



Raising Capital for Real Estate Ventures: *Do Not Ignore Securities Laws*



Peter Pokorny
Peter@RECDC.com
(703) 850-9099



Heather Batzel
Heather.Batzel
@batzellaw.com
(202) 741-9574

- **Show Me The Money** - When purchasing real property, buyers rarely pay the entire purchase price in cash. Usually there is some debt financing such as from a bank loan. Lenders, however, rarely finance the entire purchase price of a property. Lenders will usually limit their loan amount to between 60% to 90% of the purchase price of the property, requiring a buyer to use its own funds to make up the difference. The portion of the property's purchase price not financed is the buyer's equity. Requiring a buyer to have equity gives lenders comfort that the buyer will manage the property prudently.

Sometimes, a buyer may have sufficient resources to fund this equity requirement. In many cases, however, a party interested in buying property will consider having one or more investors, to collectively pool funds.

- **Joint Ventures** - A common way for parties to hold real property (as well as raise money for real estate investments) is through a joint venture (JV). A JV typically consists of two or more people and/ or entities with a view to sharing the profit or loss of a business venture in accordance with the JV agreement.

In years past, most joint ventures were limited partnerships with the general partner acting as manager and the investors as limited partners. Today, the common structure is a limited liability company (LLC), where the investors are members. Usually, the manager is a member as well, though some LLCs have non-member managers.

- **Securities Laws** - When most people hear the term "securities" they think of stocks and bonds of large companies like Google or IBM, what gets "traded" on Wall Street. The legal definition of "securities" is much broader, however, and the regulations concerning securities impact even small businesses.





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- **Securities Laws (cont.)** Almost any time a party contributes money (or even other assets like property or even services) in exchange for an interest in something that is intended to generate a profit (like share in a company), securities laws are implicated. Generally speaking, any equity interest in a company (such as stock in a corporation, membership interest in an LLC, or partnership units) is a security unless there are specific statutory exceptions.

Courts have widely held that an offering is a security if an investor has an expectation that profit will hopefully be earned substantially through the efforts of the person(s)/entity providing the offering. As an example, an investor who expects to make a profit solely by putting in cash but has no involvement, vote or say in the investment is the type of investor that the securities regulators would by default aim to protect.

Sometimes, the stock share, membership interest, etc., is indeed a security, but the transaction itself is exempt. Parties often lose sight of the fact that even exempt transactions are subject to securities laws, such as the antifraud provisions, resale restrictions and filing undertakings.

- **Misconceptions** - Contrary to popular belief, an investor who receives a deed may be considered to be buying a security. Another misconception is that sale of an investment to a number of investors below a certain threshold is not the sale of a security. Depending on the circumstances, the sale of investment property deeded to two people can be a regulated securities offering.
- **Offerings** - Each time an investment opportunity is offered, the people involved in the offering (e.g., the buyer raising equity from investors, etc.) need to determine whether it is the sale of a security and whether the transaction is exempt from SEC registration and state-based laws. From a prudent and practical legal perspective:
 - Generally, securities laws require any party seeking an investment to provide extensive and expensive disclosure documents and audited financials, regarding the nature of the venture or investment.
 - *Among other things that federal securities laws restrict are advertising and promotion to even the sponsor's existing network of family, friends, past investors and professional contacts.* In addition, the sponsor may need to make available to each prospective investor sufficient information to evaluate the merit of the offering. Even where this is not required, many, if not most, sophisticated issuers/sponsors use a private placement memorandum (summary of the investment) which sets out important disclosures, disclaimers and warnings that inform the investors and protect the issuer.



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MD: (240) 252-3386

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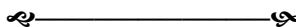
▪ Offerings (cont.)

- Federal securities laws reduce the detailed disclosure obligations if all potential investors meet the criteria for an “accredited investor” discussed below.
- If you are coming together with others to actively run the business, absent fraud or intentional omission or misstatements to your partners, the undertaking is likely not subject to SEC registration.
- Companies issuing securities (e.g., shares in a company or interest in an LLC) need consider carefully to whom they are marketing and if they are undertaking a public or private offering. Not considering securities implications in advance can close doors on desirable avenues and give rise to higher compliance standards and costs.

- **Safe Harbors** - As previously noted, the Securities Exchange Commission (SEC) and the comparable state regulators reduce the obligations concerning disclosures when dealing with an “accredited investor.” The SEC defines “Accredited Investors” at Rule 501 under Regulation D of the Securities Act of 1933 and in Rules 504, 505, 506(b), and 506(c) establishes cases where a company issuing securities relieved of specified disclosures, and/or certain cases where disclosures can be made using only a private placement memorandum or similar offering document that doesn’t have to be filed with the SEC (PPM).

Whether a particular transaction and potential group of investors meets one or more of these safe harbor exceptions is fact dependent and should be discussed with a securities lawyer. In addition to these safe harbors, finding an applicable state exemption may be required.

- **Violation** - An investor who fails to comply with applicable securities laws may face civil and criminal penalties. Additionally, securities litigation fees can be costly.
- **Conclusion** - A fundamental understanding of applicable federal and state securities regulations is essential for any investor raising money for real estate ventures through a joint venture among other contexts. An investor who makes an offering and chooses to ignore these issues may face civil and criminal penalties if non-compliant with securities laws.



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