INVESTING WISELY

PRACTICAL INSIGHTS AND SAFEGUARDS

Recognizing Risks, Avoiding Common Pitfalls, and Safeguarding Against Fraud in Real Estate Syndications

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Common Myths Regarding Real Eestate Investment and Syndications

People often invest in real estate syndications based on the following false assumptions, which can turn into a costly mistake:

THE SYNDICATOR IS VERY SUCCESSFUL, SO THEIR DEALS MUST BE PERFORMING WELL.

Syndicators can make money even if their deals don't perform well. For example, syndicators typically take acquisition fees at closing before the deal generates any profit. The syndicator also typically earns income from property management and asset management fees, which are not dependent on the deal's profits. The syndicators might also be getting kickbacks from various vendors that are being paid by the deal.

THE SYNDICATORS ARE PUTTING UP THEIR OWN MONEY IN THE DEAL (AND ALSO ROLLING IN THEIR ACQUISITION FEE), SO THEY MUST FEEL IT'S A GOOD DEAL.

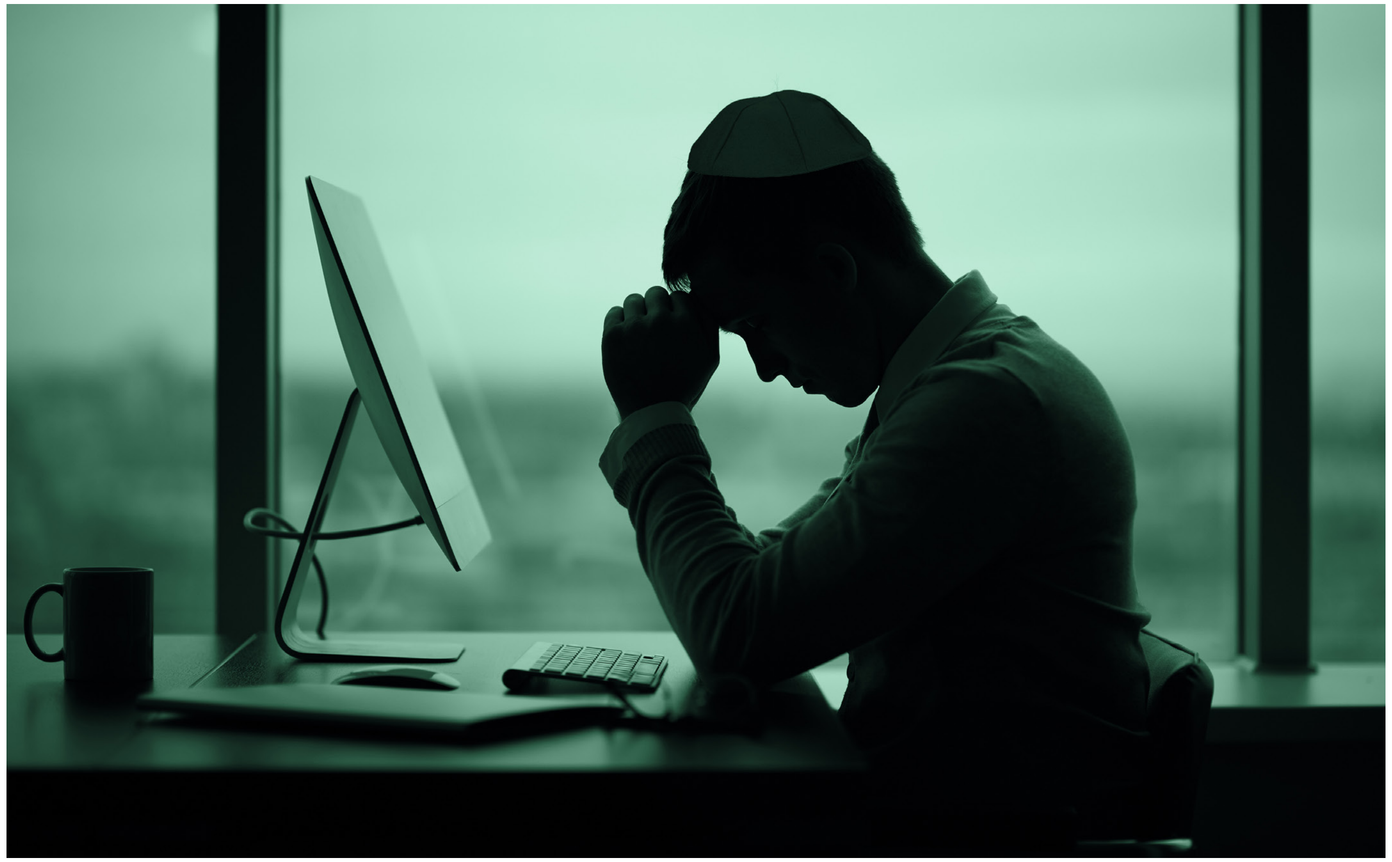
Just because the syndicator says he is investing in the deal doesn't mean he actually is (he may "change his mind" at the last minute). Additionally, it is possible that the syndicator is making money from this deal behind the scenes, which significantly outweighs the money he is putting into the deal. For example, there may be an "internal flip," which means that when the OM says that the purchase price is X, what's really happening is that the syndicator purchased the property for less than that and is now flipping it to the deal for X, thus earning the difference as the "seller."

THE ONE WHO INTRODUCED ME TO THE DEAL IS VERY EXPERIENCED AND A GOOD FRIEND OF MINE, AND HE FEELS IT'S A GREAT DEAL, SO IT MUST BE.

The one who introduced you to the deal is very possibly being paid a commission for bringing you into it (these individuals often do this in an unofficial capacity, so this arrangement may not be readily apparent to you). Accordingly, his opinion would be biased.

I KNOW THE ONE RUNNING THE DEAL PERSONALLY AND FULLY TRUST HIM WITH MY MONEY, SO IT'S SAFE TO INVEST IN HIS DEALS.

It is possible that the individual who appears to be running the deal is just a front for the real syndicator. When a syndicator doesn't have enough of a reputation to attract investors, he may partner with a better-known individual. It is possible that the only thing this individual is doing is speaking to investors, and your money is being fully managed by someone with no reputation (or worse).



THERE ARE OTHER EXPERIENCED AND SAVVY INVESTORS INVESTING IN THIS DEAL, SO IT MUST BE GOOD.

It is possible that these experienced investors (because of their investment size or early commitment) are getting significantly better terms than you are. Just because it's a good deal for them does not mean that it's a good deal for you.

THE SYNDICATOR TOLD ME HE WILL PERSONALLY GUARANTEE MY INVESTMENT.

This oral commitment is not necessarily binding (although it may be, depending on the circumstances).

I WENT THROUGH ALL THE DETAILED FINANCIAL INFORMATION SUPPLIED TO ME BY THE SYNDICATOR AND SEE THAT IT'S A GOOD DEAL, THEREFORE IT IS SAFE TO INVEST IN THE DEAL EVEN THOUGH I DON'T KNOW THE INTEGRITY OF THE SYNDICATOR.

There are numerous ways that a syndicator can spin the numbers so that an unfavorable deal looks favorable. ("Cherry picking" the comps or including artificial rent are some examples.) The numbers are only as good as the person supplying them.

I DID MY OWN INDEPENDENT DUE DILIGENCE ON THE DEAL AND BELIEVE IT'S GOOD. THEREFORE, IT IS SAFE TO INVEST IN THE DEAL EVEN THOUGH I DON'T KNOW THE INTEGRITY OF THE SYNDICATOR.

Even if the deal is fundamentally good, there are numerous ways that a syndicator can potentially divert profits away from the investors. Receiving kickbacks, taking "loans" from the deal, unfavorable allocations on expenses shared with other properties they own, taking "leasing commissions" and lending to the deal at high interest rates are just some examples. Investors typically don't have access to the deal's books and records other than summarized financials, which can easily be manipulated to cover up such actions.

THE SYNDICATOR IS A NICE, G-D-FEARING PERSON, SO THERE IS NO REASON TO SUSPECT ANY WRONGDOING.

Some of the conduct mentioned above may be technically halachically permissible on the syndicator's part (especially if the operating agreement grants them such rights). Therefore one can't assume that the syndicator won't take advantage of such rights.

Furthermore, even with regard to the practices that are not halachically permissible, the ones mentioned above are generally not perceived as outright theft. Even an otherwise well-meaning individual could (as a result of his bias) rationalize that such practices are fair and even beneficial to the investors. Unfortunately, managing other people's money with little or no outside oversight can present a temptation, which for some may be too hard to overcome.

Red flags

The following warning signs can help you identify potential risks and save you from falling prey to fraudulent or poorly managed syndications:

- **YOU ARE TOLD BY THE SYNDICATOR, "THIS IS TOP SECRET."**
- **YOU ARE ASSURED OF EXTRAORDINARY RETURNS.**
- **THE OPPORTUNITY IS PRESENTED AS BEING IN A DISTANT PLACE WITH HARD TO VERIFY DETAILS.**
- **THE AGREEMENTS THE SYNDICATOR IS PRESENTING TO YOU ARE POORLY DRAFTED.**
- **A WELL-KNOWN BUSINESSMAN IS SUDDENLY OFFERING OUTSIDERS THE OPPORTUNITY TO INVEST WITH HIM. (THIS IS A SIGN THAT HE HAS LIKELY ENCOUNTERED FINANCIAL TROUBLES AND IS TAKING ADVANTAGE OF HIS REPUTATION TO GET OTHERS TO BAIL HIM OUT.)**
- **THE SYNDICATOR HAS HAD A SUDDEN METEORIC RISE IN FINANCIAL SUCCESS AND BEGINS EXTRAORDINARY LUXURIOUS SPENDING AND DISTRIBUTING HUGE SUMS TO TZEDAKAH.**

Investor Precautions

Taking the following steps to safeguard your investments can help you minimize risks and ensure better outcomes in syndication opportunities:

- **IF THE SYNDICATOR'S INTEGRITY IS QUESTIONABLE IN ANY WAY, STAY AWAY FROM THE INVESTMENT. DO NOT THINK THAT YOU WILL PROFIT ALONG WITH HIM IN THE FRAUD, AS HE WILL END UP STEALING FROM YOU AS WELL.**
- **AS A GENERAL RULE, DON'T INVEST WITHOUT THE PROPER DOCUMENTATION. ORAL AGREEMENTS IN BUSINESS ARE OFTEN NOT WORTH MUCH.**
- **IF YOU DON'T FULLY UNDERSTAND THE DOCUMENT YOU'RE SIGNING, HAVE AN ATTORNEY LOOK IT OVER. PEOPLE HAVE LOST HUGE SUMS OF MONEY BECAUSE THEY WERE TRYING TO SAVE A FEW THOUSAND DOLLARS ON LEGAL FEES.**
- **DO NOT BE PRESSURED TO SIGN ANYTHING IMMEDIATELY—EVEN IF THE SYNDICATOR TELLS YOU THAT THE DEAL WILL SLIP AWAY.**
- **DO NOT INVEST IN A DEAL THAT YOUR WIFE DISAPPROVES OF.**
- **DO NOT INVEST IN A DEAL THAT YOUR RAV DISAPPROVES OF, EVEN IF YOU DON'T AGREE WITH HIS REASONING. HE MAY NOT BE AT LIBERTY TO RELAY THE TRUE REASON FOR HIS DISAPPROVAL.**
- **USE EXTRA CAUTION BEFORE INVESTING WITH SOMEONE YOUNG AND INEXPERIENCED.**