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How do we raise money to buy distressed real estate?

Doug

How much? Where? Who are 'we'?

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My partner and I want to get 3 or 4 million dollars in cash from half a dozen friends, and friends of their friends, to buy deeply discounted homes and mortgages. How can we legally ask these people to invest in this idea? Do we need something in writing to give them?

Doug

Where do you want to do this?

A

Northern California, in outlying Bay Area communities—within an hour drive of the City if possible.

Doug

First, when you intend to ask others for their money to do something, it is a good idea to have at least a short form (say, two or three-page) business plan to show to them. Most entrepreneurs first reduce their good idea to writing and show it to some friends and colleagues—just to check out the “vision thing” and maybe the numbers.

Aside from the paper work, you have to deal with the grim fact that, in the United States, when you take other people's money in the hopes of making more money, for you and for them, whether it is to start a small company or to invest in some great real estate idea, you have to worry about whether you are creating securities. If you are, they must be registered or be exempt from registration. Please go to ----- for a full discussion of this topic.

Interestingly, your particular facts may permit you to avoid the entire securities hurdle.

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How so?

First, general partnership interests are not deemed to be securities. So if the members of your investment group all agree to be jointly and individually responsible for all liabilities incurred by the group, and also assume decision making responsibility, you are home free on the securities issue.

The same reasoning applies to a TIC (tenancy in common) arrangement **if** all the parties are involved in management. Most TICs are centrally managed and the TIC interests are considered securities as a result.

The practical answer to liability problems with smaller deals, in order to avoid securities issues, is to go ahead and assume the joint liability of a general partnership and then be sure to budget for (and pay for) a comprehensive insurance policy that covers everything you are doing jointly.

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What if we start a LLC, a limited liability company, maybe in Nevada? I can get a PO Box in Reno.

Doug

You don't need an address in Nevada to start an LLC. Whoever sets that up for you will provide you with an address for service of process. But there is little need to use Nevada to incorporate in your case, for reasons we do not have time to address here.

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So let's go back to what we have to do to ask people for money to join us in an angel investor group to buy distressed properties, and where the management is going to be my partner and me.

Doug

Well, ok, but first I want to mention another way to go about this that also avoids security problems—if you restrict the offering to CA residents—and that is to make them all members of a members-managed LLC. But they all will still have to be involved in management.

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No, we don't want to have the whole investor group acting as a committee to make decisions. My partner and I want to make all the important decisions if possible.

Doug

You will need to have what is called a private placement, which are exempt from registration, if you want to avoid a lot of time, trouble and expense.

Private placements do, however, involve restrictions on advertising and soliciting, and also there are financial requirements for the prospective investors.

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We would love to be able to advertise what we are doing if it would lead to getting investor money and it did not cost much. How about using Craigslist?

Doug

You could make use of a 25102(n) offering if the offer is only to California residents. Here are the rules: 1) you have to keep the amount you raise to \$5 million or less; 2) you have to use a tombstone or bare bones ad; and, 3) only qualified investors may invest. If the offering entity is an LLC, the investors have to be accredited investors as well.

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How about a SCOR offering?

Doug

There is a Small Corporation Offering Registration exemption for offerings limited to less than \$1 million, but California makes it harder to do SCOR offerings than other states—audited financials are required and the State has to approve the terms of your offering. Forget SCOR in California.

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Alright, let's go back to the 25102(n) exemption. How does that work?

Doug

You can put a tombstone ad on a web site and allow those who want more information to contact you. You will still have to ask them to sign a document verifying that they are qualified to be a purchaser before you can follow up with sales literature or the offering documents.

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What does 'qualified investor' mean? Or 'qualified to be an investor'? What does that mean?

Doug

In California, a qualified investor is someone with a net worth of at least \$250,000 and gross income of at least \$100,000, or a minimum net worth of \$500,000 excluding the primary residence (but including spouse's net worth). This relatively low threshold applies only if you are a corporation, not a LLC. If you are using a LLC ownership entity, all investors have to meet the more stringent "accredited investor" standard—unless you already had a business relationship with them.

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What does that mean? What does 'accredited investor' mean?

An individual accredited investor is someone whose gross income has been in excess of \$200,000 for the last two tax reportable years, or whose income combined with the spouse's income was at least \$300,000 for those two years, and whose net worth or joint net worth is in excess of \$1 million. This is the same as the Federal Reg D Rule 506 exemption, which allows offerings in unlimited amounts with no state review, to accredited investors (or to sophisticated investors with whom there is a pre-existing relationship).

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If there is no state review and the investor benchmark is the same, why would I not want to use Reg D?

A

Most businessmen do prefer Reg D's Rule 506, and for just those reasons. The only justification to use the California 25102(n) exemption is that it allows you to advertise, and that is a big consideration for some people. Another way to be able to advertise is to use Reg D Rule 504, but only if you are raising \$1 million or less. Using the California 25102(n) exemption in conjunction with the Federal Reg D Rule 504 exemption is one approach that has worked when advertising for small amounts of money from California residents.

Another way to do it, if you are raising \$5 million or less from California investors, is to combine Federal Reg D Rule 505 with California 25102(h) so that you may legally solicit, by email, mail or otherwise, individuals who may or may not be qualified investors, let alone sophisticated or accredited investors.

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Can I ask for people to invest if I do not have a securities license?

A

Yes, as long as you are raising money for your own deal and not paying yourself on a commission basis. You can pay yourself a salary out of proceeds raised.

If you are paying anyone else, he or she must be licensed as a securities rep.

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How can the securities be sold?

Doug

You can contact anyone you already know by email, letter, or phone—if you reasonably believe they meet the required investor benchmarks. You cannot make use of a list of names if you do not know if everyone of the list qualifies.

One of the advantages of a Rule 506 Reg D offering is that you CAN purchase a list of names from a licensed securities broker who has prescreened the investors to establish that they are all accredited.

Another way to go is to go ahead with a web site but use it to just describe what your idea is or what your company does, without asking for money or trying to sell interests. At that web site, you can have a link, “For More Information,” that leads to an investor questionnaire which must be returned to you so you or someone else can review it to determine that the investor is qualified. At that time, a password may be give to the potential investor allowing him or her to go to the section of your web site that contains offering materials.

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What happens if I violate the securities laws? So what?

Doug

That is actually a good question. As a friend puts it, “There is a crime wave going on, and it never ends.” The friend, another securities lawyer, says this, tongue-in-cheek, to confirm that many, many offerings of what are technically securities occur every day without being registered or being exempt from registration. The vast majority of these kinds of unregistered “offerings” are small scale business deals where one of the parties does most of the work and other party or parties put up most of the money.

What people seldom understand is that complying with the applicable securities laws is a very good insurance policy if a deal goes sideways. If you lose someone’s money and it is not your fault—but you got your hands on that money using what is technically a security—you will lose a law suit asking for the money back if you have ignored the law. Plus penalties are almost assured.

Paying up to \$7500 for a Reg D compliant package of documents for your offering could be the least expensive \$7500 of your career.

Those first, initial contacts—unless they make it clear they are not interested— are obviously your first potential investors, by the way. And you can use whatever you have given those individuals to write an outline of a business plan or executive summary—which you will need.