SPECIAL DISCLOSURES FOR INVESTMENTS IN REAL ESTATE DEALS COMING?

Wanted to alert readers to a California Senate Bill, SB978 which went into suspense last week, but which raises significant issues that most of us working with real estate investors have seen particularly over the last five years. The issues were highlighted June 2011 by Sac Bee reporters Charles Piller and Robert Lewis when they wrote a story about the damage done to investors in hard money loans in Nevada County. The victims in the story were not the borrowers, but people who loaned money to hard-money lenders to fund the hard money loans:

> *Some of those investors entrusted their entire life savings to brokers who used the money to make high-interest loans to people who either didn't qualify for a traditional bank loan or who needed money fast.*

[Reading the stories, it turns out that most of these investors, though not all, were pretty well off financially, before the real estate crash]. In reaction, a bill is winding its way through the California Senate, SB 978, intended to address these problems. SB 978 as amended to date would have imposed significant legal burdens not only on most borrowers but also the entire real estate industry. Although it won't get into law this year, I think it is important for everyone working in the industry to be advised of the issues raised by the proposed legislation. I have seen varieties of such "security" related non-disclosure claims in a number of cases I have handled over the last couple of years. These disclosure requirements will probably not disappear.

As it stands, and in gross summary [I am truncating for simplicity's sake] Corporations Code 25102 requires disclosure of financial risks to investors in securities, in writing, when an investment is not exempt. Generally, investment in real estate promissory notes have been treated as a non-security unless they are a pooled submission, and even if deemed a security, normally the people who invest would qualify under one of the limited offering exemptions so that the entity putting together the investment would not be required to prepare and file a securities prospectus. Thus investments in real estate limited partnerships and LLC's generally have not received any kind of risk analysis from any broker.

What SB 978 would do is require detailed disclosures to potential investors. As written it affect a wide swath of the real estate industry, including, for example, real estate investment companies that offer and sell equity securities in reliance on Corporations Code Section 25102(f) or real estate brokers implementing stock option plans in reliance on Section 25102(o). These new regulatory burdens will weigh not just on the real estate industry and borrowers generally, but also on the Department of Corporations. If SB 978 is enacted, the Department will be forced to contend with a massive influx of new filings largely unrelated to the problem of hard-money lending. It is interesting that the onus of regulating this type of disclosure will end up with the Department of Corporations under SB978, instead of the Department of Real Estate, given the Arranger of Credit rules and disclosure forms already required to be used by real estate brokers, and mortgage brokers [See California Civil Code §§2956-2967]. Those forms assume a seller-carry back or smaller "creative financing" solution – but the risks inherent in investing in real

estate, especially in a California historically antagonistic to deficiency judgments, can be incorporated into the pre-existing forms.

In effect, the bill requires the building of a haystack of new security filings to find some needles of information about hard-money lenders, and expand jurisdictional supervision of such loans. These proposed requirements are very similar to those currently applied to attorneys in ensuring compliance with the sale of securities, interests in stock offerings, for example, but which have always previously been exempted when applied to real estate transactions handled by real estate agents, brokers, or mortgage brokers.

First, the bill would amend Section 25102(e) to require a notice-filing for the offer or sale of any evidences of indebtedness [including all real estate investments-this is new, new]. This change alone would impact a huge number of *borrowers*. Section 25019 defines "security" to include any evidence of indebtedness. Currently, borrowers can rely on Section 25102(e) as a self-executing exemption from the qualification provisions of Section 25110 provided the offer and sale does not involve a public offering. If the bill is enacted in its current form, the Department of Corporations will be inundated with filings, the vast majority of which will not be made by hard-money lenders.

Second, SB 978 would impose additional informational, recordkeeping and suitability requirements on virtually any real estate related issuer – read "loan or mortgage broker or arranger of credit". The bill would add a new Section 25102.2 to require any issuer [that is someone who packages the loan] that relies upon an exemption from Section 25110 with respect to the offer or sale of securities, other than an exemption provided by Section 25102.5, and that is principally engaged in the business of purchasing, selling, financing, or brokering real estate, to provide additional information regarding the nature of the proposed offering on a form prescribed by the Commissioner. These issuers would also be required to make reasonable efforts to ensure all of the following:

- All persons to whom securities are sold can be reasonably assumed to have the capacity to understand the fundamental aspects of the investment, by reason of their educational, business, or financial experience.
- All persons to whom securities are sold can bear the economic risk of the investment.
- The investment in the security is suitable and appropriate for each purchaser, given the purchaser's investment objectives, portfolio structure, and financial situation.