

Securities Law in Real Estate Transactions

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0 I. Introduction to Regulatory Scheme

1. It is very common for real estate entrepreneurs to raise capital for their projects. In this context, it is very important for real estate attorneys to understand the basics of securities law. In each transaction we must understand whether securities are involved and, if there is a securities offering, what exemption from registration is to be used. Publicly traded securities are beyond the scope of this seminar.

2. What is a security? The Securities Act of 1933 (the “Act”) defines a “security” as

“any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘security’, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”

3. The *Howey* test, *SEC v W.J. Howey Co.* 328 U.S. 293 (1946), interpreted the meaning of “investment contract”. The three parts of the test are (1) an investment of money (2) in a common enterprise (3) with profits to come solely from the efforts of others. There are hundreds of cases interpreting this in different contexts. Common examples of securities which are investment contracts are limited partnership interests, membership interests in a manager managed LLC.

4. Uniform Securities Act, MCL 450.501 et seq, (the “Michigan Act”) is the Michigan statute governing securities. The definition is similar to the federal act. MCL 450.501 includes a definition similar to the *Howey* test, as follows:

“Security” includes any contractual or quasi contractual arrangement pursuant to which: (1) a person furnishes capital, other than services, to an issuer; (2) a portion of that capital is subjected to the risks of the issuer’s enterprise; (3) the furnishing of that capital is induced by the representations of an issuer, promoter, or their affiliates which give rise to a reasonable understanding that a valuable tangible benefit will accrue to the person furnishing the capital as a result of the operation of the enterprise; (4) the person furnishing the capital does not intend to be actively involved in the management of the enterprise in a meaningful way; and (5) a promoter or its affiliates anticipate, at the time the capital is furnished, that financial gain may be realized as a result thereof.”
5. For each transaction, one must analyze whether there is a security. For example, a co-partnership where everyone participates in management, is not a security. An LLC without managers where each member has meaningful opportunity to participate would not be a security.
6. If it is a security, then federal statute requires that it be either registered, an exempt security (Section 3 of the Act) or an exempt transaction (Section 4 of the Act) before it can be offered or sold.
7. Under the Michigan Act, each security must be registered or an exempt security (Section 402[a]) or an exempt transaction (Section 402[b]). Similar analysis must be made under each state in which the securities are offered. There is federal preemption, however, if there is an exempt transaction under Rule 506 promulgated under Section 4 (discussed below). See “Business Guide to Selling Securities in Michigan”, Exhibit “A”.

1 II. Rules for Exemption from Federal Registration

1. Securities offerings must either be registered with the Securities and Exchange Commission (“SEC”) or be exempt from registration under one or more statutory exemptions under the Securities Act on 1933, as amended (the “Act”), as well as under the “blue sky law” of each state in which the securities offer will be made. This discussion focuses solely on exempt transactions and exempt securities. Remember that even though an exemption applies, the offerings are still subject to all of the anti-fraud provisions of the Act.
2. Section 4(2) of the Act is the private placement exemption. It exempts “transactions by an issuer not involving any public offering”. This is not defined by statute. It has generally been held to mean offerings conducted in a non-public manner without general solicitation, involving sophisticated offerees and purchasers who have access to or are provided the same kind of information that

a registered offering would provide. These offerings are generally made to offerees and investors who have the sophistication and the means of access to fend for themselves. Because of the uncertainty of interpreting what this means in a particular case, most issuers do not like to rely upon it.

3. Regulation D (“Reg D”) has been promulgated by the SEC to provide a safe harbor from registration. Reg D has three different basic types of offerings, Rules 504, 505 and 506. See Exhibit “B” for reprint of Reg D. Rules 504 and 505 are adopted pursuant to Section 3(b) of the Act and 506 is adopted under Section 4(2).
 - a. Rule 504 allows a raise of up to \$1,000,000 in a 12 month period. It requires no specific form of disclosure. Rule 504 is not recognized as an exemption from state registration in Michigan under the Uniform Limited Offering Exemption (“ULOE”) so the issuer must find another exemption to comply with state law. Form D must be filed with the SEC within 15 days after the first sale. See Exhibit “C” for Form D.
 - b. Rule 505 is used for offerings of up to \$5,000,000 in a 12 month period. There can be up to 35 non-accredited investors and unlimited accredited investors (defined below). Rule 505 is recognized under ULOE in Michigan. Although no specific form of disclosure is required, Rule 502(b) provides that the issuer must disclose the same kind of information that would be disclosed in a registration statement and to provide financial statements. This is not applicable if all of the investors are accredited. Form D must be filed with the State of Michigan and the SEC within 15 days after the first sale. Other states may have different filing requirements.
 - c. Rule 506 has no limitation on the dollar amounts raised. There can be up to 35 non-accredited investors and unlimited accredited investors. The issuer must reasonably believe the non-accredited investors are sophisticated in business and investment matters. Sophistication may be established through an investor representative. The same disclosure requirement applies as stated above for Rule 505. The same Form D filing requirement applies. Rule 506 unlike Rules 504 and 505 preempts state law so the state cannot impose additional requirements on the offering. However, each state may impose a filing fee and require a notice filing. Michigan requires the filing of Form D with a \$100 fee.
 - d. Accredited investors fall into several categories. There are several categories of institutional investors set out in Rule 501. Some of the more important non-institutional categories are:
 - i. Individuals having a net worth of \$1,000,000 or more including joint property and property owned solely by the non-investing spouse. There are no exclusions from net worth so home, home furnishings and autos count toward net worth.

- ii. Individuals having income in excess of \$200,000 or joint income in excess of \$300,000 in each of the two previous years and a reasonable expectation of the same for the current year.
 - iii. Entities in which each owner is an accredited investor. This is important for family partnerships.
 - iv. Directors, officers, executives and general partners of the issuer.
 - v. Trusts having assets in excess of \$5,000,000 if the trustee is sophisticated.
- e. There are significant restrictions on resale. Investments are to be held indefinitely, which is generally thought to mean at least two years. The issuer must make reasonable inquiry to assure that investments are not purchased for the purpose of resale, make written disclosure that the securities cannot be resold without registration or exemption and place a restrictive legend on the certificates.
- f. The issuer cannot use any general solicitation or advertising. Rule 502(c) prohibits advertisements in any general media, such as newspapers, television, magazines or radio. It also prohibits seminars or meetings in which participants have been invited by means of a general solicitation.
4. Intrastate offerings are exempt under Section 3(a)(11) of the Act. SEC Rule 147 provides guidance for the issuer. The issuer must be incorporated or organized where the securities are offered for sale. Also, the company must actually conduct business in the state, although it can conduct some of its business elsewhere. Offers and sales may only be made to residents of the issuer's state. 80% of the net proceeds from the offer must be spent in the state. Issuer will still need a state exemption as neither ULOE nor Rule 506 apply.
5. Regulation A is another exemption under Section 3(b) for offerings under \$5,000,000. It is not commonly used as it requires the filing of an offering circular and approval by the SEC.

2 III. Private Placement Memorandum

1. Each Reg D offering should have a private placement memorandum. Even if no disclosure is required because the offering is entirely made to accredited investors under Rule 505 or 506 or if it is under Rule 504, the Private Placement Memorandum ("PPM") should be used. It accomplishes several objectives for the issuer:
- a. Protects issuer on fraud claims.
 - b. Explains the deal to the investors and avoids disputes over interpretation.
 - c. Provides the necessary language to prove conditions for exemption.

2. PPM has no specific format but there are certain basics that follow the format of a registration statement. These basic components are:
 - a. Coversheet—A brief statement of the securities offered, contact information and certain disclosures. It states that the securities have not been registered and that the PPM has not been reviewed by any governmental body. It also contains the requirement of an investment representation by the investor.
 - b. Summary of the Offering—This section contains brief bullet points with the highlights of the offering. Should discuss the terms, the structure of the company, the purpose of the investment, management, distributions and compensation of management.
 - c. Terms of the Offering—Discusses the securities offered, the price, the length of time the offering will be open, escrow conditions, fractional units, oversubscription, maximum and minimum offerings.
 - d. Description of the Business—Describe the project or the business. In a real estate context, describe location, improvements, neighborhood, occupancy, purchase agreement terms, financing, reserves, construction issues, environmental factors, management and anything else which would be material. Identify matters which are the belief of management as opposed to empirical facts. It is helpful to reference any appraisals, title work, studies and other due diligence matters, but it is not necessary to attach these to the PPM.
 - e. Management—Describe the management of the company and the experience of the principals. Certainly disclose any negatives, such as prior syndications which have ended in bankruptcy or foreclosure. Should describe all prior experience with syndications. Discuss all experience in the type of project being syndicated, as well as other real estate experience.
 - f. Compensation of Manager and Affiliates—All compensation to managers and affiliates must be disclosed in detail.
 - g. Financial Summary—The PPM should contain financial forecasts or projections. These can be done by an accounting firm or by management. If forecasts are included, significant assumptions must be explained, after in the form of footnotes. Show perspective of the company and the investor. Most people like to see an internal rate of return for the investor.
 - h. Conflicts of Interest—Describe any conflicts of interest which the issuer and its principals might have. This is a good place to describe conflicts the issuer's law firm might have.
 - i. Investor Suitability Standards—Explain if it is open to accredited investors only or (if under 506) can non-accredited sophisticated investors participate.

- j. Sources and Uses of Funds—Describe all the money coming into the project from the offering and how this money will be spent. Do this with both the minimum and maximum raise.
- k. Summary of Operating (or Partnership) Agreement Provisions—Summarize paragraphs concerning distributions of cash and allocations of tax items. Also consider summarizing paragraphs relating to withdrawal of members and restrictions on transfer. Also discuss management issues, including any rights (or lack of rights) the investors have to participate in significant management decisions.
- l. Risk Factors—Probably the most important part of the PPM because it will be relied upon by the issuer to protect itself from claims of misrepresentation and omissions of material information by the investors. The idea is to be as comprehensive as possible. The risks are two types: general and specific. There is a broad statement at the beginning that it is a speculative investment. Some risks common in real estate syndications are:
 - i. lack of liquidity in the investment (always true)
 - ii. risk from competition, both in the general market place and in the location of the property (almost always true)
 - iii. financing risk, (always true, even if the property has permanent loan, it will expire some day and rates might be higher or money harder to get)
 - iv. environmental risk, (always true, even if there is an environmental study, the engineer might have missed something or there could be a future spill)
 - v. lack of appraisal (unless there is a fresh MAI appraisal for the syndication)
 - vi. development risks (permits, wetlands, cost overruns, etc)
 - vii. dependence on manager's activities (always true, what happens if something happens to the key people)
 - viii. lack of operating history (on acquisitions or developments)
 - ix. conflict of interest
 - x. foreclosure
 - xi. unreliability of financial forecasts
 - xii. arbitration, if applicable.

Be creative. Think of every possible doomsday scenario.

- m. Tax Aspects—Should have some discussion although each investor must be counseled to seek his own tax advice. Explain basics of pass-through entity, passive activity rules, at risk limitations, tax allocations,

depreciation assumptions, tax audits and other matters. Unless it is a tax shelter syndication, no tax opinion is expected. The discussion would be much more detailed if it is a tax shelter deal.

3. Subscription Agreement is important. It contains the investment representation of the investor needed for compliance with Rule 506. Also should include representation as to accredited status and residency. Provide signature page for operating (partnership) agreement. Investor should acknowledge receipt and review of PPM, disclaim oral representations and other normal contractual matters.
4. Confidential Offeree Questionnaire is used to establish accreditation or sophistication.
5. There should be a “control sheet” to keep a record of who receives each copy of the PPM. Number each copy and write down who it goes to. Control sheet is the master. Remember the burden of proving the exemption is on the issuer.
6. There are significant questions concerning the use of short form disclosures or executive summaries prior to actual delivery of the PPM. “Solicitation of interest” is really an offering.

Exhibit A

Business Guide to Selling Securities in Michigan

View online at http://www.michigan.gov/documents/cis_ofis_guide_25011_7.pdf.

Exhibit B

Regulation D

View online at <http://www.sec.gov/divisions/corpfin/forms/regd.htm>.

Exhibit C

Notice of Sale of Securities

View online at <http://www.sec.gov/divisions/corpfin/forms/formd.htm>.

Exhibit D

Understanding the Securities Law

View online at <http://www.icle.org/partners/materials/2001CP7192/20012A7192-exd.pdf>.