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# Dense Property Crowdfunding Field Demands Deft Vetting

By **Natalie Rodriguez**

*Law360, New York (April 21, 2015, 3:20 PM ET)* -- As the real estate crowdfunding marketplace explodes with new players, attorneys in the thick of the emerging market say vetting these platforms for developer clients requires delicately weighing both a portal company's liability risks and its ability to get the deal done.

The real estate crowdfunding market is expected to hit $2.5 billion this year, and new financial and tech players are entering the sector, hungry to take a bite out of the expanding pie via online fundraising portals. But with the relatively neophyte sector mushrooming, attorneys advising developer clients must conduct careful due diligence into both the legal and business risks of a potential platform partner, experts say.

"Most important from the attorney's perspective is making sure it's a right fit for the client," says Jeffrey R. McDonald, a real estate associate with Liner LLP who is currently vetting platforms for a client. "One of the concerns we have is making sure that bringing on a crowdfunding investor source would not create unwanted liability for our developer clients."

Last month, market research firm Massolution put the number of active real estate-focused crowdfunding platforms at 85. Realty Mogul Co., Fundrise LLC and others are some of the better-known players for either their boundary-pushing firsts in the sector or iconic projects, but several newer competitors have been sprouting up.

Among these are Acquire Real Estate LLC, which launched a first-of-its-kind resale exchange last week for investors to trade their equity interests, and Patch of Land, which recently announced it had raised $23.6 million in financing.

While not "crowdfunding" under the most technical terms — that would involve opening up the opportunity to nonaccredited investors — these campaigns conducted under the U.S. Securities and Exchange Commission's new Rule 506(c) guidelines offer developers a new way to quickly put together cash for a small project or to cover a mezzanine financing gap by tapping scores of individual investors willing to pony up chunks of the needed capital.

Before taking advantage of the fundraising tool, however, developers need to carefully weigh the risks that can come with signing on to one of these crowdfunding platforms.

While there are a handful of exceptions to the rule, you should generally try to steer a developer client toward a registered broker-dealer, according to Markley S. Roderick, head of Flaster/Greenberg PC's crowdfunding practice. Federal law allows for some gray area as to when property crowdfunding portals need to be registered as a broker-dealer — when the sector first started, many of the players didn't think the rules applied.

The handful of platforms that don't charge a commission for their services probably are in the clear and don't have to register. But for the majority that do charge commissions, attorneys say it's important to ensure developer clients have registered as broker-dealers, or clients may face liability when a project sours.

"It holds a lot of risk for developers," Roderick says. "If you put your deal up on the site and it gets funded, wonderful. But if the site was supposed to be registered as a broker-dealer and wasn't, then the investors probably have the right to get their money back if the deal goes sideways."

Also, it's important to carefully vet whether a crowdfunding platform is compliant with the relatively new federal rules that allow for advertising and general solicitation of investors, according to experts.

"They should be figuring out which of the platforms are following the new law properly," says Jonathan Bloch, a capital-raising expert at Jeffer Mangels Butler & Mitchell LLP. He adds that it's also important to look into which platforms are "really raising money, getting deals done and getting them done in a fast-enough period of time that it works for the clients."

"If it takes six months of raise the money, it's not very useful," he says.

In the relative Wild West of real estate crowdfunding, due diligence for legal and business risks is intricately interwoven, according to experts. One area where the two issues are particularly enmeshed is in choosing the right platform structure for your client.

Generally speaking, the property crowdfunding crowd is divided into two types of structures: the platforms that allow individual investors to contribute directly to a project's capital structure and those that create a special purpose vehicle into which all the investors get pooled. Each has its pros and cons.

With the SPV structure, a major benefit is that the developer essentially has to deal with only one person. "The developer deals with the platform, and they don't get 47 investors that they potentially have to take telephone calls from," Roderick notes.

Depending on the terms of the deal and the size of the developer, this individual unitholder or limited partner structure can be preferable, according to McDonald.

But this structure also means that the developer itself isn't really building a relationship with the investors, Roderick says. Instead, the platform is securing that long-term value of a relationship that could be potentially tapped again in the future.

And, depending on the deal, the SPV route also means that platform might demand more of a role than any of the individual investors would.

"If the platform is insisting on being a partner, I think it's a lot more complicated and less interesting to the developer," Bloch says.

Beyond the structure, it's also important to vet the experience behind the leaders of the platform, according to experts.

In getting to know a new real estate crowdfunding platform, it's key to get to understand not just the nuts and bolts of how the operation works but also the company's investment philosophy, to ensure it aligns with a developer client, according to McDonald.

“In these real estate development deals, in addition to providing equity dollars, you're also bringing on someone who is going to be involved in your client's project for potentially many years," McDonald says. "You want to make sure it's a relationship that will have staying power."

Generally, it's best for developers to lean toward platforms with leaders who have some experience in the real estate sector, experts say.

“Are they just some technology guys who created a website? That would be a definite red flag," Roderick says"If I'm a developer, I really want a portal that is run by real estate folks. Most of the portals that are successful today fit that category."

Last but not least, it's also key for developers to assess how quickly a crowdfunding platform is generally able to fund its projects. So far, many of the companies are still working hard to attract a sizable pool of investors that will allow speedy deals. While there are tons of portals coming online, only a handful of real estate platforms have proven their ability to attract investment dollars, Roderick says.

And the competition for investor dollars will likely get fiercer in the coming months, as more and more platforms enter the fray.

“I expect over the next six to 12 months that the number of portals out there is going to absolutely mushroom. It wouldn't surprise me at all if it doubled or tripled,” Roderick says, noting he had fielded calls from four to five people regarding potential new projects in the past week alone.

The extra effort, however, can pay off in spades for a developer client. For example, especially in the early stages, when a developer is assembling properties or beginning entitling work, the fundraising process needs to move quickly, and crowdfunding can play an interesting role, according to McDonald.

“We are obviously going to be deliberate and cautious as to who we potentially bring on in a development," McDonald says. "But there are fascinating opportunities here with access to capital that might be a little faster than traditional offline or non-Web-based equity raises."

--Additional reporting by Zachary Zagger and Kat Greene. Editing by Jeremy Barker and Edrienne Su.