



ELEMENTS OF A PRIVATE PLACEMENT MEMORANDUM INVOLVING REAL ESTATE

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OVERVIEW



A Private Placement Memorandum (PPM) is a securities disclosure document used by a company (issuer) that is engaged in a private offering of securities. A PPM serves as a single, comprehensive document outlining the material details about the offering. The purpose of the PPM is to provide necessary disclosures about the risks, strategies, management team, investment criteria and other information about the issuer's securities to protect itself and the issuer's principals against claims of misrepresentation or omission. The PPM will disclose to prospective investors needed information about the issuer and its securities, allowing a prospective investor to make an informed decision regarding the purchase of the issuer's securities.

Great care should be taken when crafting a PPM so all of the vital and material information about the issuer and the securities being issued is included. This white paper analyzes sections of a standard, well-drafted PPM for a real estate securities offering, some of which are more important than others.

INTRODUCTION

The introduction provides an overview of the issuer and the offering, allowing investors to review the basics of the offering. Usually, the following information is included in this introduction section.

- A description of the issuer, manager and sponsor as well as a brief statement regarding the issuer's business. For example, "acquisition of a 200 unit Class A apartment complex in Bend, Oregon." This brief description should contain a brief statement about which entities are performing which duties.
- A statement regarding the specific securities exemption used by the issuer (e.g., 506(b) or 506(c)).
- A description of the specific security being offered (e.g., a debt security or equity security) and the basic economic details of the securities being offered. This allows an investor to whether the offering suits the investor's investment objectives.
- The minimum and maximum offering amount. The contingency of a minimum offering amount is designed to protect all parties.
- The price per interest or unit.
- The number of membership or limited partnership interests or units being sold.
- The minimum individual investment amount. The PPM should also reserve the right for the issuer to accept an amount less than the minimum investment. Without this reservation, the issuer is unable to waive the minimum and would have to amend the PPM to lower the minimum.
- The offering termination date. This is usually one year from the initial offering or the date that corresponds to successful raising of the maximum offering amount.
- If the issuer is (i) using an escrow agent to hold investor funds until the minimum amount is sold; (ii) holding funds in a segregated account until the minimum offering amount is reached; or (iii) allowing funds to remain in the investor's bank account until the minimum amount is reached.
- If the issuer is using a broker-dealer or placement agent to sell the securities.

DISCLAIMER / INVESTOR NOTICES

A PPM should include important notices for prospective investors. Common investor notices in most PPMs include:

- No registration; reliance on exemptions from registration.
- No public market.
- High degree of risk.
- Restrictions on transfer of the securities.
- No authorization to make representations outside the offering materials.
- Descriptions and summaries of documents in the PPM that are qualified by the actual documents.
- No legal, business or tax advice.
- Opportunity for the investor to ask questions and receive information.

INVESTOR SUITABILITY

The investor suitability section of the PPM outlines the type of investor that may purchase securities from the issuer. In most cases, this will only be “accredited investors.” In many cases this section will include a list of those investors that fall within the definition of accredited investors.

If the issuer is conducting a 506(c) offering, this section will also include information regarding the process or manner in which the issuer will verify that all investors are accredited investors.

STATEMENTS REGARDING FORWARD LOOKING INFORMATION

PPMs often include forward looking information, such as events or results, regarding the issuer’s business. A statement regarding forward looking information is a cautionary statement identifying important factors that could cause actual results to differ materially from those set forth in the PPM.

EXECUTIVE SUMMARY / BUSINESS PLAN

This is the most marketing-oriented section of the PPM, and it is basically a business plan. Investors invest based on the likelihood of success of a business plan. In a blind pool investment fund where the managers have complete discretion as to how to invest the funds, the business plan section may be simple. If the business plan involves target assets, the business plan may be more complex and include a detailed market analysis. Any plan presented to

prospective investors should detail target investments and important operational considerations. Prospective investors are also keenly interested in knowing the anticipated hold period for the investments.

SUMMARY OF TERMS

This section is a high-level overview of the nuts and bolts of the offering. This usually looks like a term sheet and should include high-level details of all the important aspects of the offering that are described in greater detail elsewhere in the PPM. This section often repeats much of the information that is provided in the introduction and overview section.

PLAN OF DISTRIBUTION

This section discusses how and who will sell the offering to prospective investors. If an issuer is using a broker-dealer or placement agent to sell the offering, it will be disclosed in this section along with any compensation the broker-dealer is receiving.

ESTIMATED USE OF PROCEEDS

This section includes a table that shows where funds are coming from and how the issuer will use those funds. The use-of-proceeds table is valuable for investors contemplating an investment because the table paints a picture of how investor capital will be used. For instance, the table indicates what portion or percentage of those funds will be applied to the purchase of land and the construction of improvements versus the amount of money to be spent on management fees and reimbursements/payments for other expenses to the manager or sponsor

Sources of funding for a commercial real estate project can come from:

- A commercial loan;
- Sponsor contributions; and
- Investor funds from the offering.

Uses can include:

- The purchase price (or down payment if using a loan) on the property;
- Pre-closing expenses;
- Loan fees;
- Closing costs, such as title, escrow, transfer taxes and fees;
- Capital improvements or construction costs;

- Working capital and reserves;
- Loan payments;
- Management fees and reimbursable expenses;
- Taxes; and
- Insurance.

MANAGEMENT

Like the executive summary section, prospective investors pay close attention to the qualifications, experience and track record of the manager's management team. An issuer may have an excellent business plan, but if the management team cannot execute it, the issuer will have trouble raising the capital. For each member of the management team, the issuer should provide a brief biography describing the member's relevant education and career experience, specifically highlighting the expertise that each member has in relation to the offering's business plan.

MANAGEMENT COMPENSATION

This section discloses the compensation payable by the issuer to the issuer's manager.¹ One of the most critical components when determining what fees to charge, is to verify that the manager's interests are aligned with the investor's interests. Attracting investor capital remains a key concern in today's crowded and competitive market, and it is vital for managers to take note of investors' concerns regarding fund terms, especially the management fees charged. A manager should try to achieve the best possible value for the investor without compromising the success of the issuer.

LEGAL MATTERS

This section should disclose any past criminal convictions, material litigations, bankruptcies or other negative events related to the issuer and members of the management team. The best way to get this information is through the use of a due diligence questionnaire that each member of the management team completes, signs and returns to securities counsel drafting the PPM. Remember that it is critical to disclose anything that a prospective investor may consider material to the investor making a decision to invest. Thus, it is far safer to disclose these negative events than to raise funds, have something go wrong and be sued for material misrepresentation for failure to disclose.

¹ Please see the white paper titled: "Real Estate Syndication Fees: How do fund managers/sponsors make money" for a non-exhaustive list of typical fees charged by managers in real estate syndication/fund transactions.

CONFLICTS OF INTEREST

Most real estate issuers and members of the management team are going to have conflicts of interest, such as additional real estate funds and other real estate investments. Disclosing all potential conflicts of interest that members of the management team may have cannot be underestimated. The conservative approach dictates disclosure of all items that could even appear to a prospective investor to be a conflict of interest.

DESCRIPTION OF SECURITIES SOLD / SUMMARY OF OPERATING AGREEMENT / LIMITED PARTNERSHIP AGREEMENT

This section will highlight important considerations regarding the membership interests/units (if the issuer is an LLC) or limited partnership interests/units (if the issuer is a LP) being sold by the issuer. The section also draws investors' attention to critical items set forth in the operating agreement (if the issuer is an LLC) or limited partnership agreement (if the issuer is a LP). Some of the important things to disclose in this section include the following:

- Explanation of the distribution waterfall to demonstrate to prospective investors how money will be returned. This should include a description of the preferred return (if any), distributions of cash flow during operations and distribution on liquidation;
- Description of the voting rights held by investors, if any;
- Description of the reports the issuer will deliver to investors;
- Description of the investor's obligations with respect to mandatory or voluntary capital calls;
- Explanation of how the manager may be removed and/or replaced, if possible;
- Explanation of the transfer restrictions associated with an investor's ownership interest;
- Explanation of how the operating agreement (if the issuer is an LLC) or limited partnership agreement (if the issuer is a LP) may be amended and what amendments, if any, require investor approval;
- Explanation of the issuer's indemnification obligation to the manager; and
- Description of the power of attorney, if any, that investors are agreeing to by becoming a member of an LLC or a limited partner of a LP.

RISK FACTORS

This is the most important, and generally the largest, section of the PPM from a risk management perspective. Risk factors should be grouped into general categories. Some of the more common categories are:

- Risks related to the issuer and the specific securities being sold;
- General real estate risks;
- Specific real estate risk if the offering is a specified offering;
- Tax risks; and
- Management risks.

A major mistake in drafting the risk factor section is failing to include a detailed, customized set of risk factors and, instead, relying on generic, boilerplate risk factors found in a template. The SEC has indicated the need for specific, relevant risk factors.

INCOME TAX CONSIDERATIONS

The tax section of the PPM will detail the tax implications for an investor. Most PPMs will not detail the specific state tax requirements, so each investor would be required to speak with their local state and local tax accountant. For non-US investors, the tax implications will be important for profit and loss and each country will have its own rules.

ERISA CONSIDERATIONS

Most sponsors seek to avoid falling under the Plan Asset Regulations of the Employee Retirement Income Security Act of 1974 (ERISA) by ensuring that “benefit plan investors” hold, in the aggregate, less than 25% of the value of securities issued by the issuer. If this limit is exceeded, the issuer could be considered (subject to certain exemptions including the issuer operating as a real estate operating company) to hold “plan assets” and could be subject to a host of ERISA-related regulations, including certain fiduciary obligations. This section describes that the investment in the issuer may not be suitable for investors subject to ERISA and details the issuer’s desire to avoid being deemed an ERISA fiduciary.

ADDITIONAL INFORMATION

This section will provide all of the relevant contact information for the members of the management team so that prospective investors can reach out with questions concerning the PPM and the offering.

HOW TO SUBSCRIBE

This section should lay out the subscription process, including:

- The method, process and required documents necessary for an investor to subscribe;
- Acceptable ways to fund the subscription, such as whether only certain types of funding will be accepted, e.g., a wire or ACH; and
- The use of an escrow account (if applicable).

The PPM is one the most critical documents in a private placement of securities. The PPM is intended to fulfill the disclosure requirements of Rule 502(b)(2). A properly prepared PPM should contain fair and balanced disclosures regarding the issuer and the offering. The PPM should be prepared to fulfill the issuer's disclosure requirements while shielding the issuer and its management team from any future charges of violating the anti-fraud provisions of the federal securities laws. Issuers should engage experienced securities counsel to assist in the careful drafting of the PPM.

ABOUT THE AUTHOR

As a results-oriented dealmaker, Jason enjoys creating solutions that bring together great people, projects and capital.

When working on sophisticated business and financing transactions, Jason focuses on the big picture to ascertain his clients' strategic business direction and formulate risk mitigation strategies to protect corporate capital and profitability. His extensive experience includes advising businesses, lenders, investors, startups, and real estate investment companies and developers across the United States, on business transactions from formation to exit, acquisition, due diligence, real estate securities offerings, joint ventures, disposition and financing of real estate.

Passionate about real estate investing, Jason frequently speaks, writes and teaches on the topic, and is also a real estate investor himself. He has authored two books about private money lenders and is working on an eBook focusing on real estate syndication. Jason leads Foster Garvey's Real Estate Funds & Syndications Team.

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