HIDDEN DANGERS FOR REAL ESTATE DEVELOPERS: POTENTIAL VIOLATIONS OF SECURITIES LAWS IN EQUITY FINANCING

BY SUZANNE MULVIHILL

Sophisticated real estate developers and owners rely heavily on private equity financing for their projects, the goal being to use as few of their own assets to fund such projects as possible. Developers must comply with certain securities laws if they are to continue raising private equity. Non-compliance with applicable securities laws could potentially result in serious adverse consequences including fines, penalties, a right of rescission for the equity owners, and possible criminal prosecution.

Many developers and owners are unaware that even selling a portion of a real estate project in a Tenancy in Common (TIC) or joint venture context may trigger securities compliance. Ending the debate as to whether TIC interests constitute real estate or securities, the US Supreme court ruled TIC syndicates are within the definition of "security" under the Securities Act of 1933 and as such, the SEC views the sale of undivided TIC interests as securities.

Under the Securities Act of 1933, any offer to sell securities must either be registered with the Securities and Exchange Commission (SEC) or meet an exemption. Regulation D of the Securities Act contains three rules providing exemptions from the registration requirements, allowing companies to offer and sell securities without registering them with the SEC – Rules 504, 505 and 506.

Most issuances for developers are exempt from registration provided the offerings are limited in nature and sponsors do not engage in general solicitation, except with respect to Rule 506. Rule 506 provides a safe harbor for issuers, or sponsors, where they may file the requisite paperwork setting forth the applicable limited offering exemption with the SEC and state regulators. Failure to file such notices could result in the issuer being barred from qualifying for any Regulation D exemption in the future. Rule 506 in particular includes the so-called "penalty box" binding the founders to the disqualification as well as the company. In other words, the next company formed by any one of the formerly disqualified founders will be disqualified from this exemption as well. Developers acting as sponsors should always review pertinent federal and state laws prior to any kind of issuance to determine if an applicable exemption is available. But even before that point, the very act of selling the interests in such projects may trigger compliance with securities rules and regulations.

Any person engaged in the business of buying and selling securities for such person's own account, through a broker or otherwise, is considered a broker-dealer requiring registration with the SEC, subject to certain exemptions. This catch-all definition would include many, if not all developers who act as sponsors seeking to sell interests in any portion of their projects. The SEC's interpretation of the Exchange Act does not require that the purchase and sale of securities constitute an entity's primary business before requiring registration. Instead, regular participation at various points of a securities transaction may be enough to require registration as a broker-dealer. To determine if registration is required, the SEC analyzes the activities that an entity, through its employees, performs and how it participates in securities transactions.

Some issuers rely on the so-called issuer exemption to conduct sales activities without their personnel being required to register as brokers or dealers. The rule provides a non-exclusive safe harbor for "associated person(s)" of the issuer (i.e., employees, partners, officers and directors) who sell interests in the projects, if they meet certain conditions.

> IN ORDER TO QUALIFY FOR THE SAFE HARBOR, THESE NDIVIDUALS CANNOT RECEIVE COMPENSATION BASED ON THE SUCCESS OF THE TRANSACTIONS"
> SUZANNE MULVIHILL

In order to qualify for the safe harbor, these individuals cannot receive compensation based on the success of the transactions. Compensation that is contingent upon a securities sale or that is based on a percentage of investment is viewed by the securities regulators as a commission. Bonuses based on equity raised, for example, would likely also fall within the definition of sales based compensation. Forms of compensation that may not be viewed as commissions, depending on all the facts and circumstances, may include professional fees based on hourly billing rates or fixed fees, non-transaction based consulting fees, non-transaction based due diligence fees, or expense reimbursements.

In addition to the compensatory element, the associated person's sale activities must be passive in nature and fall within one of three categories. First, the associated person must restrict his/her participation to transactions involving offers and sale of securities to a registered broker or dealer; a registered investment company; an insurance company; a bank; a savings and loan association; a trust company or similar institution supervised by a state or federal banking authority; or a trust for which a bank, a savings and loan association, or a registered investment adviser. Second, the associated person primarily performs at the end of the offering substantial duties for or on behalf of the issuer otherwise than in connection with transactions in securities; and (a) was not a broker or dealer, or an associated person of a broker or dealer, within the preceding 12 months; and (b) does not participate in selling an offering of securities for any issuer more than once every 12 months other than as described in the first and second scenarios set forth above The final category requires the associated person restrict his/her participation to performing ministerial and clerical work involved in effecting any transaction.

Taken as a whole, the exemption is clearly intended to provide a means for a smaller developer to raise capital for a one-off deal. It is not meant to provide a vehicle for larger developers to regularly sell portions of their own projects even if such developers meet the letter of the exemption requirements. The SEC could, and very well might, take a substance over form position attacking developers who form separate and distinct entities for each individual deal. Courts also may uphold a disgruntled investor's suit for a right of rescission, which allows the investor to receive all of its original investment back plus interest. This remedy is particularly onerous and has widespread implications should a downturn in the economy affect real estate as it did just a short time ago.

Though exemptions exist for both the registration as well as broker-dealer aspects, failure to meet the statutory and regulatory requirements could result in loss of the exemption which could open the door for SEC and state enforcement, as well as private rights of action. The costs of defending such actions alone can be detrimental to a developer, not to mention the potential fines, penalties and rights of rescission. It is critical that developers get advice of counsel prior to raising private equity in order to successfully avoid such lawsuits or even criminal prosecution.

Suzanne Mulvihill is Managing Partner of Haight Brown & Bonesteel's Sacramento office and leads the firm's Transactional Practice Group. She focuses her practice on all aspects of corporate, real estate, tax, business, securities/finance, and employment matters.