



Top 5 legal issues in LLC Agreements for crowdfunders

November 25, 2013 - Front Section

As commercial real estate crowdfunding websites start to operate, they are struggling to impart key legal ramifications that investors in crowdfunding projects will care about. For example, the recently launched Groundbreaker.co has a Frequently Asked Questions section for potential investors covering the lack of voting rights and the risk of dilution if future capital is needed but they don't mention other key legal and business issues which will impact crowdfunding investors like phantom income. If you intend to use this new financing source, here are several of the key issues that sophisticated crowdfunders or their advisors will likely review before they invest in a particular deal:

Phantom income: Since virtually all crowdfunding vehicles will be LLCs or other pass through entities with distributions payable only at the discretion of the manager, income could be charged to the investor without the receipt of cash from the LLC. While Groundbreaker vaguely refers in its FAQs to paying income tax on the LLC's profits, it does not mention the risk of the lack of cash distributions. Investors may demand a written provision in the LLC agreement requiring a minimum cash distribution to match the potential tax liability, commonly referred to as a tax draw.

Fiduciary duty: Fiduciary duty is the duty of managers of a venture to act in the best interests of the investors in the deal. Delaware LLC law permits the LLC agreement to include a disclaimer or modification of any fiduciary duty owed by the manager to the investors thereby essentially abrogating the common law duty typically owed to investors by managers. Since most ventures will be organized as Delaware entities, advisors to investors will review the agreement for any disclaimer of modification and may object if the sponsor disclaims or materially limits fiduciary duties.

Transfers: Groundbreaker, for example, mentions that they expect that the investments should be considered opportunities to "buy and hold" only and refers to future secondary trading only as potential. But Groundbreaker does not mention its policies on whether their sponsors will permit friends and family transfers or transfers on death, etc. These details matter.

Fees: What fees are payable to affiliates of the sponsor? Although investors will be sensitive to fees paid to affiliates, most investors will accept reasonable management or asset management fees and some form of "promote" or disproportionate income allocation as long as the amounts seem reasonable and are disclosed in advance.

Cash shortfalls: What happens if additional cash is needed? If the sponsor is permitted to loan funds to the LLC, what will the sponsor be entitled to earn on the advance? If new capital is brought in, to what extent will existing investors be diluted? If investors are given the opportunity to invest additional funds, how much time are they given before dilution is imposed? Real estate investment LLCs typically have a penalty, i.e., disproportionate, cramdown provision if additional funds are not timely advanced if required - how big is the cramdown?

Of course, there are numerous other potential issues in a typical real estate investment LLC agreement and some investors or their advisors may not pay too much attention to detail given the

comparatively small investments anticipated from the typical crowfunder. However, real estate professionals should be aware that the sites promoting real estate crowdfunding may begin to formulate standards for the sponsors they permit to use the site. If they do, the issues above will undoubtedly be among the key ones addressed.

Tom Kearns is a partner at Olshan Frome Wolosky, New York, NY.

New York Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540