

AN OVERVIEW OF PRIVATE PLACEMENT REQUIREMENTS WHEN RAISING FUNDS IN CALIFORNIA FOR REAL ESTATE INVESTMENT USING LIMITED LIABILITY COMPANIES

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1. Introduction

Lately there has been a surge in the popularity of privately held real estate investment vehicles, most often in the form of limited liability companies that are put together by small groups of wealthy investors for the purpose of investing in real estate. These activities present complex legal and tax aspects.

The purpose of this article is to provide a general introduction to securities law issues that should be considered when offering and selling limited liability company interests in the context of private real estate investment.

2. Analysis

Although not exhaustive, the analysis set forth below covers many basic questions relating to raising capital for privately held limited liability companies.

What is a limited liability company?

A limited liability company (LLC) is a flexible type of legal entity that allows investors to purchase membership interests in the limited liability company in exchange for capital contributions. LLCs are normally managed by a Manager, who undertakes the active role of managing the LLC, including identifying investment opportunities.

Are LLC interests in the proposed real estate investments considered securities?

In general, an interest in a limited liability company is considered a security. State and federal laws regulate securities and set forth compliance requirements for securities offerings. As a basic rule, under both federal and state law, every offer or sale of a security must be either registered or exempt. This applies even when offering securities to a very limited number of persons.

What is the preferable exemption to use?

Under federal law, there are two basic routes that are available to exempt an offering: Section 4(2) and Regulation D. Although they are technically part of the same exemption, a brief discussion of each is presented below.

Section 4(2)

Section 4(2) of the Securities Act of 1933, as amended, exempts transactions not involving a public offering (i.e. limited or private offerings) from the federal registration requirements. The Section 4(2) exemption is self-determining. In other words, there are no

precise guidelines under the statute to qualify for the exemption, but certain general requirements must be met:

(1) Sophistication. Investors must be sophisticated. Investors are considered sophisticated if they either have “such knowledge and experience in financial and business matters that they are capable of evaluating the merits and the risks of the prospective investment,” or are represented by a sophisticated “qualified representative”, as this term is defined in Regulation D.

(2) Access to Information. The offeror or issuer must make available to the investor information “similar to” that found in a registration statement. Offerees must be provided with material information about the issuer or have access to such information or economic bargaining power that effectively enables them to obtain the specific information they desire. The relationship between the issuer and each offeree is critical when the issuer relies on “access” to establish the exemption. The information need not be as extensive in scope as the information called for by the registration statement but should include information generally available in a registration statement, such as:

- (a) relevant financial statements and basic information on financial condition and results of operations;
- (b) information on the offering (including unusual attributes of the securities);
- (c) business, property, and management information;
- (d) information on the use of proceeds, special tax considerations, and risk factors (especially those specific to the issue) to the extent applicable for a fair understanding of the offering.

A useful practical reference to the type of information that should be provided is Schedule A of the Securities Act of 1933, as amended.

(3) Limited Number of Offerees. The availability of the Section 4(2) exemption also depends on the number of offerees. Their number must be limited and the greater the number of offerees, the more likely that the Section 4(2) private placement will not be available. Under no circumstances should the number of offerees exceed 35.

(4) Non-Public Manner of Offering. The manner in which an issuer effects its non-public offering is crucial to a valid Section 4(2) exemption. Two general conditions must be met:

- (a) The offering should be made through direct communication with eligible offerees; and
- (b) The offering cannot include any general solicitation or general advertising.

(5) Investment Purpose. The Section 4(2) exemption does not allow any immediate redistribution by the first-tier purchasers that would result in the overall transaction being a public offering. Therefore, the persons using the Section 4(2) exemption must purchase the LLC interest for investment purpose only, and not with a view toward distribution.

Offerings that rely on Section 4(2) are subject to an additional layer of state regulation for private offerings under California law. This means that the offering has to be qualified in California unless a corresponding state exemption is available. California has a private offering exemption for non-public offerings, which generally mirrors the exemption under Section 4(2). However, if a state exemption is unavailable, the offering has to be qualified under state securities laws.

Additionally, in California, real estate programs in the forms of limited partnerships and real estate programs in other forms are also subject to comprehensive regulatory guidelines for Real Estate Programs. These guidelines mandate disclosures about experience and net worth requirements for the sponsor of the program, limitations on indemnification of the sponsor, strict investor suitability standards, caps on fees (including brokerage and management fees) and on compensation and other expenses, enhanced conflicts of interests provisions and restrictions on investments, financing and exchange of interests.¹ See discussion below about special disclosure obligations for sponsors and organizers.

Regulation D

By contrast, Regulation D of the Securities Act of 1933 provides “safe harbor” rules allowing transactions that meet the requirements of these rules to *automatically qualify* for the Section 4(2) exemption.

The three safe harbor rules promulgated under Regulation D are Rule 504, Rule 505 and Rule 506. Although the rules are conceptually similar, there are differences in their respective requirements, including differences in the maximum amount allowed for the offering. Rule 504 and Rule 505 place caps (\$1 million and \$5 million, respectively) on the maximum offering amount in any 12-month period. Rule 506 is not subject to any maximum offering amount.

Whether it is preferable to rely on Section 4(2) alone or on a safe harbor rule depends on the nature of the offering and the applicability of the exemption requirements to a given set of facts. In general, however, Rule 506 is recommended, for two main reasons: (1) it is a safe harbor provision (that takes the guess work out of whether or not the offering is in compliance with Section 4(2)), and (2) offerings made pursuant to Rule 506 are not subject to state regulation of private offerings.

The remainder of this article covers requirements for safe harbor exemption under Rule 506.

How can an offering qualify for an exemption under Rule 506?

As a general rule, an offering qualifies for an exemption under Rule 506 only if it meets all the Rule 506 requirements. Rule 506 requirements include the number and type of investors, their relationships with each other and with the issuer; the number of units offered; the size of the offering, the information provided, the manner of the offering, resale limitations and notice filing requirements. These requirements are more fully discussed below.

¹ See Title 10 California Code of Regulations §§ 260.140.110 et seq.

What and how many investors can participate in a limited offering under Rule 506?

The number of investors who can participate depends on whether the investors are “accredited” or “non-accredited.” In fact, Rule 506 exempts offers and sales to no more than 35 purchasers, but excludes from this count “accredited” investors.

Accredited

There is technically no limit on the number of “accredited” investors who can participate in a limited offering under Rule 506, provided that the offering complies with all the other Rule 506 requirements and, in particular, with the solicitation and general advertising prohibition discussed later.

To be accredited, investors must meet certain objective criteria. There are eight categories of accredited investors under Rule 501(a), but the applicable definition for individuals is essentially a person who makes \$200,000 per year (or jointly with his/her spouse \$300,000) in the past two years with a reasonable expectation of the same in the current year, or who has individually or jointly a net worth in excess of \$1 million at the time of purchase. This \$1 million may include a person’s net worth in his or her primary residence. The accreditation requirements are more fully set forth in the definition of accredited investor under Rule 501(a).

Non-accredited

Investors who do not meet the Rule 501(a) accreditation requirements are “non-accredited”. Only up to 35 non-accredited investors can participate in a limited offering under Rule 506, provided that each non-accredited investor is “sophisticated” and that the offering complies with all the other Rule 506 requirements.

Investors are sophisticated if they either have “such knowledge and experience in financial and business matters that they are capable of evaluating the merits and the risks of the prospective investment,” or are represented by a sophisticated “qualified representative”, as this term is defined in Regulation D.

The offeror has a duty to assess the qualifications of each investor to determine whether such investor is eligible for participation. For example, a questionnaire can be used to obtain specific information to assess the objective accreditation criteria of prospective purchasers. It is crucial to ensure that all purchasers qualify. In fact, a purchaser’s failure to qualify constitutes a violation of the exemption requirement. Under ordinary circumstances, such violation makes the exemption automatically unavailable.

What information must be provided to investors under Rule 506?

A key element is to provide investors with enough information so that they are capable of reaching informed investment decisions. All information should be material to an understanding of the issuer, its business, and the securities offered, as is required if the securities were being registered. In applying this requirement, Rule 506 draws a distinction depending on whether the investors are all accredited or not.

If there are non-accredited investors, an issuer must, at a minimum, (1) furnish specified written information to each investor a reasonable time prior to sale, and (2) give each purchaser, at a reasonable time prior to sale, an opportunity to ask questions and receive answers. Information to be furnished includes extensive financial and non-financial information, akin to a SEC registered offering, as more specifically provided under Rule 502(b).

If an offer is solely directed to accredited investors, an issuer is technically not required to comply with the Rule 502(b) information requirement. Written disclosure is nevertheless advised both as (a) a matter of proof to establish what information is conveyed to the investors, and (b) for purposes of limiting the issuer's potential liability under applicable antifraud provisions. In fact, for any purchase and sale of securities, whether exempt or registered, the issuer must comply with applicable antifraud provisions, including Rule 10b-5 of the Securities and Exchange Act of 1934, as amended. Rule 10b-5 is a criminal provision that makes illegal any false or misleading statement or omission of a material fact made in connection with the purchase or sale of a security. At a minimum, it is very important to fully disclose the nature and risks of the investment to the investors. Specifically, key items such as appropriate risk factors, a description of the real property investment and the management of the LLC should be given in any written disclosure materials.

Are there special disclosure obligations for sponsors or organizers?

There may be special disclosure obligations imposed on persons organizing or controlling a limited partnership or similar vehicles such as LLCs. The Ninth Circuit Court of Appeals court held that "when a person organizes or sponsors the organization of a limited partnership and is primarily responsible for the success or failure of the venture for which the partnership is formed, he will be considered an issuer for purposes of determining the availability of the private offering exemption."² According to this holding, investors in limited partnerships in Section 4(2) offerings should receive detailed information about any sponsor or promoter who is primarily responsible for the success or failure of the venture for which the partnership is formed, including:

- (1) A detailed description of all services to be rendered by the sponsor and all compensation to be paid;
- (2) A detailed description of any goods or materials to be provided and the price to be paid, or the method for determining the price;
- (3) A description of the method of allocation of the acquisition of properties by two programs of the same sponsor seeking to acquire similar types of properties; and
- (4) Financial statements of the sponsor and of its affiliates.

As discussed above, California also imposes special disclosure standards on "sponsors" of real estate programs. In 1996, the National Securities Market Improvement Act ("NSMIA") was enacted, pre-empting state regulation of private offerings that rely on Rule 506.³ Arguably, under NSMIA, the special limited partnerships disclosure obligations required by California for

² See *SEC v. Murphy*, 626 F.2d 636 (9th Cir. 1980)

³ See §18 of the Securities Act of 1933

qualified offerings may not apply to private offerings made under the Rule 506 safe harbor provisions.

Nonetheless, based on the foregoing and considering both the broad reach of the antifraud provisions and the applicable information requirements of Rule 506, it is considered advisable by some practitioners to provide to investors the specific disclosure on persons organizing or controlling limited partnerships or LLCs.

What are the limits on the size of an offering under Rule 506?

Although the number of units and size of an offering are not express requirements for the exemption, if taken together with other factors, they may be relevant in the overall determination of the true nature of an offering. Some courts have looked at this issue in terms of “the smaller the size of the offering, the less likely it will be deemed to be public.”

How must the offering be conducted under Rule 506?

General solicitation and advertising in connection with the offering are prohibited. A key factor in determining whether a solicitation or advertisement is either general (prohibited) or limited (permissible) is the existence of a relationship between offerees and the issuer or any person acting on its behalf. For a solicitation from an issuer to be deemed to be limited, the issuer must have a substantive pre-existing relationship with the persons it contacts. This essentially means that (1) the offeror must have enough information to evaluate the offerees' sophistication and financial circumstances, and (2) the offeror-offerees relationships were created before the transmission of any pre-offering materials and they are separated from the offering by a sufficient lapse of time.⁴

Although the number of persons solicited does not appear to be a factor in determining whether a solicitation is in compliance with Rule 506, the magnitude of an offeror's solicitation may be important in showing the existence of substantive pre-existing relationships with each of the offerees.

Are pre-offering communications to determine a prospective investor's interest in the offering permissible?

Pre-offering communications are usually permissible so long as they comply with the limited solicitation and advertising rules stated above. As a precautionary measure, besides ensuring that the recipients all have a substantive pre-existing relationship with the offeror, any communications with offerees should clearly state that no LLC interests will be offered or sold until first (1) all required information is provided to each prospective investor; and (2) the issuer has determined that each prospective investor qualifies to participate in the offering.⁵

Are there any limitations on resale under Rule 506?

⁴ See *E. F. Hutton & Company Incorporated*, SEC No Action Letter, 1985 WL 55680 (December 3, 1985)

⁵ See *id.*

As a general rule, securities cannot be resold unless the resales are also either registered or qualify for an exemption from registration. The policy behind this is essentially to prevent public distribution of unregistered securities through conduits.

Under Rule 506, an issuer is required to exercise reasonable care to assure that the securities are purchased with “an investment intent and not with a view toward distribution.” Generally, an issuer can satisfy the reasonable care requirement if the issuer (a) makes a reasonable inquiry about the purchaser’s intent, (b) obtains a written representation from the purchaser and (c) places restrictive legends on the certificate or other document evidencing the security. (See Rule 502(d)).

What filings are required under Rule 506?

When an issuer claims the limited offering exemption under the Rule 506 safe harbor, the issuer must satisfy certain filing requirements via a Form D filing.⁶ Generally, Form Ds must be filed with the SEC and with the corresponding commissions in the states in which the securities are offered. Most states charge filing fees.

Will the LLC offering be combined with other LLC offerings under Rule 506?

An important issue to consider in connection with using Rule 506 is the concept of integration. As a general rule, offerings that occur within a six-month period and share similar characteristics can be deemed “integrated”.⁷ This essentially means that the offerings are treated as a single offering for purposes of compliance with the exemption requirements. For example, offerings could meet the limited offering requirements individually but not if aggregated. Accordingly, integration can potentially jeopardize the availability of the limited offering exemption and expose the issuer to liability for conducting an unregistered public offering.

Under certain circumstances, the integration concept is also applicable to offerings made by different issuers within a six-month period if the issuers are deemed to be a “single business enterprise.” If so, all offers and sales of securities are deemed to be “part of the same offering” and, therefore, must meet all the conditions for the exemption.

The criteria vary for determining when a relationship between business entities constitutes a single business venture for purposes of integration. In one case, a court suggested that offerings made by two different limited partnerships with projects in different states but with the same managing partner and with the same interests, rights and obligations given to the limited partners might be integrated.⁸ However, in another situation involving the sale of limited partnership interests by partnerships that developed apartment building projects in different sites but had the same general partner, the SEC staff concluded that the offerings were not subject to integration.⁹

⁶ See 17 CFR 230.503.

⁷ See 17 CFR 230.502(a).

⁸ See *Western-Realco Ltd. Partnership 1983-A v. Harrison*, 791 P.2d 1139 (1989).

⁹ See *Vance Miller*, SEC No Action Letter, 1979 WL 13490 (February 23, 1979)

In practice, the determination of whether two or more affiliated businesses are a single business enterprise is made on the basis of numerous considerations, not the least of which is how independent each business entity will be after the offering of its securities.

Do state securities requirements apply?

As mentioned above, securities offerings are also subject to state law requirements. In general, if securities are offered or sold in different states, the offerings must be either qualified or exempted in each state, as applicable. Even though NSMIA has pre-empted state regulation of private offerings that rely on the Rule 506 exemption, Rule 506 offerings can still be subject to certain state filing requirements such as, for example, Form D notice filings. Accordingly, it is necessary to know beforehand in which states the issuer proposes to conduct the offering.

What are the consequences for failing to observe the Rule 506 requirements?

Failure to comply with any one of the Rule 506 requirements ordinarily makes the Regulation D safe harbor unavailable and may invalidate the Section 4(2) exemption. In that case, the offering would be deemed an unregistered public offering in violation of federal securities law registration requirements. Furthermore, offerings that are not exempt under Rule 506 may also be violating state securities regulation and qualification requirements and may also be subject to special state legislation applicable to real estate programs.

3. Conclusion

Real estate investing through privately held limited liability companies presents opportunities but also has many risks and complexities. As discussed above, there are many securities law issues that should be considered when considering to offer and sell limited liability company interests. In view of these and other issues, and the potential pitfalls, anyone who is interested in learning more about these topics should consult with legal and tax advisors before taking any action.

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