

Michigan Exemptions From Registration¹

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Michigan Exemptions From Registration

I. Introduction

- A.** Although the general structure of the Michigan statute regulating the sale of securities is substantially the same as the Securities Act of 1933 (the “1933 Act”), the genesis and regulatory philosophy of the Michigan statute, as well as many other State statutes, is fundamentally different from the 1933 Act (especially with respect to the registration of sales of securities).
- B.** The Michigan Blue Sky law, MCLA 451.501 et seq., is a version of the Uniform Securities Act which has been adopted by 41 States. While the 1933 Act adopted a pure disclosure philosophy, the Uniform Act is based on merit regulation (which applies in cases of registration by qualification (§306, MCLA 451.706).
- C.** The Federal and State regulatory schemes are in almost all cases complementary. As a practical matter, this means that each offer or sale of a security must either be registered or exempt under the 1933 Act and in the State or States where each offeree or purchaser is a resident.
- D.** Since the amendment of §18 of the 1933 Act in 1996, limited preemption of the State regulation of sale of securities arises to the extent Rule 506 is the federal exemption relied on.
- E.** The Michigan Act is to be construed consistently with the laws of the other States which have also enacted the Uniform Act and the related Federal regulations. MCLA 451.815.

II. The Michigan Definitions are Substantially the Same as Those Found in the Federal Statutes.

- A. “Security means any note, stock, treasury stock, bond, debenture, evidence of indebtedness . . . any interest or instrument commonly known as a security . . . any guaranty . . . of the foregoing.” MCLA 451.801(Z) This definition also includes a risk capital test..
1. Notes, as well as other evidences of indebtedness, are presumed to be securities, but are then tested under the “family resemblance” test of Reves v. Ernst & Young, 110 Sup. Ct. 945 (1990). Under the federal securities laws, a 100% interest in a whole mortgage will rarely be a security, while an undivided interest in a pool of mortgages will almost always be a security.
 2. A limited partnership interest is almost always a security. Borovoy v Bursar Realty Corp., 86 Mich. App. 732 (1978). A membership interest in a limited liability company will be tested under the Howey analysis, as will a general partnership interest. Will the LLC be “manager” or “member” managed?
 3. A fee interest in real estate may be a “security” depending on how it is marketed. Is a condominium unit marketed as a “great” investment, with a mandatory management agreement pursuant to which rents and expenses for multiple units are pooled, a security? Vacation time shares have been determined to be securities under the Michigan statute. In re Vacation Internationale, Ltd., 34 Corp. Fin. & Bus. Newsletter (Sept.-Oct., 1976).
 4. Frequently, whether or not a security is determined to exist will depend on the identity of the purchaser and/or method of distribution. Is the purchaser an institution who typically buys securities of this type in blocks of \$500,000 (and where a single purchaser purchases 100% of a given issue)? Or is the purchaser one of a number of individuals investing \$5,000 or less?
- B. Sale or sell includes every contract of sale of, contract to sell, or disposition of a security or interest in a security, for value. MCLA 450.801(v)(1). Under the Michigan statute, a stock dividend is not a sale, even if a cash election is waived or an affirmative stock election made (v)(6).
- C. “Commission” means any payment in cash, securities, or goods for offering or selling, promise, or commitment to provide payment in the future for offering or selling, or any other similar payment. MCLA 451.801(e) (first sentence). Commissions don’t include customary real estate commissions paid to licensed real estate agents or disclosed fees paid to attorneys or accountants with pre-existing relationships (Id., balance of paragraph).
- D. “Direct or indirect compensation or remuneration” means any payment, receipt or use of proceeds of an offering for the benefit of the promoter, general

partners, officers or directors, or persons occupying similar positions or their affiliates, any receipt, payment, or use of securities or goods by those persons at less than the amount public investors paid for the securities or goods, or any markup charged on sale of property to the entity raising capital, any advantageous contractual relationships, any real estate commission or other similar payments or arrangements to those persons.” MCLA 451.801(f).

- E. “Finder” means a person who, for consideration, participates in the offer to sell, sale, or purchase of securities or commodities by locating, introducing, or referring potential purchasers or sellers. MCLA 451.801(i). This definition is not in the Uniform Act.

III. The Michigan Exemptions Most Frequently Relied on for Investments in Real Estate are Found in Section 402(b)(9).

- A. As under §5 of the Securities Act of 1933, under the Michigan statute offers or sales of securities must either be registered or exempt. MCLA 451.701. Either the security itself may be exempt (MCLA 451.802(a)) or a non-exempt security may be sold in an exempt transaction. MCLA 451.802(b). The typical real estate offering will not involve an exempt security, but rather must satisfy the requirements to be an exempt offering. Certain exemptions depend on the type of issuer.
- B. In order to claim an exemption under 402(b)(9), an issuer must:
 - 1. exercise reasonable care to prevent non-complying resales, including (a) inquiry to determine that the initial purchaser is acquiring the securities for his own account, (b) legend the securities, (c) issuing or noting stop transfer instructions, and (d) obtaining an agreement of the purchaser restricting resale without compliance (the “resale restrictions”);
 - 2. make no offers or sales by means of general advertising or general solicitation; and
 - 3. refrain from paying any commissions, other than to a Michigan registered broker-dealer (which commission is fully-disclosed in writing to each prospective purchaser and fully reflected on the broker-dealer’s books and records).

MCLA 451.802(b)(9)(A)-(C). The requirements described above that appear in paragraphs A through C of (b)(9) are referred to in this outline as the “General Conditions.”

- C. Section 402(b)(9)(D) contains 21 paragraphs which contain separate exemptions from registration under the Michigan Act. The exemptions most frequently relied on in real estate capital raising are set forth in paragraphs (1), (2) and (5). Paragraph 1 contains separate exemptions in sub-paragraphs (i) and (ii), as does Paragraph 5.

- D.** Under (D)(1)(i), an issuer may make sales to ten of the following persons in a 12 month period: promoters, persons actively engaged or reasonably expected to be actively engaged in the issuer's management or professional advisers (attorneys and accountants) to the issuer and persons directly related by blood or marriage to any of the foregoing persons, if such persons are purchasing with investment intent.
- E.** Under (D)(1)(ii), an issuer may make sales to not more than fifteen persons whose principal business is the line of business to which the offering relates, and who are qualified by previous experience to evaluate the risks of the investment. Although the resale restrictions are not required to be included in offerings relying on the (D)(1) exemptions, they should, nevertheless, always be included in any offering in Michigan for which an exemption is claimed.
- F.** Under (D)(2), sales to not more than fifteen persons in any twelve month period are exempt where the issuer provides to all offerees at least 48 hours before sale a disclosure document which:
1. sets forth the intended application of proceeds;
 2. sets forth the current financial condition of the issuer;
 3. sets forth all direct or indirect compensation or remuneration to be received by a promoter and/or any of its affiliates;
 4. sets forth the issuer's form of organization, date and jurisdiction where formed and nature of its business;
 5. describes the kind and amount of securities offered and the offering price; and
 6. sets forth certain investor rights of inspection, to call meetings and to receive reports on the actual application of proceeds and continuing annual balance sheets and income statements.
- G.** Under (D)(5)(i), sales may be made to business entities having in excess of \$100,000 in net income from operations after taxes in its last fiscal year or latest twelve month period or a net worth in excess of \$1,000,000 at the time of purchase, so long as after the purchase the purchaser has less than 10% of its total assets invested in securities of the issuer.
- H.** Under (D)(5)(ii), sales may be made to individuals, each of whom has after the purchase an investment of \$50,000 or more (including installment payments due in one year after the instant purchase) in the securities of the issuer, who have personal income before taxes for his last fiscal year or latest 12 month period in excess of \$100,000 (and who is capable of bearing the economic risk) or net worth in excess of \$1,000,000, and who has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment or who has obtained the advice of an attorney, CPA or registered investment adviser with respect to the merits and risks of the investment.

- I. For purposes of the (b)(9) exemptions, the general rule is that you look through entities to their beneficial owners, unless, in general terms, the particular entity is independent of the issuer and has 10% or less of its assets in the securities offered or sold by the issuer. MCLA 451.802(b)(9)(F)(1)-(3). Husband, wife and children living as a family are considered as one individual MCLA 451.802(b)(9)(F)(5). Clients of investment advisors and customers of broker-dealers are counted separately. MCLA 451.802(b)(9)(F)(6).
- J. The burden of proving an exemption is on the person claiming it. MCLA 451.802(c). You may combine issuer exemptions under Michigan law, other than the so-called ULOE exemption. MCLA 451.802(d) and R 451.803.7.

Top Ten Issues in an Exempt Securities Offering

The following is a checklist which, although developed for an attorney just taking off into the “wild blue yonder” of securities law, should serve to vet each exempt securities offering. It consists of practice points for the lawyer and client counseling suggestions. While the orientation is decidedly from the view of issuer’s counsel, many of the issues will be important to counsel for either the prospective investor or an investor in a failed venture. The goal is to create a method for the lawyer to enhance his or her efficiency and minimize the risk of pilot error.

1. Rescission Right

If you do not document a valid exemption from registration for all purchasers, and probably for all offerees, the issuer is effectively giving all purchasers a two-year free look at the deal.

- Unless a sale of securities is registered or exempt, a purchaser has a right to rescind the purchase and receive the purchase price paid plus interest (less any distributions made).
- The issuer’s liability for failure to register is wholly-independent of any fraud or misrepresentation.
- The issuer’s good faith, lack of knowledge of legal requirement and/or reliance on an opinion of counsel are irrelevant.

2. Absolute Liability/Burden of Proof

Issuer liability for failure to register is absolute, unless it sustains its burden of proof to establish a valid exemption from registration.

- Substantial compliance with the requirements of an exemption may be insufficient, unless the exemption relied on, by its terms, expressly indicates that non-compliance with certain provisions do not affect the exemption. Compare Regulation D with any of the Michigan statutory exemptions.

- Whenever possible, rely on an exemption with objective, rather than subjective, criteria. Sophistication is a question of fact. Dzentis v Merrill Lynch, 494 F2d 168 (10th Cir. 1974).
- A file should be created, contemporaneously with each offer or sale, documenting the exemption(s) for each purchaser and/or offeree. It will usually consist of a questionnaire, subscription agreement, copy of the security (including the legend), disclosure document (if one was prepared) and a record of any other due diligence (including a memo indicating number of purchasers, offering size and federal and state exemptions relied on).
- It is very difficult to establish a valid exemption after the fact.

3. Securities Law Statutes of Limitation are Very Short

The federal limitations period with respect to a failure to register is one year from the violation upon which it is based but not later than three years after the date the security was first bona fide offered to the public.. §13 of the 1933 Act.

The Michigan limitations period with respect to a failure to register is two years from the contract of sale. MCLA 815.810(e). Although the statutory language is different, the one year/three year federal statute of limitation scheme also applies to misrepresentation claims. Under Michigan law, claims based on misrepresentation must be brought within two years after the misrepresentation is discovered or should have been discovered with reasonable care, but not later than four years after the contract of sale.

- If representation of a plaintiff's case is declined, the need to quickly consult other counsel should be noted in the rejection letter to the putative client.

4. Attorney Fees are Mandatory Under the Michigan Securities Statute

Damages in a successful action based on a failure to register or misrepresentation under the Michigan Securities Statute include reasonable attorneys' fees. MCLA 451.810(a). The existence of attorney fees as an element of recovery should influence knowledgeable plaintiff's attorneys to include, where appropriate, a count based on a breach of the Michigan Securities Statute. By virtue of the ability to recover attorney fees, defense attorneys may be more likely to settle the close case.

5. Liability for Violations of Securities Laws is Very Far Reaching

Under the federal securities law, a person who controlled, directly or indirectly, an entity liable for a failure to register or a misrepresentation is also liable, subject to the controlling person's ability to establish it did not know, and in the exercise of due diligence could not have known of the facts underlying the violation. §15 of the 1933 Act and §20(a) of the Securities and Exchange Act of 1934 (while the statutory language in the 1934 Act creating the due diligence defense is different, the standard of conduct is substantially the same). The Michigan analog extends control person liability to "partners, officers and directors of the seller, every person occupying a similar status or performing similar functions, [and] every employee of such a seller who materially acts in the sale." MCLA 851.810(b). There is an equivalent due diligence defense.

- Issuer’s counsel should advise a prospective seller’s management of the extent of this potential liability.
- Plaintiff’s counsel should expand the list of defendants if the primary violator is uncollectible.

6. Certain Indemnities and Waivers are Invalid Under the Securities Laws

Waivers of compliance with the securities laws are void. §14 of the 1933 Act, §29(a) of the 1934 Act and MCLA 851.810(g).

The 1933 Act and the 1934 Act are silent on the subject of indemnification. Indemnity agreements against liability arising under the securities laws are usually unenforceable, although contribution is permitted. See §11(f) of the 1933 Act and the last sentence of MCLA 451.810(b). The SEC takes this position in registered offerings. Item 512 of Reg. S-K. See also Laventhal et al v Horwitch, 637 F2d 672 (9th Cir. 1980) and Globus v Law Research Service, Inc., 418 F2d 1276 (2d Cir. 1969).

7. Criminal and Civil Liability are Co-Extensive

Many, if not most, actions which give rise to civil liability under the securities laws could also be prosecuted. Although the criminal statutes speak in terms of a “willful violation” (§24 of the 1933 Act and MCLA 451.409(a)), specific criminal intent is not required. Intent to sell a security is sufficient. The seller does not need to know it was a security or that registration was required.

- Under the Code of Professional Responsibility, a lawyer may not assist a client in the commission of a fraud or a crime. MRPC 1.2(c).

8. A Lawyer Should Exercise Caution in Accepting a Securities Engagement from a New Client

- Certain exemptions are not available to persons with past securities law violations. See R 451.803.7 (“ULOE”) and MCLA 451.704a.
- It is inadequate in most cases to rely solely on the client’s assurances.
- Due diligence on the client should include a litigation check and inquiry of the SEC and the NASD.
- Document all advice to the client in a letter or file memo.
- Securities law violators have a very high rate of recidivism.

9. Confirm Professional Liability Insurance Includes Securities Law Matters

Some policies exclude coverage for securities law claims unless an endorsement for such coverage is attached to the policy. Usually the application will require a supplemental application if the prior involvement in securities offerings box is checked. A sample securities supplemental application is attached.

- The supplemental application contains representations and/or undertakings by the firm. Each offering should be reviewed for compliance with these representations or undertakings.
- A second partner/shareholder in the firm should review the memo summarizing the exemptions claimed. This is frequently called for by the supplemental securities application., and is a good idea in any event.
- Professional liability insurance generally excludes coverage when an attorney in the firm owns 10% or more of the client.

10. Certain Actions by the Attorney would be Outside of Professional Liability Coverage

Absent special circumstances, a lawyer generally has no duties to persons who are not his client. In the context of a securities offering, those special circumstances may arise where the attorney issues a tax opinion which he knows will be relied on by prospective investors or in a registered offering where the attorney's opinions enable the offering to close (at least in the view of the SEC).

Apart from his lawyer's responsibilities, an attorney may act as a director or officer of a client or invest in a client.

A lawyer may solicit other persons to invest in a client. Liability arising by virtue of these actions under the securities laws would be excluded from professional liability coverage.

Employee Incentives

I. Description of the Issue or Problem

- A. It is common for a real estate developer to allow certain of its senior employees to participate as investors in some projects. If the developer does not typically seek or accept outside investors, it may be completely unaware of the legal requirements with respect to capital raising transactions.
- B. In some cases, the developer will pay the amount required to be invested on behalf of the employee (a "carried interest"). In other cases, the employee will be allowed to invest on the same terms as are available to the developer.
- C. Where an employee receives a carried interest, a strong argument can be made that the investment is both involuntary and non-contributory and so not subject to registration under the Daniel case.
- D. Where the employee invests money directly, the investment has to be analyzed under the principles set forth in these materials as any other security.

II. Possible Exemptions

- A. Under Michigan law, the most likely exemptions for employees would appear to be either 402(d)(i)(ii) (persons engaged in the same line of business) or (d)(2) (forty-eight hour disclosure).
- B. Under federal law, unless the employee offering is more than six months removed from the primary syndication, the employee offering will have to be brought within the federal exemption otherwise relied on.
- C. Although it may not be possible to satisfy its requirements, a possible exemption might be Rule 701 if the securities are issued pursuant to a compensation plan of the issuer. It might be necessary to obtain interpretive advice or a “no action” letter from the SEC staff before relying on Rule 701 in the real estate development context. Where the incentive interest is in the development company itself, Rule 701 should provide an exemption in most cases.

Contribution of Real Estate to an Upreit

- I. If properly structured, contribution of real estate to an umbrella partnership real estate investment trust (an “UPREIT”) can provide liquidity and diversification on a tax deferred basis. A transaction in which limited partnership interests in the UPREIT’s operating partnership (“OP Units”) will be issued for real estate, or 100% of the equity interests in an entity owning real estate, raises a host of tax, securities and business issues for the UPREIT and the contributing property owner. This outline focuses on the securities issues associated with the receipt of OP Units by the contributing property owner.
- II. The REIT will issue the OP Units pursuant to an exemption from registration found in §4(2) of the 1933 Act or Rule 506 of Regulation D. Only accredited investors may receive OP Units. The OP Units are restricted securities, as defined in Rule 144 under the 1933 Act (a copy of which is attached).
- III. The OP Units are exchangeable one-for-one for shares in the REIT. The REIT shares are the securities which are publicly traded. There is no market for the OP Units, nor are they transferable (although typically they can be pledged).
- IV. After an exchange of OP Units for REIT shares, the REIT shares will also be restricted securities and a new holding period will commence (i.e., no “tacking”). Under Rule 144, restricted securities must be held for at least one year before any sales may be made. As the exchange is a taxable event, the prospective holder of OP Units should negotiate for registration rights as a part of the original property contribution. Unless the contributing property owner will become an affiliate of the REIT or the amount of OP Units will exceed 10% of the REIT’s outstanding shares (fully-diluted), the need for registration of resales ends two years after each exchange (unlimited sales under Rule 144(k)).

- V. If a contributing property owner will become a director or executive officer of the REIT, or will beneficially own more than 10% of the REIT's outstanding shares, he will be subject to §16 of the 1934 Act, the short -swing profit rules.

Attachment 1
Securities Supplemental Application

View online at <http://www.icle.org/partners/materials/2001CP7192/20012B7192-exa.pdf>.

Attachment 2
MCL 451.802

View online at
<http://www.michiganlegislature.org/mileg.asp?page=GetObject&objName=mcl-451-802>.

Attachment 3
General Rules and Regulations promulgated Under the Securities Act of 1933

View online at <http://www.law.uc.edu/CCL/33ActRls/rule144.html>.

Attachment 4
General Rules and Regulations promulgated Under the Securities Act of 1933

View online at <http://www.law.uc.edu/CCL/33ActRls/rule701.html>.

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