ndbf.nebraska.gov</a>                          | \$200            | EFD           | 15 days  | No      |
| <b>Nevada</b>         | Sec. of State, <a href="http://nvsos.gov">nvsos.gov</a>                                          | \$500            | EFD           | 15 days  | Annual  |
| <b>New Hampshire</b>  | Banking Dept., <a href="http://banking.nh.gov">banking.nh.gov</a>                                | \$500            | EFD           | 15 days  | No      |
| <b>New Jersey</b>     | Bureau of Sec., <a href="http://njconsumeraffairs.gov">njconsumeraffairs.gov</a>                 | \$750            | EFD           | 15 days  | No      |
| <b>New Mexico</b>     | RLD Sec. Div., <a href="http://rld.nm.gov">rld.nm.gov</a>                                        | \$350            | EFD           | 15 days  | No      |
| <b>New York (RE)</b>  | NYAG REF Bur., <a href="http://ag.ny.gov">ag.ny.gov</a>                                          | \$300 to \$2,135 | EFD + Form 99 | 15 days  | Annual  |
| <b>North Carolina</b> | Sec. Div., <a href="http://sosnc.gov">sosnc.gov</a>                                              | \$350            | EFD           | 15 days  | No      |
| <b>North Dakota</b>   | Sec. Dept., <a href="http://ndsecurities.com">ndsecurities.com</a>                               | \$100            | EFD           | 15 days  | No      |
| <b>Ohio</b>           | Div. of Sec., <a href="http://com.ohio.gov">com.ohio.gov</a>                                     | \$100            | EFD           | 15 days  | No      |
| <b>Oklahoma</b>       | Dept. of Sec., <a href="http://securities.ok.gov">securities.ok.gov</a>                          | \$250            | EFD           | 15 days  | No      |
| <b>Oregon</b>         | DFR, <a href="http://dfr.oregon.gov">dfr.oregon.gov</a>                                          | \$250            | EFD           | 15 days  | No      |
| <b>Pennsylvania</b>   | DOBS, <a href="http://dobs.pa.gov">dobs.pa.gov</a>                                               | \$525            | EFD           | 15 days  | No      |
| <b>Rhode Island</b>   | DBR, <a href="http://dbr.ri.gov">dbr.ri.gov</a>                                                  | \$300            | EFD           | 15 days  | No      |
| <b>South Carolina</b> | Sec. Div., <a href="http://sos.sc.gov">sos.sc.gov</a>                                            | \$300            | EFD           | 15 days  | No      |
| <b>South Dakota</b>   | Div. of Insurance, <a href="http://dlr.sd.gov">dlr.sd.gov</a>                                    | \$250            | EFD           | 15 days  | No      |
| <b>Tennessee</b>      | Dept. of Commerce, <a href="http://tn.gov/commerce">tn.gov/commerce</a>                          | \$500            | EFD           | 15 days  | No      |
| <b>Texas</b>          | SSB, <a href="http://ssb.texas.gov">ssb.texas.gov</a>                                            | Up to \$500      | EFD           | 15 days  | No      |
| <b>Utah</b>           | Div. of Sec., <a href="http://securities.utah.gov">securities.utah.gov</a>                       | \$0 or \$100     | EFD           | 15 days  | No      |
| <b>Vermont</b>        | DFR, <a href="http://dfr.vermont.gov">dfr.vermont.gov</a>                                        | \$600            | EFD           | 15 days  | No      |
| <b>Virginia</b>       | SCC, <a href="http://scc.virginia.gov">scc.virginia.gov</a>                                      | \$250            | EFD           | 15 days  | No      |
| <b>Washington</b>     | DFI, <a href="http://dfi.wa.gov">dfi.wa.gov</a>                                                  | \$300            | EFD           | 15 days  | No      |
| <b>West Virginia</b>  | State Aud., <a href="http://wvsao.gov">wvsao.gov</a>                                             | \$125            | EFD           | 15 days  | No      |
| <b>Wisconsin</b>      | DFI, <a href="http://dfi.wi.gov">dfi.wi.gov</a>                                                  | \$200            | EFD           | 15 days  | No      |
| <b>Wyoming</b>        | Sec. of State, <a href="http://sos.wyo.gov">sos.wyo.gov</a>                                      | \$200            | EFD           | 15 days  | No      |
| <b>Puerto Rico</b>    | OCFI, <a href="http://ocif.pr.gov">ocif.pr.gov</a>                                               | \$350 to \$1,500 | EFD           | 15 days  | No      |

| State           | Regulator / Website          | Fee     | Filing | Deadline | Renewal |
|-----------------|------------------------------|---------|--------|----------|---------|
| U.S. Virgin Is. | Off. of Lt. Gov., ltg.gov.vi | \$1,500 | EFD    | 15 days  | No      |

### A Note on Fee Accuracy

*State filing fees change without advance notice. The fee figures in the table above reflect published requirements as of early 2026, but several states have adjusted their fee schedules in recent years. Always confirm the current fee with the state regulator's website or through the EFD system before submitting payment.*

*For states whose fees are calculated based on the amount sold in that state, rather than a flat fee, the figure shown reflects the typical fee for a mid-sized real estate offering. A handful of states, including Arkansas, Delaware, Minnesota, Montana, Texas, and several others, use tiered or percentage-based fee structures where the actual amount depends on the dollar value of securities sold to that state's residents.*

*The NASAA EFD system charges a one-time \$150 enrollment fee. This is separate from the individual state fees.*

*Several states impose late fees that can exceed the original filing fee by an order of magnitude. New Mexico's late fee, for example, can reach \$1,050 on a \$350 filing. The U.S. Virgin Islands assesses a \$3,000 late fee on a \$1,500 filing. The cost of a missed deadline is rarely just the original fee.*

## PART SIX

### The Ongoing Blue Sky Compliance Calendar

*Filings, renewals, and amendments for offerings that remain open.*

Blue sky compliance is not a one-time event at the offering's launch. For offerings that remain open beyond their initial closing, which includes most blind pool funds, any syndication with rolling closings, and any offering where capital is raised over more than a few months, the state filing obligations continue throughout the offering period.

### Blue Sky Compliance Calendar for an Active Offering

*At first sale in any state: calendar the 15-day deadline from the date the subscription agreement is signed; prepare and file the state notice within the deadline; retain the EFD receipt or paper filing confirmation as proof of compliance.*

*When a new state is added (new investor from a state not previously filed): the same 15-day deadline applies from that investor's subscription date; file in the new state before accepting wire funds from investors in that state whenever possible; update the investor log to reflect the new state.*

*Annual obligations for offerings remaining open beyond 12 months: file the federal Form D annual amendment through EDGAR; check each filed state for annual renewal requirements (most states do not require renewal, but Nevada and New York real estate filings do; confirm for each filed state); review the EFD system for any renewal notifications.*

*When material information changes: amend the federal Form D if any material information has changed (total offering amount, number of investors, issuer contact information); file corresponding state amendments where required.*

*At offering close: no additional state filings are typically required at closing; retain all filing records for at least 7 years; if the offering closes before all planned investors are admitted, confirm no additional state notice filings are pending.*

## PART SEVEN

### Five Things Every Sponsor Should Know

*The fundamentals, summarized.*

#### 1. One filing covers all investors from a state, but the clock runs from the first one.

A sponsor does not file one notice per investor. Fifteen investors from Texas yield one Texas notice. But that notice must be filed within 15 days of the first Texas investor's subscription agreement, not the last one. The filing obligation starts on the day of first sale in that state, regardless of how many more Texas investors will follow.

#### 2. Florida requires nothing. New York requires the most.

These are the two outliers that every sponsor should know before starting investor outreach. Florida has no notice filing requirement and charges no fee. New York imposes the most onerous regime in the country for real estate syndications, including manual filing of Form 99

with the Real Estate Finance Bureau, annual reporting obligations, and substantial enforcement risk under the Martin Act. Every other state falls somewhere in between.

### **3. The blue sky filing does not prove the offering was compliant. It just proves the issuer showed up.**

A timely notice filing tells the state the issuer was there. It does not protect the issuer from enforcement if the offering involved material misrepresentations, if the investors were not genuinely accredited, if the verification process was inadequate for a 506(c) offering, or if any other condition of the federal exemption was not satisfied. The notice filing is an administrative obligation. Substantive compliance with the securities laws is a separate and more important requirement.

### **4. Missing a filing in a state with rescission rights is the most expensive mistake.**

Most states provide investors with a rescission remedy when the issuer violated state securities law in connection with the sale. A failure to file a required blue sky notice is, in many states, a state securities law violation. In a state that recognizes rescission rights for this type of violation, an investor can demand return of their entire investment plus statutory interest, regardless of how the investment performed. In a successful real estate offering, rescission exposure from a few investors can be larger than the total filing fees for all 50 states combined.

### **5. State requirements change. Build verification into the process, not just into this guide.**

The reference table in Part Five reflects requirements as of early 2026. States update their fee schedules, their filing procedures shift between paper and electronic, and regulators occasionally add requirements that did not previously exist. The NASAA EFD system at [nasaaefd.org](https://nasaaefd.org) and the EFD resources page at [nasaa.org](https://nasaa.org) are updated regularly and are the most reliable single source for current participation status. Confirming requirements before each offering, rather than relying on requirements confirmed for a prior offering, is the appropriate compliance posture.

## **Why Blue Sky Compliance Looks Easy and Goes Wrong Anyway**

Blue sky compliance is one of the most straightforward components of a private real estate offering compliance program. Each state has its own process, but the process for each state is defined and fixed. The filing obligation does not require interpretation or judgment. It requires execution on a known deadline. What makes it a source of failure is not its complexity but its invisibility. Sponsors who are focused on the property acquisition, the investor relationships, and

the offering documents tend to treat state filings as administrative background noise right up until the deadline passes.

The sponsor who builds a simple investor log, tracking each investor's name, state of residence, and subscription date from day one, and who delegates state filing management to securities counsel from the moment the first subscription agreement is signed, will rarely miss a deadline. The sponsor who tries to reconstruct who signed when from a pile of emails after the offering closes will miss some, and the consequences will be disproportionate to the oversight.

### **A Note from Counsel**

*Blue sky compliance is one of the areas where engaging counsel pays for itself in avoided enforcement exposure and rescission risk many times over. The work we do for clients on state filings typically falls into four categories: (1) sponsors preparing for a first offering who need a complete state-by-state compliance plan calibrated to their target investor base; (2) sponsors running an active capital raise across multiple states who need ongoing filing management as new investors are admitted; (3) sponsors who have realized mid-offering that earlier filings were missed or late and need to assess late-filing remediation and rescission exposure; and (4) sponsors planning to admit New York investors and needing to navigate the Martin Act real estate syndication requirements before the first subscription agreement is signed.*

*If any of those scenarios describes your situation, we would be glad to talk. You can reach us through [crowdfundlawyer.com](http://crowdfundlawyer.com).*

**APPENDIX I**

# Bad Actor Disqualification Reference Guide

Every Regulation D Rule 506 offering carries a threshold obligation that must be satisfied before the offering begins and monitored throughout its life. The issuer must confirm that none of the people connected to the offering in a covered role has been the subject of a disqualifying event. If a person who qualifies as a covered person under Rule 506(d) has a disqualifying event in their background, the issuer loses the right to rely on the Rule 506 exemption. The loss applies not just to that person's involvement; it applies to the entire offering.

This appendix is a practical reference guide to the bad actor rules. It explains who counts as a covered person, what specific events disqualify an offering, how long the lookback periods run, what the issuer must do when a pre-existing event exists, what to do if a disqualifying event is discovered mid-offering, and how to conduct a pre-offering bad actor check that satisfies the reasonable care standard the rules require. It closes with a sample bad actor questionnaire and a step-by-step checklist for use with every offering.

The bad actor rules became effective on September 23, 2013, under Rule 506(d), adopted pursuant to Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Events occurring before that date do not disqualify an offering, but they may have to be disclosed to investors under the separate Rule 506(e) disclosure obligation. Both the disqualification rules and the disclosure obligation are addressed in detail below.

## The Core Rule, in One Paragraph

*If any covered person connected to a Rule 506 offering has been the subject of a specified disqualifying event within the applicable lookback period, the issuer cannot conduct that offering under Rule 506(b) or Rule 506(c). The exemption is not merely suspended; it is unavailable. The effect is the same as if the offering had no exemption from registration at all. Every sale of securities in that offering constitutes an unregistered securities offering in violation of the Securities Act, with all of the enforcement and rescission consequences that follow.*

*Three elements must all be present for disqualification to occur: (1) a covered person must be involved in the offering; (2) that covered person must have been subject to one of the specified disqualifying events; and (3) the disqualifying event must have occurred within the applicable lookback period. If any one of these three elements is absent, there*

*is no disqualification. If all three are present, the offering is disqualified, unless a waiver applies or the reasonable care-exception is available.*

## PART ONE

### Who Is a Covered Person?

*The first and most important step in the bad actor compliance process.*

The bad actor rules apply to a defined list of people and entities connected to the offering. These are the covered persons. The issuer must identify every covered person before the offering begins and conduct a factual inquiry into whether each one has had a disqualifying event. Identifying the correct universe of covered persons is the first step that determines whether everything that follows is built on a sound foundation.

The covered persons list is broader than many sponsors expect. It reaches beyond the sponsor's own team to include the entities themselves, their predecessors, the entity's investment manager (where the issuer is a pooled investment fund), and anyone paid to bring investors to the deal. The practical implication is that a sponsor who hires a placement agent or pays a finder to introduce investors has expanded the covered persons list to include those persons and their own covered control persons, people the sponsor may not know personally and whose backgrounds are outside the sponsor's direct knowledge.

| Category                                | Who It Covers                                                                                                                                                                                                       | Practical Note                                                                                                                 |
|-----------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------|
| <b>The Issuer</b>                       | The entity selling the securities (the LLC, LP, or corporation conducting the offering), together with any predecessors and any affiliated issuers that are co-issuers of the same securities in the same offering. | Every entity formed for each offering is itself a covered person. Predecessors and affiliated issuers travel with the issuer.  |
| <b>Directors, GPs, Managing Members</b> | Members of the Board of Directors (for corporations), general partners (for LPs), and managing members (for LLCs) of the issuer.                                                                                    | Both LLC managers and LP general partners qualify. The Manager LLC of a real estate syndication is therefore a covered person. |
| <b>Executive Officers and Officers</b>  | The CEO, CFO, COO, President, Vice Presidents in charge of a principal                                                                                                                                              | Title does not control; function does. An "Investor Relations                                                                  |



| Category                                                                    | Who It Covers                                                                                                                                                                                                                                                                                                                                                           | Practical Note                                                                                                                                                               |
|-----------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Participating in the Offering</b>                                        | business unit, Secretary, Treasurer, and any other person performing a policy-making function. Plus any other officer who actively participates in the offering.                                                                                                                                                                                                        | Manager” who participates in the offering is a covered person.                                                                                                               |
| <b>20% Beneficial Owners</b>                                                | Any person who directly or indirectly owns 20% or more of the issuer's outstanding voting equity, calculated on the basis of voting power per Exchange Act Rule 13d-3.                                                                                                                                                                                                  | Look-through to controlling persons is required for entity beneficial owners. Voting agreements that create a group must be aggregated.                                      |
| <b>Promoters</b>                                                            | Any person who acts as a “promoter” as defined in Rule 405 of the Securities Act: a person who takes initiative in founding the issuer's business or who receives 10% or more of any class of issuer securities or 10% or more of sale proceeds.                                                                                                                        | A person who conceptualized the deal and assembled the team may qualify as a promoter even without a formal title.                                                           |
| <b>Investment Manager and Its Principals (pooled investment funds only)</b> | For an issuer that is a pooled investment fund, the fund's investment manager and that manager's directors, general partners, managing members, executive officers, and officers participating in the offering. Plus the directors, executive officers, and officers participating in the offering of any general partner or managing member of the investment manager. | Relevant to every blind pool real estate fund. The investment manager (typically the Manager LLC or a separately formed advisory entity) and its principals must be cleared. |
| <b>Compensated Solicitors</b>                                               | Any person paid (directly or indirectly) to solicit investors, plus their directors, general partners, managing members, executive officers, and officers participating in the offering.                                                                                                                                                                                | Captures placement agents, finders receiving transaction-based compensation, and any other intermediary paid to bring investors to the deal.                                 |

### **1 A. The 20% Beneficial Owner Calculation: Looking Through Entities**

The 20% beneficial ownership test requires more than reviewing the ownership records at the issuer level. Rule 506(d) incorporates the definition of beneficial ownership from Exchange Act Rule 13d-3, which means that indirect ownership through intermediate entities must be traced to the natural persons (or entities) that ultimately exercise voting power or investment power over the securities. The SEC's Compliance and Disclosure Interpretations confirm that this requires a look-through analysis for entity beneficial owners.

In practice, if a Delaware LLC that owns 25% of the issuer's voting interests is itself controlled by two principals who each hold 50% of that LLC's voting interests, each of those principals is an indirect 12.5% beneficial owner of the issuer (25% multiplied by 50% equals 12.5%), below the 20% threshold in this example. But if the LLC owns 60% of the issuer and one principal holds a majority of the LLC's voting interests, that principal's indirect ownership of the issuer may cross the 20% threshold and make them a covered person.

The SEC has also addressed voting agreements. If shareholders enter a voting agreement under which each agrees to vote shares in favor of director candidates designated by one or more of the other parties, the parties may form a group, and the group's combined holdings are aggregated for the 20% test. Parties that have or share voting power over other parties' shares beneficially own those shares.

The analysis is done at the time of the sale, not the time of the offering's launch. If a beneficial owner's stake changes during the offering (for example, an investor who receives equity as part of a deal structure acquires a stake that crosses the 20% threshold), the covered persons list must be updated and the bad actor check re-run for the newly identified person.

### **1 B. The Placement Agent and Finder Problem**

The compensated solicitor category is the one most likely to expand the covered persons list in unexpected ways. Any person paid to solicit investors, whether they are a licensed broker-dealer, an exempt finder under a claimed exemption from broker-dealer registration, a co-sponsor who receives transaction-based compensation, or an informal contact who gets a referral fee, is a compensated solicitor. Any person who is a compensated solicitor brings with them their own covered persons: their directors, general partners, managing members, executive officers, and officers who participate in the offering.

A sponsor who engages a placement agent to raise capital for a fund has, in effect, acquired a set of covered persons they have never met. The placement agent's own key personnel, executives, and officers who participate in the offering are covered persons of the issuer for bad actor purposes. The issuer must conduct its bad actor check on those persons as well, or must rely on representations from the placement agent that its own covered persons are clean, representations that must be documented and that the issuer has a responsibility to follow up on.

### **Paying an Unregistered Finder Creates Two Problems, Not One**

*Sponsors who pay unregistered finders for introducing investors face a two-part compliance exposure that the bad actor rules add to an already significant problem.*

*First, paying transaction-based compensation to an unregistered finder is broker-dealer activity that violates Section 15(a) of the Securities Exchange Act. Any sale made through an unregistered finder gives investors rescission rights and exposes both the finder and the issuer to enforcement.*

*Second, the unregistered finder and their covered control persons are compensated solicitors, covered persons under Rule 506(d). If the finder has a disqualifying event in their background, the entire offering is disqualified from Rule 506, compounding the Section 15(a) violation with a securities registration violation.*

*The bad actor check for compensated solicitors is therefore not just a compliance formality. It is the check that may reveal the second layer of exposure from a relationship that was already problematic.*

## **PART TWO**

### **What Are Disqualifying Events?**

*Eight categories of triggering events, each with its own lookback period.*

Rule 506(d) lists eight categories of disqualifying events. Each category has its own lookback period, and some have different lookback periods depending on whether the covered person involved is the issuer itself or another covered person. The rule is precise about what counts. Only events in these specific categories trigger disqualification. A civil judgment in a business dispute that has nothing to do with securities, false filings, or financial fraud is not a disqualifying event. A prior conviction for tax evasion may or may not qualify depending on the specific facts. The categories below follow the SEC's own enumeration in its small entity compliance guide.

**EVENT 1 Criminal Convictions**

**Lookback period:** 5 years (issuer, predecessors, affiliated issuers) or 10 years (all other covered persons), measured from the date of the conviction to the date of sale.

Any conviction for any felony or misdemeanor in connection with the purchase or sale of any security, involving the making of any false filing with the SEC, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities.

**Practical effect.** A conviction for securities fraud, for misrepresenting information to investors, for operating an unregistered broker-dealer, or for filing false documents with the SEC triggers disqualification. The conviction does not need to be a felony. Misdemeanors in connection with securities transactions qualify. Note the different lookback periods: 5 years for the issuer entity, its predecessors, and affiliated issuers; 10 years for all other covered persons.

**EVENT 2 Court Injunctions or Restraining Orders**

**Lookback period:** 5 years from the date the order was entered, and the order must remain in effect at the time of sale.

Any order, judgment, or decree entered by a court that, at the time of the proposed sale, restrains or enjoins a covered person from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security, involving the making of a false filing with the SEC, or arising out of the conduct of the business of a securities professional.

**Practical effect.** Civil injunctions are commonly sought by the SEC and state securities regulators even when criminal charges are not pursued. A covered person who consented to an injunction without admitting wrongdoing can still trigger disqualification. An injunction that has expired or been lifted before the proposed offering is not disqualifying, even if it was issued within the 5-year window.

**EVENT 3 Final Orders of Certain State and Federal Regulators**

**Lookback period:** 10 years from issuance of the order (for orders based on fraudulent, manipulative, or deceptive conduct); ongoing for bars (for as long as the bar remains in effect).

Final orders issued by state securities regulators, state insurance regulators, state banking regulators, state savings association or credit union regulators, federal banking agencies (OCC, FDIC, Federal Reserve), the Commodity Futures Trading Commission, or

the National Credit Union Administration that either (a) bar the covered person from associating with an entity regulated by that authority, from engaging in the business of securities, insurance, or banking, or from engaging in savings association or credit union activities; or (b) are based on fraudulent, manipulative, or deceptive conduct and were issued within 10 years of the proposed sale.

**Practical effect.** *A bar from the securities industry imposed by a state, a banking regulator's order based on fraud, or a CFTC order for manipulative conduct all trigger disqualification. Many sponsors focus on SEC orders and overlook state agency orders. A former mortgage broker barred by a state banking regulator for deceptive lending, or a former insurance agent barred by a state insurance department for fraud, can disqualify a Rule 506 offering.*

#### **EVENT 4   SEC Disciplinary Orders**

**Lookback period:** *Ongoing for as long as the order remains in effect.*

Final orders of the SEC under Section 15(b) or 15B(c) of the Securities Exchange Act or Section 203(e) or (f) of the Investment Advisers Act that (a) suspend or revoke a covered person's registration as a broker, dealer, municipal securities dealer, or investment adviser; (b) place limitations on the person's activities, functions, or operations; or (c) bar the person from being associated with any entity regulated by the SEC or from participating in the offering of any penny stock.

**Practical effect.** *Unlike criminal convictions and civil injunctions, which have finite lookback periods, an active SEC bar, suspension, or limitation disqualifies for as long as the order remains in effect. Once the bar is lifted or the suspension expires, the disqualification ends. Censures and orders to pay civil money penalties (assuming the penalties are paid) are not disqualifying.*

#### **EVENT 5   SEC Cease-and-Desist Orders**

**Lookback period:** *5 years before the proposed sale, and the order must remain in effect.*

SEC orders to cease and desist from violations or future violations of the scienter-based antifraud provisions of the federal securities laws (including Section 17(a)(1) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5, Section 15(c)(1) of the Securities Exchange Act, and Section 206(1) of the Investment Advisers Act), or of Section 5 of the Securities Act.

**Practical effect.** Only cease-and-desist orders based on knowing or reckless violations (scienter-based) qualify, plus orders for Section 5 violations (unregistered securities offerings). A cease-and-desist order for an ordinary negligence-based violation is not within this category.

## **EVENT 6 SEC Stop Orders and Orders Suspending the Regulation A Exemption**

**Lookback period:** 5 years before the proposed sale, including pending proceedings.

The offering is disqualified if any covered person filed a registration statement or Regulation A offering statement that was the subject of a SEC refusal order, stop order, or order suspending the Regulation A exemption within the last 5 years, or is the subject of a pending proceeding to determine whether such an order should be issued. The same disqualification applies if the covered person was named as an underwriter in such a registration statement or offering statement.

**Practical effect.** Relevant to any sponsor who has previously attempted a registered offering or a Regulation A offering. A prior Reg A offering that was suspended within the past 5 years, even one for which the issuer was an underwriter rather than the issuer of record, disqualifies a Rule 506 offering.

## **EVENT 7 Suspension or Expulsion from a Self-Regulatory Organization (FINRA, NYSE, etc.)**

**Lookback period:** Ongoing, as long as the suspension or expulsion remains in effect.

Suspension or expulsion from membership in, or suspension or bar from association with a member of, a registered national securities exchange, registered national securities association (primarily FINRA), or other self-regulatory organization, for any act or omission constituting conduct inconsistent with just and equitable principles of trade.

**Practical effect.** Placement agents operate through FINRA-registered broker-dealers. Their registered representatives are subject to FINRA disciplinary authority. Checking FINRA BrokerCheck for every registered representative of a placement agent who participates in the offering is a non-optional step in the bad actor diligence process.

**EVENT 8 U.S. Postal Service False Representation Orders**

**Lookback period:** 5 years from the date the order was issued.

Any false representation order issued by the U.S. Postal Service against a covered person, or any temporary restraining order or preliminary injunction with respect to conduct alleged to violate the federal false representation statute applicable to use of the mails.

**Practical effect.** *The least commonly encountered of the eight categories. It is included in the questionnaire and background check for completeness, but it rarely affects the outcome of a typical bad actor review.*

**2 A . Lookback Period Quick Reference**

The table below summarizes every disqualifying event category with its applicable lookback period. All lookback periods are measured from the date of the disqualifying event to the date of sale, not to the date the offering was launched.

| Type of Disqualifying Event                                                                                                                                            | Covered Persons Subject to It                                                                                            | Lookback Period                         |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------|-----------------------------------------|
| <b>Criminal conviction in connection with securities, false SEC filings, or securities-business conduct</b>                                                            | Issuer, predecessors, affiliated issuers                                                                                 | 5 years                                 |
| <b>Criminal conviction in same categories</b>                                                                                                                          | All other covered persons (officers, directors, GPs, 20% owners, promoters, investment managers, compensated solicitors) | 10 years                                |
| <b>Court injunction or restraining order in same categories</b>                                                                                                        | All covered persons                                                                                                      | 5 years (order must still be in effect) |
| <b>Final order of state or federal regulator (securities, insurance, banking, savings, credit union, CFTC) based on fraudulent, manipulative, or deceptive conduct</b> | All covered persons                                                                                                      | 10 years from issuance                  |
| <b>Final order of same regulators imposing a bar</b>                                                                                                                   | All covered persons                                                                                                      | Ongoing while bar is in effect          |

| Type of Disqualifying Event                                                                                    | Covered Persons Subject to It | Lookback Period                                    |
|----------------------------------------------------------------------------------------------------------------|-------------------------------|----------------------------------------------------|
| <b>SEC disciplinary order (Section 15(b), 15B(c), 203(e), 203(f)): suspension, revocation, limitation, bar</b> | All covered persons           | Ongoing while order is in effect                   |
| <b>SEC cease-and-desist order (scienter-based antifraud or Section 5)</b>                                      | All covered persons           | 5 years (order must still be in effect)            |
| <b>SEC stop order or order suspending Regulation A exemption (including pending proceedings)</b>               | All covered persons           | 5 years                                            |
| <b>FINRA or other SRO suspension or expulsion</b>                                                              | All covered persons           | Ongoing while suspension or expulsion is in effect |
| <b>U.S. Postal Service false representation order</b>                                                          | All covered persons           | 5 years                                            |

### How Lookback Periods Are Measured

*The lookback period runs backward from the date of each individual sale to an investor, not from the offering launch date. This has a practical consequence for long-running offerings.*

*Example: an offering launches on January 1, 2025. A covered person had a criminal conviction on February 15, 2016. The applicable lookback period for that covered person is 10 years. On January 1, 2025, the conviction is 8 years and 10 months old, within the 10-year window. The covered person disqualifies the offering.*

*If the offering continues and a new investor signs a subscription agreement on March 1, 2026, more than 10 years after the February 2016 conviction, the lookback has expired for that specific sale. The offering is no longer disqualified for sales made after February 15, 2026.*

*Lookback periods that expire during the course of a long-running offering require attention. Securities counsel should track the expiration dates for any near-miss situations identified in the initial bad actor review.*



**PART THREE****Events Before September 23, 2013***Mandatory disclosure instead of disqualification.*

The bad actor disqualification rules apply only to triggering events that occurred on or after September 23, 2013, when Rule 506(d) became effective. An event that occurred before that date does not disqualify the offering. It is not, however, simply ignored.

Under Rule 506(e), if a covered person had an event before September 23, 2013, that would have triggered disqualification if it had occurred after that date, the issuer is required to disclose that event in writing to every investor in the offering. The disclosure must be made a reasonable time before any sale to that investor. Failure to provide the required disclosure is itself a violation that can render the Rule 506 exemption unavailable. The practical effect of a pre-2013 event is not meaningless. It creates a mandatory investor disclosure obligation that must be met for every investor.

**The Rule 506(e) Disclosure Obligation: What the Disclosure Must Cover**

*When required. Whenever a covered person's background includes an event that would have been disqualifying if it occurred after September 23, 2013, and that event falls within the applicable lookback period. Events outside the lookback period do not require disclosure. If a criminal conviction of a covered person is 12 years old and the lookback period is 10 years, no disclosure is required.*

*What to disclose. The issuer must provide a written description of the nature and circumstances of the event, including: who was involved (the specific covered person), what the event was (the conviction, order, injunction, or bar), when it occurred, and what regulatory body or court issued it.*

*When to deliver. A reasonable time before the sale. The SEC has not specified a fixed number of days. The disclosure should be made early enough that an investor can evaluate it before committing capital, as part of the offering documents, not at the subscription closing.*

*Best practice. Include the disclosure as a stand-alone section of the PPM, not as a brief footnote. Investors who receive a clearly labeled disclosure section are in a better position than investors who receive a disclosure buried in dense risk-factor language.*

*To whom. The disclosure must be provided to all investors in the offering, not just investors who were introduced by the placement agent associated with the event. This*

*applies in particular to placement-agent-related events, which require disclosure to every investor in the offering regardless of who introduced them.*

## PART FOUR

### When Disqualification Can Be Avoided

*Three routes by which an issuer may avoid or cure a disqualification.*

Three routes exist by which an issuer can avoid or address a disqualification that would otherwise apply. They are not equally available in all situations and none is a guaranteed solution, but each is a legitimate path worth understanding before concluding that a disqualifying event ends the offering.

#### Exception 1: The Reasonable Care-exception

Rule 506(d)(2) provides that an issuer is not disqualified if it can establish that it did not know, and in the exercise of reasonable care could not have known, that a disqualification existed. This exception is narrow and fact-specific. The SEC has made clear that an issuer cannot simply say it did not know. It must affirmatively demonstrate that it conducted a reasonable factual inquiry and that the inquiry was conducted in a manner appropriate to the circumstances of the offering.

What counts as reasonable care depends on context. For a small offering with a handful of known investors and a sponsor team that has worked together for years, a simpler inquiry may be sufficient. For a large offering involving a placement agent the sponsor has not previously worked with, a more thorough investigation is required. In every case, the issuer cannot establish reasonable care unless it conducted an actual factual investigation. Relying on verbal assurances or self-certification alone is not sufficient.

The SEC has clarified that the reasonable care-exception is available even when the issuer discovers, after making a reasonable inquiry, that its initial identification of covered persons was incorrect. If the issuer later learns that someone it reasonably believed was not a covered person is actually a covered person, the exception may still apply, but only if the initial analysis was genuinely reasonable given the information available at the time.

#### Exception 2: SEC Waiver for Good Cause

The SEC has authority to grant waivers from Rule 506(d) disqualification upon a showing of good cause. Waivers are handled by the SEC's Division of Corporation Finance, Office of Small

Business Policy, which can be reached at (202) 551-3460 for preliminary discussions before a formal waiver application is submitted.

The SEC does not grant waivers routinely, but it does grant them in appropriate circumstances. Factors the SEC considers include the nature and seriousness of the disqualifying event; the issuer's level of responsibility for the conduct that produced it; whether the persons responsible for the conduct are still in the organization; how much time has passed since the event; what remedial steps the issuer or the covered person have taken; and whether denying the waiver would be unduly harmful given the circumstances.

A waiver application should be prepared with the assistance of securities counsel. The application presents the specific facts, explains why the disqualification should not apply under the circumstances, and addresses each of the SEC's stated evaluation factors. The SEC staff is willing to discuss waiver requests before formal submission. That preliminary conversation often clarifies whether a waiver request is worth pursuing and what information would be most relevant to include.

### **Exception 3: Waiver by the Issuing Authority**

If the disqualification arises from a court order, judgment, or decree, the court or regulatory authority that entered the order can itself determine that Rule 506 disqualification should not arise as a consequence. The issuer can approach the court or authority and request that it advise in writing (whether in the order itself or separately to the SEC or its staff) that disqualification under Rule 506 should not arise. This path is narrow and depends entirely on the court or authority's willingness to provide such advice, but it is available as an alternative to the SEC waiver process.

### **Curing a Mid-Offering Disqualification**

When a disqualifying event arises during an active offering (a placement agent's registered representative is barred by FINRA, an executive officer is charged with securities fraud, a 20% beneficial owner becomes subject to a court injunction), the issuer can continue to rely on Rule 506 going forward if it takes specific curative action.

For a disqualification involving a placement agent, the issuer must terminate its engagement with the placement agent and ensure the placement agent receives no compensation for any sales made after the disqualifying event. If only one specific individual at the placement agent firm is a covered person with a disqualifying event, it may be sufficient to remove that individual from any participation in the offering (by termination or role modification) without terminating the engagement with the firm.

For a disqualification involving an internal covered person (an officer, director, GP, or manager), the curative step is more difficult. If the disqualifying person is a member of the issuer's own team, removing them from participation in the offering requires actual organizational restructuring (changing roles, removing signing authority, rewriting governance documents), not simply a paper reassignment that leaves their practical control unchanged. The SEC will look at the reality of who controls the offering, not just the organizational chart.

## PART FIVE

### How to Conduct a Bad Actor Check

*A five-step process for satisfying the reasonable care standard.*

The bad actor check is a mandatory pre-offering compliance task. Its adequacy is measured by whether the issuer conducted a genuine factual inquiry appropriate to the circumstances. A questionnaire alone is not enough. Public records must also be searched. The combination of a detailed questionnaire and targeted public records searches is the standard the SEC's guidance describes as adequate reasonable care for most private real estate offerings.

#### Step 1: Build the Covered Persons List

- Identify every entity and individual in each of the covered person categories described in Part One.
- For each entity identified, trace through to identify the natural persons (or entities) that control it.
- Confirm beneficial ownership calculations: who holds 20% or more of voting power in the issuer, directly or indirectly?
- For pooled investment fund issuers, identify the investment manager and its principals.
- Identify all compensated solicitors (any person receiving transaction-based compensation) and list their covered control persons.
- Document the covered persons list in writing before beginning the background check.

This list should be maintained as a living document throughout the offering. When new covered persons are added (a new executive officer, a new placement agent, a new 20% investor who receives equity, a new investment manager engagement), the list must be updated and the bad actor check run for the new persons.

#### Step 2: Administer the Questionnaire

Every covered person must complete and sign a written bad actor questionnaire. The questionnaire asks each person to disclose, under oath, whether they have been subject to any of the disqualifying events described in Rule 506(d). The questionnaire should cover all eight event categories, include a reasonable lookback period (at minimum 10 years, the longest fixed lookback in the rule, with ongoing disqualifications running indefinitely), ask about events in both the securities industry and in other regulated industries (banking, insurance, CFTC), and require disclosure of any pending proceedings that might ripen into a disqualifying event.

The questionnaire serves two purposes. It gives the covered person an opportunity to disclose events that may not appear in public records (because court records are sometimes incomplete or because state regulatory databases do not always cross-reference each other), and it creates a documented record of the inquiry that supports the issuer's reasonable care defense if a problem is discovered later.

Self-certification is not sufficient by itself. The questionnaire is a starting point, not a conclusion. If any covered person discloses an event in the questionnaire, or if the public records search reveals an event the covered person did not disclose, securities counsel must analyze whether the event is disqualifying and what steps are required.

### Step 3: Search Public Records

After collecting completed questionnaires, the issuer must independently search public records to verify the questionnaire responses and to catch anything that was not disclosed. The minimum scope of public records search for a typical private real estate offering includes the following.

- FINRA BrokerCheck ([brokercheck.finra.org](http://brokercheck.finra.org)). Covers broker-dealers and their registered representatives. Searches their registration status, employment history, and disciplinary history. Required for any covered person who is currently or previously registered with FINRA, and for any placement agent's personnel.
- SEC EDGAR ([sec.gov/edgar](http://sec.gov/edgar)). Searches for administrative proceedings, cease-and-desist orders, and litigation releases involving the covered person. Covers SEC enforcement actions going back decades.
- PACER ([pacer.gov](http://pacer.gov)). The federal court's public access system for court filings. Searches for federal criminal and civil cases involving the covered person, including injunctions, consent orders, and fraud-related civil judgments.
- State court records. Many states have online criminal record databases. Searching for criminal convictions in states where the covered person has lived and worked is appropriate for most offerings.

- State securities regulator databases. NASAA's contact information page links to each state securities regulator. Several states maintain searchable enforcement action databases that cover state-level orders and bars.
- OFAC sanctions lists. The U.S. Treasury's Office of Foreign Assets Control maintains a Specially Designated Nationals and Blocked Persons List. Searching this list confirms there are no sanctions-related issues that would affect the offering or its participants.

#### Step 4: Analyze What You Find

For any event identified through the questionnaire or the public records search, securities counsel must analyze whether it falls within one of the eight categories of disqualifying events and within the applicable lookback period. The analysis is not always straightforward. Some events fall in a gray zone where the category definition is ambiguous, or where the lookback calculation depends on facts that must be confirmed. Counsel's judgment, informed by the specific language of Rule 506(d) and the SEC's published guidance and C and DIs, is required for any non-obvious situation.

Three possible outcomes from the analysis: (1) the event is disqualifying within the lookback period, in which case disqualification applies; (2) the event is outside the lookback period, in which case no disqualification applies but Rule 506(e) disclosure may be required; or (3) the event does not fall within any of the eight categories, in which case no disqualification and no disclosure obligation applies. Only counsel can reliably distinguish among these three outcomes for a specific event.

#### Step 5: Document Everything

The reasonable care defense requires a documented record. Before the offering launches, the compliance file should contain: (1) the covered persons list and the basis for including each person; (2) signed and dated questionnaire responses from every covered person; (3) records of the public database searches performed (including screen captures or search result summaries); (4) counsel's analysis of any events identified; and (5) any disclosures prepared under Rule 506(e) and delivered to investors.

For ongoing offerings (funds with rolling closings, continuous offerings) the bad actor check should be refreshed periodically. The SEC's guidance contemplates periodic bring-down representations, updated questionnaires, and re-checking of public databases on a scheduled basis throughout the offering period. How often depends on the offering's complexity, duration, and the number of covered persons involved. Annual refreshes are a minimum; more frequent refreshes are appropriate for long-running offerings.

**PART SIX****Sample Bad Actor Questionnaire**

*A starting point for the document every covered person must complete.*

The questionnaire below is a starting point for drafting the bad actor questionnaire that must be completed by every covered person before the offering begins. This sample is educational in nature and should be adapted by securities counsel for the specific circumstances of each offering. It is not legal advice and does not create an attorney-client relationship.

**Bad Actor Questionnaire (Sample)**

*Instructions. This questionnaire is being completed in connection with a proposed offering of securities under Rule 506 of Regulation D. All questions must be answered completely and truthfully. If your answer to any question is Yes, please provide a complete explanation in the space provided or in an attachment. All responses should cover the period from [LOOKBACK START DATE] to the present, unless a specific question states a different time frame.*

Your full legal name: \_\_\_\_\_

Your role in the offering: \_\_\_\_\_

Date completed: \_\_\_\_\_

**Section 1: Criminal Convictions**

- 1.1** Have you ever been convicted of any felony or misdemeanor in connection with the purchase or sale of any security? Yes ☐ No ☐
- 1.2** Have you ever been convicted of any felony or misdemeanor involving the making of any false filing with the SEC? Yes ☐ No ☐
- 1.3** Have you ever been convicted of any felony or misdemeanor arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities? Yes ☐ No ☐

**Section 2: Court Orders and Injunctions**

- 2.1** Are you currently subject to, or have you been subject to within the last 5 years, any court order, judgment, or decree that restrains or enjoins you from engaging in any conduct or practice in connection with the purchase or sale of any security? Yes ☐ No ☐

- 2.2** Are you currently subject to, or have you been subject to within the last 5 years, any court order, judgment, or decree that restrains or enjoins you from engaging in any conduct or practice involving the making of a false filing with the SEC or arising out of the conduct of the business of a securities professional? Yes ☐ No ☐

### Section 3: SEC Disciplinary and Cease-and-Desist Orders

- 3.1** Has the SEC ever issued an order against you that suspended or revoked your registration as a broker, dealer, investment adviser, transfer agent, or municipal securities dealer, or that limited your activities, functions, or operations? Yes ☐ No ☐
- 3.2** Has the SEC ever entered an order against you barring you from association with any SEC-regulated entity or from participating in the offering of any penny stock? Yes ☐ No ☐
- 3.3** Within the last 5 years, has the SEC issued a cease-and-desist order against you based on a violation of any scienter-based antifraud provision of the federal securities laws, or based on a violation of Section 5 of the Securities Act? Yes ☐ No ☐

### Section 4: SEC Stop Orders and Reg A Suspensions

- 4.1** Within the last 5 years, were you the issuer of, or named as an underwriter in, a registration statement or Regulation A offering statement that was the subject of an SEC refusal order, stop order, or order suspending the Regulation A exemption? Yes ☐ No ☐
- 4.2** Are you currently the subject of any pending proceeding that could result in any of the orders described in question 4.1? Yes ☐ No ☐

### Section 5: State and Federal Regulatory Orders

- 5.1** Are you currently subject to any final order issued by any state securities regulator, state insurance regulator, state banking regulator, state savings association or credit union regulator, federal banking agency, the CFTC, or the National Credit Union Administration that bars you from associating with an entity regulated by that authority, from engaging in the business of securities, insurance, or banking, or from engaging in savings association or credit union activities? Yes ☐ No ☐
- 5.2** Within the last 10 years, have you been the subject of any final order issued by any of the regulators identified in question 5.1 that was based on fraudulent, manipulative, or deceptive conduct? Yes ☐ No ☐

### Section 6: FINRA and SRO Disciplinary Actions

- 6.1** Have you ever been expelled or suspended from membership in, or suspended or barred from association with a member of, FINRA, the NYSE, or any other national securities exchange or registered national securities association? Yes ☐ No ☐

### Section 7: U.S. Postal Service Orders



- 7.1** Within the last 5 years, have you been subject to any false representation order, temporary restraining order, or preliminary injunction issued by the U.S. Postal Service in connection with conduct alleged to violate the false representation statute that applies to U.S. mail? Yes ☐ No ☐

## Section 8: Pending Proceedings

- 8.1** Are you currently the subject of any pending criminal investigation, regulatory investigation, or proceeding that could result in any of the events described in Sections 1 through 7 above? Yes ☐ No ☐

## Section 9: Certification

*I certify that all information provided in this questionnaire is true, complete, and accurate to the best of my knowledge. I agree to promptly notify the issuer in writing if any of my answers change or if any new events occur that would require a different answer to any of these questions.*

Signature: \_\_\_\_\_ Date: \_\_\_\_\_

Printed name: \_\_\_\_\_

## PART SEVEN

### Pre-Offering Bad Actor Compliance Checklist

*Minimum steps required before the first investor is approached.*

The checklist below summarizes the minimum steps required to satisfy the bad actor compliance obligation before each Regulation D Rule 506 offering. Each step should be completed and documented before the first investor is approached.

- ☐ **1.** Identify all covered persons using the categories in Part One of this appendix.
- ☐ **2.** Trace beneficial ownership: confirm who holds 20% or more of voting equity, directly or indirectly, applying the Rule 13d-3 look-through analysis.
- ☐ **3.** For pooled investment fund issuers, identify the investment manager and its principals.
- ☐ **4.** Identify all compensated solicitors (placement agents, finders) and list their covered control persons.

- ☐ **5.** Document the covered persons list in writing with the basis for each person's inclusion.
- ☐ **6.** Distribute signed bad actor questionnaires to every covered person, with a lookback period covering at least 10 years.
- ☐ **7.** Collect completed, signed, dated questionnaires from every covered person before the offering begins.
- ☐ **8.** Search FINRA BrokerCheck for all covered persons currently or previously registered with FINRA.
- ☐ **9.** Search SEC EDGAR for administrative proceedings and litigation releases involving each covered person.
- ☐ **10.** Search PACER (federal court records) for criminal and civil proceedings involving each covered person.
- ☐ **11.** Search relevant state court and state securities regulator databases for each covered person.
- ☐ **12.** Search OFAC sanctions lists for each covered person.
- ☐ **13.** Have securities counsel analyze any events identified in the questionnaires or searches.
- ☐ **14.** If any pre-September 23, 2013 events require Rule 506(e) disclosure, prepare the disclosure and include it in the PPM.
- ☐ **15.** Document the entire process: covered persons list, questionnaires, search records, counsel analysis, and any disclosures.
- ☐ **16.** For ongoing offerings, calendar periodic bring-down dates to refresh the questionnaires and re-run public searches.

## Why the Work Product Matters as Much as the Outcome

The bad actor compliance process is one of the few securities law obligations where the work product, the documented process itself, is as important as the outcome. An issuer who finds a disqualifying event through careful diligence and addresses it properly is in a defensible position. An issuer who conducts no meaningful inquiry and is later confronted with a disqualifying event it should have found has no reasonable care defense, no argument for good faith, and exposure to the full range of securities law remedies for every investor in the offering.

Real estate sponsors who run a single deal at a time tend to treat the bad actor process as a one-time obligation. Sponsors who run multiple offerings, or who run a fund with rolling closings, learn quickly that the process must be embedded into the offering workflow as a recurring task, not a one-time event. New principals join the team. New placement agents are engaged.

Investors who started below 20% acquire additional equity and cross the threshold. Each change resets the inquiry obligation for the new covered person.

The sponsor who treats bad actor compliance as a serious legal task, with a documented questionnaire process, independent public records searches, and counsel analysis of any non-obvious events, will rarely face an enforcement problem. The sponsor who treats it as a paperwork formality is exposed in a way that no other Regulation D defect quite matches, because a bad actor disqualification eliminates the exemption entirely. There is no partial cure. The offering either qualifies under Rule 506 or it does not.

### **A Note from Counsel**

*Bad actor compliance is a discrete area where engaging counsel pays for itself in avoided exemption-loss exposure many times over. The work we do for clients on these provisions typically falls into four categories: (1) sponsors preparing for a first offering who need a complete covered persons analysis, questionnaire process, and public records search protocol; (2) sponsors expanding from single-deal syndications to a fund model who need to add the investment manager category and the pooled investment fund covered persons to their compliance program; (3) sponsors engaging a placement agent or other compensated solicitor for the first time who need to extend the bad actor diligence to the agent and the agent's covered control persons; and (4) sponsors who have just discovered, mid-offering or post-closing, that a covered person has a potential disqualifying event in their background and need a rapid assessment of the disqualification, reasonable care, and waiver alternatives.*

*If any of those scenarios describes your situation, we would be glad to talk. You can reach us through [crowdfundlawyer.com](http://crowdfundlawyer.com).*

