

## **Eight Steps to Take in Forming and Operating Your Next Group Investment**

*The information here is an excerpt from Chapter 8 of the second edition of my book  
“It’s A Whole Business”*

### **1. Choose a Limited Liability Company as Your Choice of Ownership Entity**

Today, the most popular choice of entity that sponsors are choosing is the limited liability company. Investors have heard that the limited liability company is the entity of choice if they are interested in having input into the daily management of the property. Sponsors are choosing the limited liability company as the entity of choice so that they can take advantage of the limited liability offered the group sponsor, as opposed to the unlimited liability faced by general partners in general partnerships or limited partnerships.

*In Chapter 5, I give you a complete discussion of the various entity choices you will have including General Partnerships, Limited Partnerships, Corporations, “S” Corporations, and REITs along with Limited Liability Companies.*

### **2. Establish a Limited Liability Company to Act as Managing Member**

The first action you should take is to form a limited liability company for you to use as the managing member of the limited liability company you will form to actually own the property you will operate. This LLC will likely be formed in the state where the property you are acquiring is located. You can use this managing member LLC to form each of your limited liability companies you form in subsequent group sponsor offerings.

We will call your limited liability company “Managing Member, LLC”.

#### **Protects your assets**

In the event of legal action against a sponsor, it is important to limit the assets of the sponsor that will be vulnerable to legal attack. If the sponsor is an individual and a civil action is commenced, every asset of the sponsor is at risk. If the sponsor is married, all of the assets of the community are at risk. By having Managing Member, LLC act as sponsor, only the assets within that limited liability company are vulnerable.

Some sponsors will form a separate limited liability company to act as sponsor of *each* investment group they form. While that may be the most prudent way to conduct the business of being a group sponsor, it is likely that the number of groups you will sponsor will be small enough that one managing member entity will be sufficient. At some level of volume, perhaps a second entity to serve as managing member will be appropriate.

### **Allows for flexibility**

By having Managing Member, LLC, with its own operating agreement, act as sponsor, transactions relating to the investment can be handled more simply than if the sponsor were required to include a spouse or if the sponsor were required to comply with corporation regulations in making decisions and executing legal documents.

### **Allows for continuity**

One question an individual, acting as a sponsor, will encounter is “What happens to the investment if something happens to you?” Sponsors have lives and deaths, bankruptcies, divorces and health problems. Managing Member, LLC will have a legal life separate from the individual sponsor. Having at least two members in Managing Member, LLC will give potential investors more assurance in your management plan. The investors who have invested with the sponsor do not need the additional risk of unexpectedly having an investment without an ongoing management function as would be likely to happen with a single person limited liability company or with an individual sponsor.

## **3. Form the Limited Liability Company that will own the Investment**

Once Managing Member, LLC is formed, you should form the limited liability company that will sell investment interests and will own the property. A limited liability company can be formed in many states with one member, and Managing Member, LLC can be that member!

Let’s call our limited liability company “Operating, LLC”!

With Operating, LLC formed, bank accounts can be opened to accept investment funds from investors. Offers can be written on properties, in the name of Operating, LLC, so that no assignment issues will arise and no disclosures will have to be made about markups or hidden profits.

Operating, LLC, once formed, can operate according to the terms of the operating agreement and can conduct all the business activities needed to complete admission of investors and to complete the property acquisition.

## **4. Choose a Specific Property**

It will be easier for you to successfully form and fund your next group if you choose go to the investment marketplace with a specified offering, which is designed to own one specific property.

As you develop a track record of performance in your group investing, you will be more successful in fund raising, and then doing a semi-specified

offering with more than one property will be possible. It is possible that you will never do a blind pool real estate private placement offering, but you might.

### **Choose a property type based on your experience**

A specific offering has an identified property or several identified properties that will be acquired and managed by the Operating, LLC. Raising money is easiest for this form of investment group. Only after the sponsor develops a track record in setting up, operating and dissolving investment groups can the sponsor expect to be successful in raising investor money for semi-specified or public investment programs where one or more properties are specifically identified but extra money is raised to purchase additional unspecified properties.

By choosing a product type in which you have experience, the investors will face fewer risks, the property management should be more effective, and raising money will be facilitated.

Investors who are looking for rapid appreciation and tax shelter through depreciation but are not interested in current spendable income would not be interested in this type of investment.

When you choose the specific property type in which you will operate, i.e., industrial, office, multi-family, or retail, you will have a very good idea of where your investors will be found based on the benefits the property produces.

*Referring to the IDEAL acronym, I discuss in Chapter 2, each property type provides specific benefits for the investors. For example, a single tenant, net leased property will generate income from rent payments, equity build-up from debt repayment and can be purchased using leverage. Investors looking for spendable income and equity build up through principal reduction would invest in this type of investment.*

### **Choose a specific group of investors and concentrate on their goals**

Another way of choosing a specific property type would be to determine what benefits your group of investors would most likely want. For example, perhaps you already have identified a group of potential investors who are not interested in current income but want appreciation, tax benefits through cost recovery, and the advantages of leverage. They may well want to invest in multi-family properties. Another group of investors who are primarily interested in equity build-up may be interested in development projects or value added investments.

When a specific group of investors is identified as the target for raising money, their investment goals can be identified. There is a specific property type that will produce the exact benefits the investors need.

### **Determine the number of investors and dollar amount to raise**

Based on the results of the surveys I have taken of sponsors, many sponsors plan to keep the equity they plan to raise to less than \$2,000,000 and the number of investors in their group to less than 10. Many sponsors want to be sure that each investor in the investor group can contribute a minimum of \$50,000.

### **Provide for positive cash flow**

Currently, with the exception of development projects, investors expect current cash flow distribution, on at least a quarterly basis. The management plan for Operating, LLC should be designed so that the first cash distribution will occur within the first six months after the acquisition of the property.

It is not important that the early cash distribution be the full amount expected to be achieved as the property operations mature during its ownership. For example, if the property were expected to produce a 6% annual distribution, it might be acceptable to distribute 2% during the first year, especially if the management plan calls for the retention of cash flow to build up reserves or complete needed capital improvements.

## **5. Secure the Property**

You must, in some way, secure the specific property or properties to be purchased by Operating, LLC. Without securing the property you will find it very difficult to raise investor funds. If Operating, LLC raises a large portion of the investment funds needed to purchase the property, but not 100% and must return the funds to the investors, it will be very difficult to raise money for your next group. Be sure that you have a plan to close on the property you have identified yourself, regardless of the amount of money you actually raise.

The surest way to secure the property is for Managing Member, LLC to have the funds needed to purchase the property and contribute it to Operating, LLC. Operating, LLC would have to have a provision in the operating agreement that allows it to repay Managing Member, LLC the amount of equity that was used to purchase the property.

Barring your ability to totally front the capital needed to purchase the property, there are several other ways to secure a property. All of these have been successful in certain situations.

### **Enter into a binding purchase agreement**

Operating, LLC could identify the property or properties to be purchased and put them under contract. You would write the offer in the name of Operating, LLC.

Whether or not a contingency clause regarding the groups' ability to raise the money to close is a viable clause will largely depend on the current state of the market in which you are attempting to purchase a property. In some markets, if a closing cannot take place in 30 days, the sellers are unwilling to tie up their property. Some markets would see a 6 month closing as lightning fast!

### **Obtain an option**

Operating, LLC may be able to place a property under option, with the ability to exercise the option at some time in the future. Some investment groups have used this acquisition strategy to facilitate the purchase of the property at a specified price, upon reaching a specified level of fund raising. While the fund-raising is progressing, the seller has the rights to continue to market the property.

### **Contribute a property owned by a member of the group**

Perhaps one of the members of Managing Member, LLC has a property that would be a good property to put in your next investment group, even if only to syndicate a portion of the equity. Perhaps a person who might not be a member of Managing Member, LLC but would like to be a member of Operating, LLC has a property that would be a good property for your first group.

*I have helped several sponsors get started this way. The strength of this approach is that there is already an operating history for the property. As projections are made as to the future operations, the projections will likely be met, which creates confidence in your investors and builds a strong track record for you. Additionally, the property is already under control so the potential investors are not concerned about the sponsor's ability to close the acquisition of the property.*

## **6. Prepare the Private Placement Memorandum (PPM)**

The Private Placement Memorandum (PPM) contains three major sections; the basic disclosures, the legal agreement, and the subscription agreement and offering questionnaire. See the complete discussion of the PPM in Chapter 5.

Use an attorney to draft and review any documents you intend to use for your group investment. Choose an attorney who will be available to you to be involved with all the operational aspects of your group. In many states the preparation of these documents must be done by an attorney. I have seen many sponsors use a "cut and paste" approach which, other than providing a disservice to their investors, is considered the unauthorized practice of law, which can subject the sponsor to legal liability.

Use a CPA to review the financial analysis of the property or properties your group intends to acquire and any track record history you intend to include in your offering material. Choose a CPA that will be available to you to be involved with all the operational aspects of your group. The CPA will be used annually, at a minimum, to review the annual report to the investors and prepare the annual tax returns for both federal and state reporting.

*In Chapter 7, I take you through a thorough discussion of what goes in a PPM. The book also contains, as exhibits two sample PPMs I have drafted for clients.*

## **7. Market the Investment Units**

Generally, the next group investment you will do will truly be a private placement, where you probably know most of the potential investors before you identify the property or start raising the funds.

Remember the material about general solicitation in Chapter 3, covering federal securities laws. No advertising or general solicitation is allowed. Here is a list of traditional sources of investors:

current clients of yours

past clients of yours

referrals from past clients

business acquaintances

current property owners

referrals from your attorney or accountant

referrals from other real estate licensees

acquaintances from investment classes, seminars and other professional meetings

relatives

*In Chapter 3 I discuss the rules relating to the prohibitions against advertising and solicitation related to the sale of securities, which is what you will be selling when you raise money for your group.*

## **8. Manage the Entity**

It is advisable to spell out, in some detail, the method in which you plan to communicate with your investors. The plan becomes a road map for you, and the investors will count on you following this plan. Do not commit to any of these events unless you intend to follow through with them.

### **Communication**

The operating agreement will specify the minimal level of communications the sponsor must have with the members of the group. It will also set forth the time line for these communications and the form in which the communication will be conducted.

It is advisable to communicate at least quarterly with the members of your group. More frequent reporting may be important if major events are taking place in the investment.

Some group sponsors schedule an annual meeting of the investors where all investors get together to vote on important business decisions regarding the investment. In most states, there is no requirement of an annual meeting of the group members.

An annual communication that includes the income tax information and an annual report on the operations of the property will be due in the first quarter of each year.

### **Fiscal responsibilities**

The sponsor of the group is held to the highest degree of fiduciary duty to the group and the members of the group.

### **Annual income tax reporting**

The group needs to file a federal income tax return each year. The return is an informational return only, as Operating, LLC is a pass-through entity. The informational report, federal Form 1065, reports the results of the group as one entity. A Schedule K-1 is prepared for each group member, reflecting their share of the operational result of the group, according to the profit sharing arrangement described in the operating agreement. A copy of all Schedule K-1s is attached to the informational report. Every group member must be provided a copy of their individual Schedule K-1.

Operating, LLC may need to file a state income tax return, also, which is also of an informational nature. In certain states, there is a minimum annual tax due as a result of operating under the limited liability company rules of the state.

It is possible that Operating, LLC may have to file with the county some annual statement. It is also possible that the county has levied some sort of tax on the income received by the group, even if that income is in the nature of rental income.

While there is no date set for the distribution of annual tax information to the group members, the group sponsor should be aware that investors expect to receive this information by February 15, as they receive their W-2 and 1099 forms around that time. Delaying the distribution of the annual tax information to the group members will likely result in a number of telephone calls to the sponsor and some disgruntled investors, as they can not file their return and get their refund until they have the information from the group. Being late with the distribution of these materials will show the group members that the sponsor lacks organizational skills.

### **Investor documents**

The operating agreement may require that the group members be provided with a legal certificate representing their ownership interests in the group.

### **Closing out the Group**

The steps listed below are typically the steps, in order, that are required when the group dissolves.

#### Pay liabilities

All of the bills of the group need to be paid and some reserve for undiscovered bills must be considered. An estimate and reserve for potential federal and state income tax and reporting fees may need to be established.

#### Pay investors

The members should be paid according to the rules as spelled out in the operating agreement for the group.

#### Pay the sponsor

The sponsor should be paid according to the rules as spelled out in the operating agreement for the group

#### File final tax return

The final returns for both the federal and state income taxes must be filed and any taxes due must be paid. The final tax return will be marked as a final return to identify it as such to the various organizations that collect taxes. Informational returns must be provided to the members.

#### File dissolution documents

Appropriate dissolution documents must be filed. States who regulate the legal entity chosen by the group may have specific documents that must be filed to notify the state that the entity is no longer doing business within the state.

#### Abandon fictitious name report

File the correct report within the county or counties of the state in which the group was organized and approved to do business so that the county knows that Operating, LLC is no longer in operation.

*One of the most common mistakes I see my clients make is to ignore the rules relating to how their group is supposed to operate. These rules are found in the Operating Agreement which the Managing Member and the investing Members execute at the beginning of the group. These rules must be adhered to by the members of the group or amended if needed.*

### **Summary**

Now that you have seen the steps that I recommend for you in forming and operating your next group, you should see that this might be different than you thought, but then “It’s a Whole New Business!” I hope you purchase and enjoy my book.

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