Tokenizing Fractional Real Estate Ownership

Tokenizing Real Estate

Currently, one of the most popular applications of blockchain technology in real estate is tokenization of real estate ownership. Tokenization is a form of fractional real estate ownership. The notion is that each token, an automated contract called a "smart" contract, represents a fractional ownership share of a specific property. Because the blockchain tokens are non-fungible tokens (NFT), let's refer to fractional real estate ownership (RE) tokens as RE NFT.

In recent years, crowdfunding of real estate has gained popularity. It too represents a form of fractional ownership, except that most crowdfunding projects put the participants in the role of lenders, rather than being owners of fractions of a property. For any crowdfunding project that cedes a portion of ownership to participants, generally the same points below about RE NFT apply.

Fractional Real Estate Ownership Isn't New

Fractional ownership of real estate is nothing new. It is recognized in law through joint tenants in common (JTIC) and in business in the form of real estate syndications. It is arguable that most real estate investment trusts (REIT) are a form of fractional ownership.

REITs are distinct from JTIC and most syndications because REITs often contain a portfolio of properties, rather than being tied closely to just one, or two, properties.

Democratizing Real Estate

Fractional ownership of real estate is attractive to many people. It is attractive to professional real estate investors because it shifts the burden of capital to fund deals from them to a herd of "silent" investors, each with a small stake. These other investors are silent because they aren't involved in the details of making the project successful. They are limited to contributing money and receiving proceeds.

For people with modest amounts of cash to invest, fractional ownership gives them a chance to enjoy the benefits of real estate investing without requiring them to invest large amounts of capital.

Spreading the capital requirements for real estate investing from professional investors to a host of small investors is often referred to as "democratizing" real estate investing. The name alone sounds like a good idea. The terminology is often used as a sales point for fractional ownership offerings.

To graphically illustrate the target buyer for democratized real estate, envision a white-haired, retiree, a grandmother living on a fixed income. She cashes in a banking certificate of deposit

(CD) from her retirement nest egg and uses the money to buy a fractional real estate ownership share. Sales literature tells her she will receive steady monthly income, sometimes beginning the same day she puts in her money. She invests, hoping this will make her life easier and help her retirement nest egg last longer than it would if she left it in the bank. Don't forget Grandma. She will show up a little later in this discussion.

Securities and Fractional Ownership

Crowdfunding has recently been carved out for a special place in securities laws. However, the same cannot be said for RE NFT.

The Securities and Exchange Commission (SEC) is currently taking a very aggressive approach to everything crypto. They are categorizing almost anything in the blockchain world as a security.

Regardless of the aggressiveness of the SEC, most folks with even a little knowledge of securities laws can look at RE NFT and see that they meet the criteria of a security. Reputable Offerors should handle them as a security and issue the appropriate documentation. Appropriate documentation ranges from certain required crowdfunding disclosures to a private placement memorandum (PPM), all the way up to the small library of documents required for a public security offering.

Good Points of Tokenization

From a profit and administration perspective, RE NFT is a marvelous opportunity. Smart contracts reduce friction by automating many of the most onerous parts of administering fractional ownership returns. The contract documents the capital contribution of each participant along with their ownership stake. As cash flows from the property into the contract, the proceeds are automatically distributed according to the terms of the contract.

Because the contract and transactions are recorded on the blockchain, there is excellent transparency and easy reporting of the project. This transparency is limited, however. Whatever is not contained in the contract, i.e., the actual real estate and the cash flows outside of the contract, is invisible to the blockchain.

Problems with Tokenization

Unfortunately, RE NFT has three major flaws which are like three icebergs converging on the path of the Titanic:

1. RE NFT ownership is not legally recognized in any jurisdiction.
2. Fractional ownership is always a lawsuit waiting to happen. RE NFT puts this risk on steroids.
3. RE NFT scaled across multiple offerings is a RICO case waiting to happen.

Legal Recognition

Currently, RE NFT ownership is not recognized in any jurisdiction. This means that owners with tokenized fractional shares have no legal standing to protect or enforce their property rights.

The short version of this problem is that fractional owners can't use the courts to enforce their property rights. Only the owners listed on the deed filed with the local government have that privilege. In most cases, the name on the deed for a fractionalized property is a trust or an LLC, with no mention of the fractional ownership interests. The trust or LLC is usually owned or controlled by another LLC.

Although there may come a day when governments accord legal rights to RE NFT it is not done today. Until then, lack of legal standing for RE NFT is a fatal flaw that makes this a stellar opportunity for fraudsters who may be able to use this loophole to confuse, delay, and possibly dismiss prosecutions.

Lawsuits

Every fractional ownership of real estate is always a lawsuit waiting to happen. Returns to owners depend heavily on the actions of the party managing the offering (Offeror). If the expectations of investors aren't fully met one or all of them may decide to take the Offeror to court to get satisfaction.

Litigation risk is escalated dramatically when fractional owners are consumers instead of sophisticated investors. Marketing efforts to democratize real estate (i.e., Crowdfunding and RE NFT) consistently target consumers. Remember Grandma (from above)? She and dozens more like her are important participants in successfully funding every RE NFT offering.

When Grandma gets upset with the Offeror, she calls her attorney.

Negative Cash Flows

Experienced real estate investors know there are many circumstances when a real estate investment has negative cash flows. If cash reserves are insufficient, the result is what the investing industry terms a "capital call." Instead of receiving money, participants are required to put more money into the investment. In contrast with investing professionals, consumers are conditioned by the stock market to put money into an investment only when they buy-in. Capital calls are alien to them. To consumers, the need to put in more money to resume an interrupted flow of returns looks like a scam.

When Grandma puts her money into RE NFT, she buys with the expectation that she will be receiving a steady cash flow every month. In fact, many sites hawking RE NFT advertise that the cash flows begin immediately. If Grandma's cash flow suddenly stops and she is told that to get it restarted she needs to put in more money, she calls her attorney. A savvy attorney will quickly

SEC v Howey

The origins of the Howey Test, used to evaluate if an investment is a security or not, comes from an enterprising orange grower in Florida named W. J. Howey. He sold fractional interests in his orange crops. When the crops were sold, the investors got paid a piece of the profits. All went well until something natural happened. A freeze damaged the harvest, and the farmer notified the fractional owners that there were no profits to be shared. This cessation of cash flow, although a common occurrence for orange growers, was unexpected by the fractional owners. They sued and the case ended up before the US Supreme Court and established legal precedent for the securities industry.

Something very much like this is inevitable with tokenized fractional real estate ownership realize that this client is merely one among many RE NFT buyers. That immediately opens the prospect of a class action lawsuit.

Fractional ownership is a form of direct real estate ownership. “Reality TV” notwithstanding, many real estate deals require subsequent capital calls which interrupt and may even reverse cash flows. Negative cash flows will always catch unsophisticated investors off guard. Angered and confused by this unexpected reversal they will likely take their grievances to regulators and to court. Given the numbers of fractional investors in any given property may exceed twenty people, a class action status is ready-made.

Racketeering

When discontented participants occur in multiple fractionalized properties, a racketeering charge is likely to arise alongside the class action lawsuit.

For rental properties the probability of negative cash flows is 100%. They will occur sooner or later. When they occur, Grandma is going to sue.

To protect themselves from lawsuits, the RE NFT Offeror wraps each offering in a limited liability corporation (LLC). The Offeror assumes this will limit damages from any lawsuit to one property.

As Grandma’s attorney digs deeper, it quickly becomes clear that the seller of the RE NFT has done this for many properties. With a phone call to the local District Attorney, or a state Attorney General, the attorney passes along prima facia evidence suggesting the Offeror is engaged in a pattern of behavior (which is a fact). This pattern of behavior across multiple offerings and multiple LLCs looks a lot like what criminals do to hide their ownership and protect their illicit gains. The legally prudent behavior of putting each offering into a separate LLC gets twisted into an indictment.

The Racketeer Influenced and Corrupt Organizations Act (RICO) provides for especially large criminal and civil penalties when actions are judged to be part of an ongoing criminal enterprise. Regardless of the intentions of the Offeror, scaled across multiple properties, tokenizing fractional ownership is a racketeering charge waiting to happen.

When the offeror ends up in court, sitting across the courtroom, the plaintiff is Grandma. When the judge, jury, and prosecutor look at Grandma and then look at the Offeror, all sympathy will is with Grandma.

Compared to Grandma’s fixed income, the Offeror has deep pockets, or appears to have deep pockets. Regardless of the intentions of the Offeror, regardless of the ultimate facts of the case, the jury will find in favor of Grandma. So will the court of public opinion.

Selling a Bridge

The iceberg sized risks already mentioned are made worse by the reality of real estate investing. The phrases, “I have a bridge I’ll sell you,” and “I can sell you waterfront real estate in Florida,” have moved from actual incidents and lawsuits into our lexicon as cautionary phrases about investing in real estate. For a variety of reasons, real estate investing is very susceptible to fraud. Some approaches to investing in real estate are more susceptible than others. RE NFT is one of the most risky ways to invest in real estate and most prone to fraud.

Recently, an investor asked us to look into an RE NFT offering they found on the internet. Because we have some human resources in the same geographic market where the Offeror claimed to hold properties they were tokenizing, we agreed to independently verify some of their offerings. The results were shocking.

First, the non-shocking parts.

Unverifiable Ownership: Not surprisingly, it was impossible in many cases to verify if the Offeror was the legal owner of the advertised property. As mentioned above, the Offeror usually holds title to the property in the name of a trust or an LLC, rather than in their own name. For someone buying the RE NFT this means you may be buying a share in a property form someone who doesn't have the right to sell you that share.

Unverifiable Incomes: The Offeror's website touted the rents currently being received for specific properties. These rents were explicitly woven into the offering of cash returns to the buyer. The only way to verify such rents involves several distinct actions:

- Obtain a copy of the executed rent agreement.
- Talk directly with the renter to verify the rental numbers shown in the agreement.
- Obtain bookkeeping records from the Offeror showing the payment of rents.
- Obtain bank records showing the deposits hitting the Offeror's business bank account reflecting the same values shown in the Offeror's bookkeeping records.

Without all four of these facts, it is impossible to verify that stated rental incomes match the Offeror's claims. Unscrupulous Offerors may create rental agreements for non-existent tenants. They may be clandestinely subsidizing renters by charging them less than the contract shows. This inflates the value of the property. It is also an opportunity for the Offeror to launder money from criminal enterprises by using it to make up the difference between the actual rent paid and the contract rent which is deposited.

Unverifiable Expenses: Verifying expenses which reduce incomes to deliver net cash flows is as difficult as verifying the incomes.

- Obtain Offeror records showing costs for repairs and maintenance for each unit offered.
- Talk directly with occupants to ensure the repairs and maintenance have occurred.
- Talk with the providers who carried out the repairs and maintenance to ensure the Offeror records match theirs.
- Obtain the Offeror's banking records showing the expenses paid and match them to the bookkeeping records.

It is an unfortunate reality that bogus and inflated maintenance and repair costs are often used by property managers to steal money and hide profits. It is also an opportunity for an unscrupulous Offeror to launder money through fictitious repairs and maintenance.

Shockers

Our team visited properties the Offeror showed on their website as current offerings and past successful offerings. What we found was shocking.

In one instance a property listed as being fully occupied and rented for more than $1,000 per month turned out to be the shell of a building. Looking through a window, investigators could see a fifteen-foot tree growing toward the missing roof in the back of the building.

In another instance, the picture of the property on the website was of a different property than the one offered. The property shown was around the corner. Both buildings were identical construction. However, the offered property was vacant and derelict. Windows were boarded up. The only reasonable conclusion is this was a deliberate deception. The Offeror asserted that this building was fully rented.

In a third instance, the property was vacant although the Offeror claimed it was rented.

In a fourth case, the address in the offering turned out to not exist. The picture was of a nearby house. The actual address was for a vacant lot.

Mathematics says that two points are needed to define a straight line. A third point confirms the straight line. In this case we found four tangible points confirming the conclusion that the Offeror was deliberately defrauding people. We found all this without ever dealing directly with the Offeror. We didn't even need to look at their books to uncover the fraud. If we had invested solely based on their website and the allure of RE NFT benefits, the investment would be lost.

If any RE NFT buyers received payments, it is likely those were the result of the Offeror operating a Ponzi scheme, using investments from one person to pay returns to another.

We believe this Offeror is acquiring derelict properties for small amounts of capital. Then they take steps to make it appear that they have fixed up and rented the property. They then sell fractional ownerships up to the fair market value that is reasonable for that type of building in that area if it were fully repaired and rented out. Given that they were listing more than twenty units, their total fraud exceeds four or five million dollars to-date.

This real-life RE NFT should serve as a cautionary tale to anyone enticed by "real estate on the blockchain" as a RE NFT.

The C*u*Bit Difference

Because of the inordinate risks associated with RE NFT, our team made the choice to take a completely different approach to the intersection of blockchain and real estate. We are committed to significant levels of transparency, compliance with applicable regulations, and strong risk mitigation for everyone involved in our deals. We know that most reputable real estate investors and crypto investors will recognize the merits of our approach and imitate it. Our formula isn't patentable, and that is a good thing. If it were patentable, it would likely also have lots of hidden parts.

The first part of our model is to create a funding pool. We are doing this through the Universal Real Estate Stable Coin (URESC*u* or C*u*Bit™). Within the limits set by US regulations relating to Know Your Customer (KYC), Anti-Money Laundering (AML), and the Office of Foreign Assets Control (OFAC), anyone can deposit US dollars (USD) or their crypto equivalents, into the C*u*BitDAO™ Asset Ledger. For approximately every $100 USD depositors receive one C*u*Bit. C*u*Bits are fully fungible. They can be exchanged one for another, and will undoubtedly become available on many cryptocurrency exchanges, although the only official way to obtain or redeem them is at the Teller Window of the Universal Real Estate Wealth Protection Solutions, LLC™ (UREWPS™, the Company) website.

Everyone who holds C*u*Bit is a member of the decentralized autonomous organization (DAO, or in this case the C*u*BitDAO™). C*u*BitDAO™ controls the C*u*Bit™ supply just like the Federal Reserve does for USD.

By agreement with C*u*BitDAO™, the Company uses an agreed upon portion of the money deposited in the C*u*BitDAO™ Asset Ledger to fund real estate deals and buy real estate in cities and towns across the USA.

To manage the risks of fraud, the Company establishes a Distributed Regional Affiliate (DRA or Affiliate) in each major city where we do deals. We sell a limited number of ownership shares in each DRA to successful local real estate investors (REI) who meet the SEC standards for Qualified Investors. In exchange for some of the profits from each deal, members of the local Affiliate provide independent verification and validation services for every deal and property we buy in their area.

Along with our Affiliate, we work with local associations of real estate investors (REI). REI are always making real estate deals and almost always need money to make the deals happen.

C*u*BitDAO™ members have money which they want to protect and grow. REI money-making real estate deals that need money to make them happen. The Company and a DRA provide the connection between C*u*BitDAO™ and REI in a way that manages risks and creates win-win situations.

Together with the REI and DRA, the Company, according to the laws of each state, form a joint venture company (JV). Each JV is an LLC. Each LLC has Articles of Incorporation and an Operating Agreement. An operating agreement specifies the rights and obligations of each member of the JV. At the heart of each JV is a smart contract, recorded on a blockchain. The terms of JV Operating Agreement are encoded into the smart contract. The smart contract automates the administration of the JV, dramatically reducing operating costs, and room for human error or fraud within the JV.

The JV acquires the real estate using money provided by the Company. The Company gets this money from the C*u*BitDAO™ Asset Ledger, under the terms of that management agreement. C*u*BitDAO™ is not a member of the JV.

During the process of acquiring the real estate, DRA members verify and validate all the relevant parts of the deal. Most especially, they verify everything about the real estate property (Property). The Property is bought into a trust. The trust is the legal owner of the property.

Within the trust, the Company, or its delegate, is the Trustee. The JV is the beneficiary of the trust. Each trust is recorded on a blockchain using a smart contract.

The REI does all the work on the property to make the deal profitable. The DRA verifies the work. The Company funds the work. Profits are split three ways.

The Company divides its share of the revenues with C*u*BitDAO™ according to the terms of the management agreement. Specifically, C*u*BitDAO™ receives the increases in equity while the Company receives fees generated from the REI who have enjoyed the use of the C*u*BitDAO™ money.

Using smart contracts to manage the trust and the JV is the best intersection of blockchain technology and real estate. Trusts and JVs have long legal histories. Their legal standing to own real estate is recognized in nearly every jurisdiction in the world. Using smart contracts to reduce the administrative friction and blockchains to record transactions, dramatically reduces the administrative time and expenses, leaving more profit for all parties.

Protecting C*u*DAO Members

As soon as the Company is fully operational and has a portfolio of real estate to back the value of C*u*BitDAO™ Asset Ledger, the Company will begin doing several things to protect the interests of C*u*BitDAO™ members.

We require annual, third-party verification of market value for every property in the portfolio. We contract with licensed property appraisers to provide independent property appraisals and perform a Comparative Market Analysis (CMA) for each property, just as though we were considering buying each property anew. These CMA will be stored on the blockchain, linked to each property.

Twice each year the Company will enlist a reputable outside auditor to verify and validate that the interests of the C*u*BitDAO™ members are being protected, as agreed. The outside auditor will be allowed unrestricted access to Company records. We will pull back the legal veils of the trusts and joint ventures, giving them an unimpeded ability to identify every property in the portfolio. They will verify our valuations and cash flows and validate that the real estate and liquid assets in the Asset Ledger are present and properly valued.

Although the detailed information within their audit will be kept confidential, as it is with the annual report of every corporation, the assertions and key findings of the auditors will be posted alongside the publicly viewable C*u*BitDAO™ Asset Ledger.

Conclusions

Although the appeal to play fast and loose using blockchain technology to fractionalize direct ownership of real estate, the risks to all honest parties are too great to ignore. Further, our financial analysis has found that the profits that come with those risks are only enticing to dishonest players who are looking to pump up real estate values, grab the cash from fractional owners, and then run away, leaving honest investors hurting and government prosecutors struggling to clean up the mess.

In the strictest sense of the word, the JV constitutes a fractionalized real estate ownership. Each party to the JV has legal rights to different portions of the cash flows. The JV itself has rights to the beneficial interests of the trust. The trust has legally recognized ownership rights to the Property. And the interests of all parties are recorded using the distributed ledger technology of blockchains while automating the administration of cash flows both reduces costs and the risks of fraud.

Our approach is different than anyone else in the marketplace. We emphasize transparency and using real estate ownership practices which are proven to protect the rights of all parties involved.

If you are an experienced real estate investor and meet the SEC criteria as a Qualified Investor, and are interested in participating in a DRA, please contact DRA@URESCU.com for more information.

If you want to benefit from real estate without taking on the risks of direct real estate ownership, please visit URESCU.com and learn how you can become a member of the C*u*BitDAO™.

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Disclaimers
Although the design of C*u*Bit™ incorporates inherent protections against volatility and Universal Real Estate Wealth Protection Solutions, LLC™ (UREWPS™, the Company) is committed to support the asset-based valuation of C*u*Bit™, as with any currency there is nothing to prevent speculators from taking unforeseen actions which might cause the price of C*u*Bit™ to vary without reference to the underlying value proposition. The Company cannot prevent and is not responsible for the actions or results of such speculative behaviors.