When it comes to raising capital for real estate projects, debt or equity, the latest buzzword is crowdfunding – “retail” equity syndication using the largest sales engine known to exist – the Internet. Such capital is funded into projects either as debt or equity.

Sponsors and operators are taking a hard look at raising and deploying capital in this manner, hoping that as macro economic conditions improve, the crowd might be a capital panacea. In order to appreciate this new trend, we’ve tried to highlight the origins of this product and its mass appeal and, at the same time, acknowledge that certain pitfalls exist within the structure that need to be addressed – or avoided – to reduce the risk of a troubled investment.

Quantum Leap Forward

In September 2013, pursuant to Title II of the Jumpstart Our Business Startups (JOBS) Act, the Securities and Exchange Commission relaxed the general solicitation rules for private companies seeking to raise capital. As a result, sponsors can now use web-based funding platforms to raise capital and promote their projects, reaching an unlimited number of investors. Democratization of capital has become the stated public policy.

Who Can Invest?

While the Internet is open to all, sponsors need to verify that only accredited investors invest through an online funding platform. While the definition of “accredited investor” covers different types of entities, an individual is accredited if he/she has an annual income of at least $200,000 for the prior two years (or joint income with a spouse of at least $300,000) or a net worth (excluding the primary residence) above $1 million. Based on certain reports approximately 7 percent of U.S. households meet this “accredited” definition with potentially billions to invest.

With A Change In Law, An Industry Develops

Crowdfunding platforms or portals have popped up on the Internet at an alarming rate. These sites have a varied approach, from simply acting as a listing service to being a co-investor in their offered projects. Some allow you to make investments entirely online, while others merely introduce you to sponsors. Some offer investment advice touting their real estate expertise and rank the quality of the project. All claim to make use of great technology to make the investment experience smooth and seamless.

The products being offered range the entire real estate gambit. To appeal to the masses, most investment amounts start at $5,000 (some are less). While there are some outliers, capital raises under $2 million are the industry sweet spot.

Caveat Emptor

Real estate equity syndication and the pooling of capital has been around for many years under many different names. In response to crowdfunding, many cynics, ourselves included, acknowledge that what is old is new again. Moreover, we do not subscribe to the theory that the crowd will police itself. Such loose standards are fraught with peril.

Critical questions must be asked about the investment, sponsor and platform: What am I actually buying; what are the risk factors for this type of investment; what rights do I have as an owner; how are proceeds being allocated; what are the other sources and uses of capital; are there hidden fees; who is on the management team and what is their prior performance and background; how are investor relations handled once closing occurs; what information will I get regarding my investment on an ongoing basis; how, and more importantly, how much, does the platform get compensated; and what is the platform’s track record? Don’t be lured by pretty pictures and colorful graphics! Ask yourself – do you have all material information to make an investment decision? If the answer is no, dig deeper to see if such information exists; if it is not readily available, then proceed accordingly. Due diligence matters; perhaps even more so when you are investing solely behind the curtain of the Internet.

Best Practices

With the new laws and a developing marketplace, and seemingly no barriers to entry, the crowd needs to be vigilant in asking smart quantitative and qualitative questions about these investments; and in response, sponsors should be crafting offerings and platforms should be crafting investment experiences with an eye to safeguard the
crowd’s money.

The crowdfunding industry is exploding. The challenge is to harness this power in a manner that fosters responsible growth. We encourage the crowdfunding industry to develop a set of standards for bringing deals to market that address the concerns we mentioned above. If this burgeoning industry adopts such measures, we believe it will only bring greater credibility and longevity to all of its participants.

John G. Balboni (jbalboni@sandw.com) is a partner at Sullivan & Worcester LLP and is the chair of the Real Estate Group; Kristen A. Young (kyoung@sandw.com) is counsel at Sullivan & Worcester LLP in the Corporate Group and is the co-chair of the Crowdfunding Group. Shelly Patel, an associate in Sullivan & Worcester LLP’s Real Estate Group, assisted with this article.