

Nuts and Bolts of the Syndication Operating Agreement and Investment Structure

Presented by:

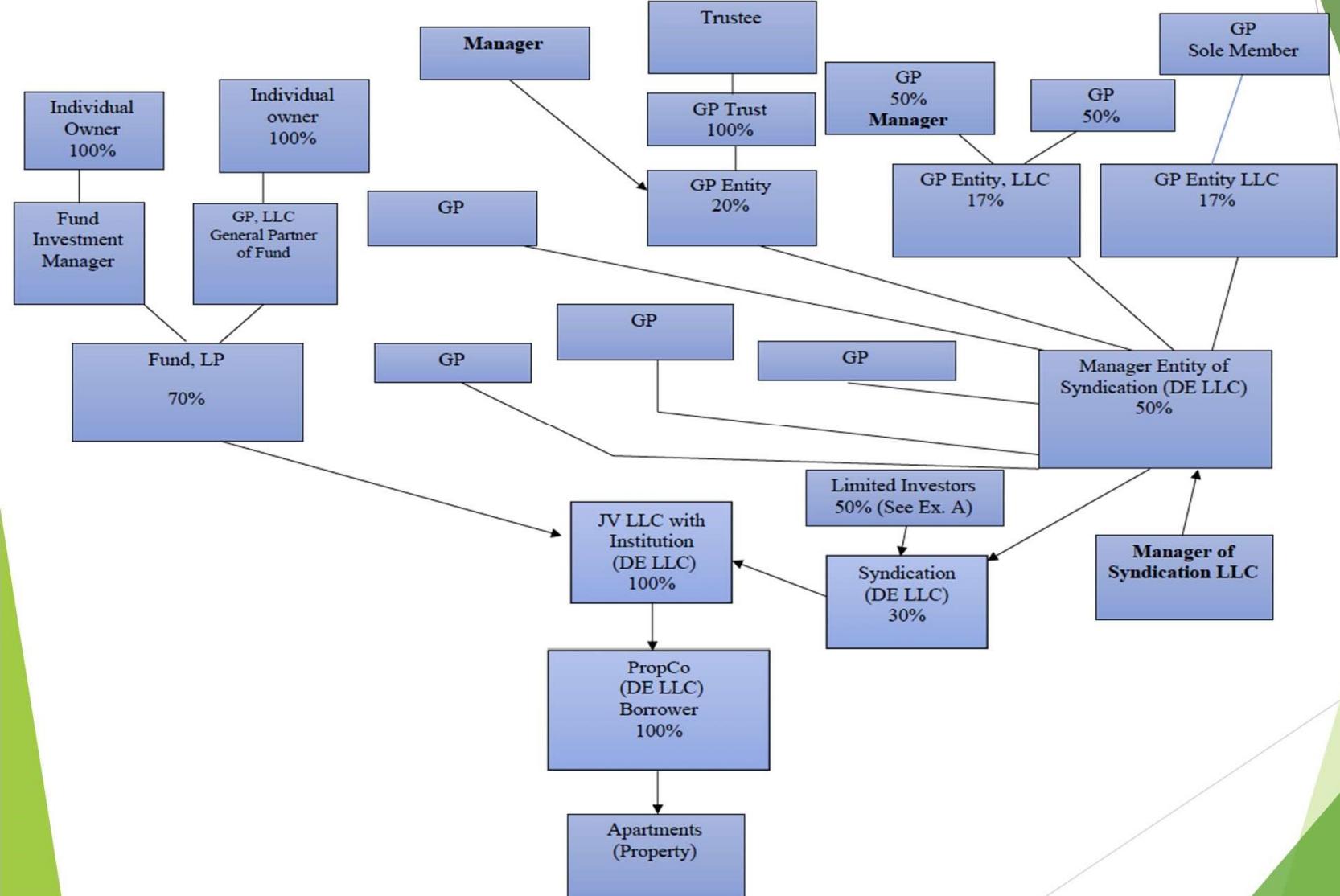
**HARBORSIDE
PARTNERS**





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- ▶ Todd Robinson is the founder of Robinson Law, a boutique corporate and commercial real estate law firm serving clients across the United States as counsel for multifamily syndicators and developers, private equity funds, financial services institutions, middle-market companies and commercial landlords. Robinson Law is based in Atlanta, Georgia with offices in New York, New York. Robinson Law is committed to providing the highest quality work product in the industry and immediate responsiveness to its clients' needs.
- ▶ With a focus on practice areas such as commercial real estate finance transactions and syndications, commercial real estate development, commercial lending, and general corporate and business law, Mr. Robinson is able to provide a full suite of legal services to clients from all sides of the deal - whether buying, selling, or financing. Todd also specializes in structuring and negotiating private equity real estate investment deals on behalf of investment sponsors and investors, which includes negotiating and structuring waterfalls and preferred returns with investors, advising on securities regulations relating to private placements, and counseling clients on capital market issues.
- ▶ Mr. Robinson's clients include multifamily investment firms, family offices, commercial real estate developers, community and regional banks, institutional non-bank lenders, investment and asset managers, national REITs, commercial real estate investors, and small business owners. Mr. Robinson also serves on the board of directors of Capital Partners Certified Development Company, a 504 SBA lender. Outside of work, Todd enjoys spending time with his wife and three boys under six and the occasional golf outing.



Who are the Members of the Company?

- ▶ Class B Member(s)
 - ▶ Individual Sponsors or sponsor entities
 - ▶ Actual voting interest and management responsibilities
 - ▶ Own a percentage of the equity in the company (typically 25% - 40%)
 - ▶ Class B membership interest is typically held by another entity (“ManagerCo”)
- ▶ Class A Member(s)
 - ▶ All limited investors that subscribe to membership interests
 - ▶ Purchase actual interest in the company through subscription agreements
 - ▶ No voting or manager control
 - ▶ Own a larger proportionate share of the equity in the company
 - ▶ Typically offered a preferred return (we will talk about this)

General, but Important Provisions

- ▶ Name of the Company
 - ▶ Can this be changed?
- ▶ Principle Place of Business
 - ▶ Jurisdictional implications
 - ▶ Legal Notices
- ▶ Purpose and Nature of the Business
 - ▶ All legal undertakings or something specific
- ▶ The purposes of the Company and the business to be carried on by it, subject to the limitations contained elsewhere in this Agreement, are: (a) to acquire own, hold, operate, manage, finance, lease, develop, and/or dispose of, in part or in its entirety, the Property; (b) engage in any activities reasonably related to any of the foregoing; and (c) to carry on any other activities necessary to, in connection with or incidental to the accomplishment of the foregoing purposes of the Company, as determined by the Manager.
- ▶ Term
 - ▶ How long with the company operate?
 - ▶ Perpetual unless terminated in accordance with Agreement or by law
 - ▶ Terminates with you sell the property
 - ▶ lawsuit

Representations and Warranties of Members

- ▶ Interest in the company has not been registered under the Securities Act of 1933 or state laws
 - ▶ Relying on exemption and not a public offering
 - ▶ No obligation to register
 - ▶ No public market exists
- ▶ Acquiring interest for their own account
 - ▶ No third-party beneficiaries
 - ▶ Not with a view of resale
- ▶ Have not received any advertisement or general solicitation
 - ▶ Important for 506(b) offerings
- ▶ Have had a chance to investigate
 - ▶ CYA
 - ▶ Read and understood the agreements and have had a chance to obtain professional advise

Representations and Warranties of Members

- ▶ Anti-Terrorism Laws
 - ▶ Not in violation
 - ▶ Not a Prohibited Person
- ▶ Executive Order No. 13224
 - ▶ No deals with terrorists

Capital Contributions and Subsequent Contributions

- ▶ Initial Capital Contributions of the Manager and Members
 - ▶ Class A Members - how many units are you selling and how much per unit?
 - ▶ Manager (Class B Members) - Nominal amount of consideration in exchange for token amount of membership interest in Class B units.
 - ▶ Since Class B units are not sold and really only represent the profit interest in the company, there is no real valuation of the shares
- ▶ Subsequent Capital Contributions
 - ▶ Shall or May require additional capital?
 - ▶ If required, then Sponsor contributes pro-rata share of equity
 - ▶ If LPs do not fund additional contributions, they are subject to dilution as the Manager may sell units to other LPs and admit them as members
 - ▶ Manager's discretion
 - ▶ May loan the funds to the company rather than issue additional equity

Capital Account Matters

- ▶ Capital Account of Members
 - ▶ Maintained by sponsor (or sponsor's accountant)
 - ▶ Increased by:
 - ▶ Contribution of cash
 - ▶ FMV of Contribution of property
 - ▶ Allocation of net income or gain
 - ▶ Decreased by:
 - ▶ Amount of cash distributed
 - ▶ FMV of property distributed
 - ▶ Allocated share of expenditures
 - ▶ Company net loss
 - ▶ Transferees succeed to the individual capital account

Capital Account Matters

- ▶ No withdraws or Capital
 - ▶ Without consent of manager
- ▶ No Interest paid on capital other than per agreement
- ▶ No obligation to restore deficient capital account
- ▶ Member Loans permitted
 - ▶ Bears interest
 - ▶ No additional ownership interest
 - ▶ Repaid in accordance with distribution schedule
 - ▶ Subordinated to lender's loan

Distributions - No Waterfall

Distributions of Cash Available for distributions

- This governs your preferred return from available cash flow
 - ▶ First, to the Class A Members (to be shared among them in proportion to their respective Unpaid Class A Priority Return), until each Member's Unpaid Class A Priority Return has been reduced to zero; and
 - ▶ Thereafter, sixty percent (60%) to the Class A Members, in proportion to their Class A Units, and forty percent (40%) to the Class B Members, in proportion to their Class B Units.

Distributions of Cash from Refinancing. First, to the Class A Members (to be shared among them in proportion to their respective Unpaid Class A Priority Return), until each Member's Unpaid Class A Priority Return has been reduced to zero; Thereafter, sixty percent (60%) to the Class A Members in proportion to their Class A Units, and forty percent (40%) to the Class B Members in proportion to their Class B Units.

- Potentially results in LPs leaving their initial capital in the deal from a refinance
- Manager discretion

Distributions - No Waterfall

- ▶ Distributions of Cash from Sale or Other Disposition. First, to the Class A Members, in proportion to their Capital Contributions, until each Class A Member's Unreturned Capital Contribution has been reduced to zero; Second, to the Class A Members (to be shared among them in proportion to their respective Unpaid Class A Priority Return), until each Member's Unpaid Class A Priority Return has been reduced to zero; Thereafter, sixty percent (60%) to the Class A Members in proportion to their Class A Units, and forty percent (40%) to the Class B Members in proportion to their Class B Units.
- In a sale, the initial capital is returned first until the capital account is reduced to zero
- Then paid to LPs to fulfill preferred returns, if not done so already
 - preferred returns accrue

Distributions - Waterfall

Distributions of Cash Available for Distribution

Subject to Section 5.7, Cash Available for Distribution, when distributed from time-to-time, shall be distributed to the Members, in accordance with the following:

1. First, to the Manager for the Management Fee described herein above.
1. Second, to Class A Members a Pref of 8% per annum of the capital contribution so long as they are Class A Members hereof;
1. Third, once the Class A Members have achieved an IRR of 8%, then, in addition to the 8% Pref, the Class A Members shall receive 75% of the residual distributable net profits distributed pro rata based on the Membership Units controlled by such Class A Member,
and 25% shall be remitted to the Class B Member(s) thereafter;
- 4Fourth, once the Class A Members have achieved an IRR of 12%, then, in addition to the 8% Pref, the Class A Members shall receive
65% of the residual distributable net profits distributed pro rata based on the Membership Units controlled by such Class A Member,
and 35% shall be remitted to the Class B Member(s) thereafter; and

Distributions - Termination of the Company

- Typically company is dissolved after property is sold
- Payment schedule
 - First to pay outstanding debts and liabilities of the company
 - Set up reserves for contingent or unseen liabilities (taxes)
 - Repayment of member loans
 - Distributions to partners

Admission of Additional Members

- ▶ Typically not permitted without prior written consent of Manager

Management of the LLC (and thus the asset)

- ▶ All decisions with respect to the business and affairs of the Company shall be managed by the Manager
 - ▶ Members to not participate in management of the company
 - ▶ Manager has full authority and power in all cases to manage and make decisions affecting the business and affairs of the Company
 - ▶ Manager discretion including, without limitation
 - ▶ Manage daily operations and control of business and Company
 - ▶ Finance, refinance, encumber, market, sell, assign, convey the property
 - ▶ Borrower money in the name of the company
 - ▶ Perform obligations under any agreement
 - ▶ Enter into contracts
 - ▶ Lease the units
 - ▶ Pay fees and expenses
 - ▶ Establish reserves
 - ▶ Appoint officers of the company
 - ▶ Engage third-party professionals
 - ▶ Fix salaries and compensation of officers
 - ▶ Obtain insurance
 - ▶ Obtain and maintain bank accounts
 - ▶ Pay taxes
 - ▶ Admit members
 - ▶ Determine timing and amount of distributions

Management of the Company

- ▶ Class A Members and Class B members other than the manager
 - ▶ No management responsibilities or control over the company
 - ▶ Very important to have a solid manager who you know and trust
 - ▶ Important to vet the sponsorship team before investing in deals
- ▶ Removal of Manager
 - ▶ A few options
 - ▶ Removal and replaced only upon final adjudication by a court of competent jurisdiction that the Manager has committed a material breach of its obligations as the Manager or has engaged in willful misconduct or fraud
 - ▶ With a vote of a super-majority of the Class A investors
 - ▶ This is where Class A investors have a bit of power
 - ▶ JV Agreements with Institutions Investors
 - ▶ The JV equity partner will likely have the discretion to remove the Manager for:
 - ▶ Fraud, willful misconduct, gross negligence
 - ▶ Material breach of the JV agreement
 - ▶ Failing to meet budget
 - ▶ Bankruptcy

Compensation of the Manager

- ▶ Compensation of the Manager (make sure this is in the operation agreement)
 - ▶ Manager entitled to an acquisition fee
 - ▶ Manager entitled to asset management fee
 - ▶ Note that fees are in addition to distributions
 - ▶ Language limiting fees based on lender's discretion
 - ▶ Fees subordinated

Additional Members; Transfer of Membership Interest

- ▶ Admission of additional members
 - ▶ Must have prior written consent of Manager
 - ▶ Absolute discretion
- ▶ Assignment by Members
 - ▶ General provision - no assignment permitted
 - ▶ Exception - with Manager's consent and typically approved for transfer to a family member for estate planning purposes

Company's Right of First Refusal

- ▶ In the event a Class A Member wants to assign or sell its shares, the Company typically will have a first right of refusal to purchase the shares
- ▶ Exercising the option is automatic upon giving notice (typically within 60 days after the Company receives a request to sell the shares)
- ▶ How do you value the shares at time of exercising the option?
 - . Valuation. The redemption price paid for Units under Section 12.2.5, shall be the lower of (a) the fair market value of the Company's assets determined in accordance with Section 16.15, with the Company's accountant determining the transferor Member's capital account balance which would exist if the Company's assets were sold in a taxable disposition for a price equal to such fair market value, and (b) any Unreturned Capital Contribution related to such Units. The per Unit purchase price shall be the amount so determined, divided by the total Units owned by the transferor Member.

Drag Along Rights

- ▶ Typical Syndication
 - ▶ Would arise in a situation where the Company is selling the membership interest rather than the asset
 - ▶ Property tax play
 - ▶ Potential drop and swap
 - ▶ A majority of the members approve the sale of the membership interest
 - ▶ With prior written consent of Manager can essentially force any non-approving members (“Dragged Members”) to sell their shares.
- ▶ JV with Institutional Capital
 - ▶ JV Equity will always have the right to accept an offer on the property or company interest and force the company to sell
 - ▶ Will require the Manager to accept the sale within a certain period of time

Disqualifying Events

- ▶ Certain criminal convictions
- ▶ Certain court injunctions and restraining orders
- ▶ Final orders of certain state and federal regulators
- ▶ Certain SEC disciplinary orders
- ▶ Certain SEC cease-and-desist orders
- ▶ SEC stop orders and orders suspending the Regulation A exemption
- ▶ Suspension or expulsion from membership in a self-regulatory organization (SRO), such as FINRA, or from association with an SRO member
- ▶ U.S. Postal Service false representation orders
 - ▶ Many disqualifying events include a look-back period (for example, a court injunction that was issued within the last five years or a regulatory order that was issued within the last ten years). The look-back period is measured from the date of the disqualifying event—in the example, the issuance of the injunction or regulatory order—and not the date of the underlying conduct that led to the disqualifying event.

Calculating Preferred Returns

- ▶ There are three main questions when it comes to calculating preferred return:
- ▶ **Is it compounded or non-compounded?** Compounded means that the calculation of a preferred return periodic growth amount comes from the amount of invested capital plus all previously earned but unpaid amounts.
- ▶ **Is it cumulative or non-cumulative?** Cumulative means that all the money earned in one period that is not paid out at the end of that period are carried forward to the following period.
- ▶ **Off of whose capital is the preferred return measured?** It is measured off of the capital invested by the LP

Preferred Return v. Preferred Equity

Preferred Return v. Preferred Equity

- ▶ The preferred return is distinct from the idea of “preferred equity,” which is a position in the capital stack that has a repayment priority.
- ▶ The difference lies in the return on and return of capital.
- ▶ The preferred return is a preference in the *returns on capital*, while a preferred equity position is one that receives a preference in the *return of capital*.
- ▶ In most true preferred equity investments, investors get their initial investment and also get a set percentage return on their investment before the subordinate equity investor gets even \$1 dollar of cash flow.
- ▶ If the investor does not receive a return of capital before the sponsor or some other equity tranche, then the investor is in a “common” or “JV equity” position and not a preferred equity position.

The True v. Pari Passu Preferred Return

- ▶ An investor in a common equity position can still receive a preferred return (“pref”), and the type of pref can be further distinguished based on the treatment of sponsor capital, called the co-investment.
- ▶ If the investor receives a preferred return (i.e. profits) before a sponsor does, then the pref is a “true” preferred return; however, if the investor and the sponsor receive the same preferred return, paid at the same time, then pref is a “pari passu” A Latin phrase meaning “equal footing,” used to describe situations where two or more assets, securities, creditors or obligations are equally managed without preference.
- ▶ With a true pref, the investor receives preferential treatment on its capital contribution; with a pari-passu pref, the investor does not. Instead, the pari-passu pref acts as a threshold up to which investor and sponsor capital are treated equally and over which the sponsor capital receives a promote.