Crowdfunding: The Future of Commercial Real Estate Lending or Just a Voice Lost in the Crowd?

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The future of traditional lending has challenges ahead. As technology advances and capital becomes more readily available, traditional lenders are likely to see increased pressures to lend and increased pressures on profit margins from lending. Crowdfunding, assuming it can withstand increased regulatory scrutiny, looks well suited to fill a niche that traditional lending may not be able to fill. However, traditional lending will likely not see any challenges posed by crowdfunding for larger and/or more complex transactions. The next several years will provide challenges and opportunities, and entities that can overcome challenges and execute on opportunities presented by technology and the widening availability of capital will be well positioned to flourish. Less nimble entities are likely to get trampled by the crowd.

Crowdfunding: What Is It and What Are Its Applications in CRE Finance?

Crowdfunding has been described as, "[t]he practice of raising funds from two or more people over the internet towards a common service, project, product, investment, cause, and experience."[1] In crowdfunding, various small investors serve as the source of capital for the project. Applications of crowdfunding have been used for a wide range of capital intensive projects over the last several years, which include the production of major motion pictures and video games.[2] In crowdfunding, a party seeking financing for a project goes onto the internet to a website that arranges the financing. The project is published on the website, and registered users are given an opportunity to invest in the project in some small increment. At the most basic level, crowdfunding is syndicated investing/lending on a micro level. It is a global phenomenon changing investing and lending.[3] Knowing what crowdfunding is at its most basic level allows a look at its application and rise in the world of CRE lending.

The principles of crowdfunding applied to CRE lending suggest that potential CRE borrowers would go to a website dedicated to crowdfunding to seek capital from the investors on that website that have "signed up" or agreed to participate in the proposed project through investing. There are already a number of crowdfunding websites devoted to CRE investments featuring different risk profiles for both assets and investors alike.[4] The role of the "crowd" in crowdfunding for CRE is varied. Some crowdfunding websites, acting as the arrangers, utilize crowdfunding structures where the crowd acts as direct lender to the CRE borrower. Some arrangers utilize a structure where the related CRE loan is prefunded, and interests in the loan are sold to investors. Other crowdfunding platforms utilize structures where the arrangers create a lending vehicle with funds collateralized by the investors' investments. The vehicle then lends such funds to the related borrower(s), and the investors are given ownership interests in the lending vehicle itself. When structured in these ways, crowdfunding looks very much like a microcosm of traditional lending. Yet, other crowdfunding arrangements work where the arranger funds upfront and creates a project note and the related crowd invests in that note. At its core, crowdfunding is a blend of traditional lending strategies that are being made available to the general small investor. In a market that has been dominated by traditional large lending institutions and large institutional real estate investors, this could signal a major shift in CRE lending away from its traditional lending present form. Nonetheless, the mechanics of crowdfunding and its ability to service the needs of CRE borrowers must be considered. In this regard, the rise of the crowd may just not be enough to replace traditional lending.

Crowdfunding: Who is in the Crowd and Who Regulates It?

As mentioned earlier, investors/lenders in crowdfunding are not traditional CRE lenders; they are the antithesis. They are individuals interested in CRE finance. They may have no experience in CRE investment, and generally are neither institutional investors nor the wealthy individual investor that have otherwise dominated CRE finance from its beginnings to present day. This raises questions and concerns simultaneously. In particular, many wonder how regulatory agencies will deal with the phenomenon that is crowdfunding.

Crowdfunding in the United States arises from the recently enacted Jumpstart Our Business Startups Act (the Jobs Act).[5] According to the legislative history of the Jobs Act, crowdfunding was designed to improve liquidity and investment in small business.[6] Most notably, the Jobs Act amended Section 4 of the Securities Act of 1933 (the 33 Act) to include provisions that permit crowdfunding in new Section 4(a)(6), yet limit the amount that may be invested by each investor within any given 12-month period.[7]

On October 23, 2013, the Securities and Exchange Commission (SEC) proposed implementing rules related to the newly amended Section 4(a)(6) of the 33 Act and crowdfunding (Crowdfunding Proposed Rules).[8] While the Crowdfunding Proposed Rules have not yet been adopted by the SEC, they contain several key points for discussion that are beyond the scope of this article. Relevant for purpose of this article, however, is discerning the legislative intent. The text of Section 4(a)(6), as amended by the Jobs Act, and the Crowdfunding Proposed Rules arguably demonstrate the legislative intent of Congress and the SEC. Congress and the SEC want to grant small business easier access to capital markets, but at the same time, protect small and/or unsophisticated investors from overreaching. The limitations that Congress and the SEC have placed on both the amount that may be offered for investment and the amount that may be invested seem to demonstrate this underlying intent. In addition, several states have already begun to regulate Crowdfunding utilizing provisions similar to the Crowdfunding Proposed Rules.[9] This leads to the next question: how will these new regulations potentially impact crowdfunding when applied to CRE?

It is highly likely that regulators would view crowdfunding of CRE very carefully and perhaps with greater scrutiny. Traditionally, CRE for both lenders and investors has been an area where only those with the requisite capital and investing experience have entered. Moreover, the regulations do not adequately provide enough capital to fund most CRE projects of any appreciable size. The length of the investment period permitted under Section 4(a)(6) does not provide a long enough period of time for traditional borrowers or investors of CRE that would otherwise seek out traditional lending. Therefore, in and of itself, crowdfunding does not pose a threat to traditional lending for the "trophy properties" that often fill the CRE lending space. In addition, given the nature of CRE and the nature of the investment, there would likely be little liquidity for a crowdfunding investor to dispose of the investment.

Another potential concern related to crowdfunding revolves around lender consent issues — especially in the context of workouts and/or defaulted loan disposition. A group of investors (even if they waive their rights to vote in any plan of disposition and/or workout) will likely have a very difficult time achieving a workout of a CRE loan that has crowdfunding. The situation is analogous to the highly leveraged CRE loans made prior to 2008. It has been very difficult for investors to exercise their rights on such loans given the complex nature of the debt stacks and the diametrically opposed interests that the holder of those debt stacks often have. It is not inconceivable that in a crowdfunding scenario the situation will be even worse given the possibly unsophisticated nature of the investors in crowdfunding. Even if they were to waive their rights to participate as an active voice in a workout, it is conceivable that litigation would arise amongst the investors for any workout or disposition strategy that goes awry, or even if such workout or strategy were to perform reasonably well, litigation would likely arise as a result of one or more of the investors being dissatisfied.

The SEC has not yet taken a stance on the Crowdfunding Proposed Rules. One scholar suggests this is a result of the SEC's concern over fraud and/or loss in crowdfunding investments.[10] Complex CRE (or CRE of a substantial nature) might involve the very risks that the SEC may have concern over. It would not take much to invite the SEC in to harshly scrutinize CRE investments utilizing crowdfunding were investors to suffer heavy losses. Potentially, this might make CRE borrowers wary of seeking this type of financing and push them toward traditional lending. How any of this unfolds remains to be seen. Suffice it to say that the regulatory mechanics involving crowdfunding are far from finalized, and if they were to invite heightened regulatory scrutiny, it may not be appealing for institutions currently engaged and (relatively) comfortable with traditional lending.

In light of the above, regulators would likely take a heightened level of scrutiny for arrangers attempting to use crowdfunding to fund a large, complex and/or highly syndicated CRE loan. Despite these obstacles, it does not mean that crowdfunding cannot fill other liquidity requirements needed in CRE.

Crowdfunding: Who Needs a Crowd Anyway?

While crowdfunding may not have great utility for long-term CRE finance and/or complex leveraged lending structures, crowdfunding in CRE may offer unique liquidity solutions for smaller balance loans short-term in nature. A CRE borrower looking for short-term financing at a low cost of funds, with minimal upfront origination fees, may find a crowdfunding solution very attractive. Indeed, origination fees currently range from a low of 0% to a high of 4%. Also, the speed at which a project can be funded and the loan closed may be quicker than the time necessary for a traditional CRE lender to fund a loan. Moreover, the loans tend not to feature asset management fees and/or other costs of borrower type fees. The lack of fees and costs, coupled with very favorable interest rates, may make crowdfunding-backed CRE loans very attractive to small, non-institutional borrowers looking for capital to develop their CRE projects. If this were the case, it arguably aligns well with legislative intent both at the federal and state levels for permitting crowdfunding.

In addition, crowdfunding can (and is) being used to attract investors that would be "accredited investors" for purposes of Section 501 and Section 506 of Regulation D to the 33 Act.[11] Under Section 506, unlimited numbers of investors, as long as they qualify under Section 501 as accredited investors and are given the notices and materials required under Section 506, may participate and/or have materials directed to them for an offering, and that offering will not be subject to registration under the 33 Act. Access to investing on a crowdfunding website could potentially be restricted to individuals that are accredited investors via password protection and other security procedures. Some CRE crowdfunding websites do limit themselves to participation by only accredited investors, and such investors are required to certify that they meet the requirements of Section 501. With this new phenomenon on the rise, the reactions of traditional lenders in the traditional lending space to crowdfunding are of great interest.

Crowdfunding: Join the Crowd or Disperse It?

With new developments to crowdfunding taking place, the reactions of traditional lenders in CRE to crowdfunding will be quite interesting. As the traditional CRE lending space is currently constituted, investment banks, state chartered banks, and other regulated lenders will likely have a difficult time competing with the speed of closing and cost of funds that crowdfunding is capable of providing. Moreover, the arrangers in the crowdfunding space are likely to draw a younger, more "entrepreneurial" type of borrower and/or investor that is not as likely going to be drawn to traditional lenders given their rigors and institutional nature. Conversely, the types of products that these borrowers are seeking through crowdfunding are not assets that lenders in CRE traditional lending typically finance. Yet crowdfunding's basic proposition of utilizing technology to draw in capital that would not otherwise be available is not so dissimilar from the rise of securitized lending several decades ago. If lenders in CRE traditional lending are going to take advantage and otherwise co-opt the crowd, their optimal strategy would likely be to acquire a current crowdfunding lending platform. This would probably be an easier endeavor administratively as opposed to such lenders building their crowdfunding platforms from the ground up. Crowdfunding may provide an expedient financing source for smaller projects of short duration. In this sense, crowdfunding may have already carved out its niche from traditional CRE financing. Although, regulatory concerns for the financial safety of unsophisticated internet investors may temper that analysis.

Conversely, for larger, more complex financings where efficient servicing is required and demanded, crowdfunding does not seem poised to challenge traditional lending. For borrowers seeking an easier end-user experience or requiring a sophisticated CRE lender, crowdfunding as currently constituted is unlikely to provide a particularly attractive debt strategy. Moreover, even if it were, it is likely that regulators would view any crowdfunding arrangements with scrutiny. The uncertainty surrounding crowdfunding may dissuade institutional borrowers from using crowdfunding, as stability in lending is valued greatly by these borrowers. So in the larger CRE financings, there is no need to disperse the crowd because the crowd is unlikely to gather in the first place.

1 Drake, David. "CROWDFUNDING: IT'S NO LONGER A BUZZWORD". http://www.crowdsourcing.org.

2 Brian Crecente (24 August 2013). The Veronica Mars Movie Project: https://www.kickstarter.com/projects/559914737/the-veronica-mars-movie-project?ref=discovery.

3 Catherine Clifford (19 May 2014). http://www.entrepreneur.com/article/234051?newsletter=true "Crowdfunding Generates More Than $60,000 an Hour (Infographic)". *Entrepreneur*. Entrepreneur Media, Inc.

4 See, http://www.crowdcrux.com/top-real-estate-crowdfunding-websites/.

5 Pub. L. No. 112-106, 126 Stat. 306 (2012).

6 See, e.g., 158 CONG. REC. S1781 (daily ed. Mar. 19, 2012) (statement of Sen. Carl Levin) ("Right now, the rules generally prohibit a company from raising very small amounts from ordinary investors without significant costs."); 157 CONG. REC. H7295-01 (daily ed. Nov. 3, 2011) (statement of Rep. Patrick McHenry) ("[H]igh net worth individuals can invest in businesses before the average family can. And that small business is limited on the amount of equity stakes they can provide investors and limited in the number of investors they can get. So, clearly, something has to be done to open these capital markets to the average investor[.]").

7 Section 4(a)(6) imposes the following limits on investments from any investor within any 12-month period: (i) the greater of $2,000.00 or 5% of the investor's annual income or net worth, if the annual income or net worth of the investor is less than $100,000.00, or (ii) the greater of 10% of the investor's annual income or net worth (not to exceed an amount sold of $100,000.00), if the investor's annual income or net worth is greater than $100,000.00

8 (Release No.33-9470) http://www.sec.gov/rules/proposed/2013/33-9470.pdf.

9 As of the date of this article, Alabama, Maine, Michigan, Texas, Washington, Wisconsin, District of Columbia, Idaho, Indiana, Massachusetts, New Mexico, Oregon and Pennsylvania have either adopted or proposed rules and laws similar to the Crowdfunding Proposed Rules.

10 Solomon, Steven, S.E.C.'s Delay on Crowdfunding May Just Save It. http://dealbook.nytimes.com/2014/11/18/s-e-c-s-delay-on-crowd-funding-may-just-save-it-2/?_r=0.

11 See CFR §230.501 and §230.506. ■