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A Not So Gentle Reminder that Real Estate Investments are Securities

It is a common misconception in the world of real estate investing that passive interests in real estate are not securities and therefore outside the scope of the Securities Act of 1933 (the "**Securities Act**"), which requires registration of securities offerings, and the Securities Exchange Act of 1934 (the "**Exchange Act**"), which requires, among other things, the registration of broker-dealers. While active interests in real estate may not be "securities" as that term is defined in the Securities Act and the Exchange Act, passive investments in real estate are "securities" and those who offer and sell such interests must conform to the requirements of the Securities Act and the Exchange Act or face severe consequences.

Capsource, Inc.

Capsource, Inc., a Nevada based hard money lender ("**Capsource**") was in the business of facilitating real estate transactions by offering and selling interests in real estate loans to investors. The real estate loans were provided to third-party real estate developers and interests in the loans were sold to third-party investors, each of whom received a fractional share of the real estate loan proportionate to its investment, including a secured interest in the underlying real estate, if applicable. From approximately January 2015 through May 2019, Capsource offered and sold over $151 million of securities, primarily loans, of approximately 60 issuers to hundreds of investors nationwide through unregistered offerings.

Capsource identified potential borrowers and projects, conducted due diligence thereon, and, for each loan, drafted a written summary describing, among other things, the loan terms, the project, the proposed use of proceeds, the borrower and the collateral. Capsource then marketed interests in the loans to prospective investors that it had identified through seminars and speaking engagements and leads provided by a network of external finders. Capsource received transaction-based compensation for each loan interest offering in the form of percentage-based fees.

Capsource was not registered as a broker-dealer with the SEC, and its principals were not associated with a registered broker-dealer.

Complaint

In December, 2020, the SEC brought suit against Capsource and two of its principals, Stephen J. Byrne and Gregory P. Herlean for (1) acting as unregistered broker-dealers in violation of Section 15(a) of the Exchange Act, (2) selling securities without a valid registration statement or without a valid exemption from registration in violation of Sections 5(a) and 5(c) of the Securities Act, (3) engaging in fraudulent practices and making untrue statements of material facts (or omitting to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading), in violation of Section 17(a) of the Securities Act, and (4) engaging in fraudulent practices and making untrue statements of material facts (or omitting to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading), in violation of Section 10(b) of the Exchange Act and Rule 10b-5.

Capsource, Byrne and Herlean consented to entry of judgement. Byrne agreed to pay disgorgement of $1,538,990, with prejudgment interest of $200,844 and a civil penalty of $192,768, Herlean agreed to pay disgorgement of $760,303, with prejudgment interest of $90,319 and a civil penalty of $192,768, and Capsource agreed to monetary relief to be determined by the court at a later date. In addition, Capsource agreed to retain a chief restructuring officer to wind down its business. Finally, each of Capsource, Byrne and Herlean were permanently enjoined from violating the broker-dealer registration provisions of Section 15(a) of the Exchange Act, the registration requirements of Sections 5(a) and 5(c) of the Securities Act, the antifraud provisions of Section 17(a) of the Securities Act, and the antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Securities Act Violations

The SEC accused Capsource, Byrne and Herlean of selling securities without a valid registration statement or without a valid exemption from registration in violation of Sections 5(a) and 5(c) of the Securities Act. Section 5(a) of the Securities Act states that, "[u]nless a registration statement is in effect as to a security, its shall be unlawful for any person, directly or directly (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale." Section 5(c) of the Securities Act states that "[i]t shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8."

No registration statement was filed in connection with any of the securities offerings nor did any of the transactions satisfy the condition for an exemption from registration. Therefore, if the interests Capsource, Byrne and Herlean sold to investors constituted "securities" as defined under the Securities Act, such sales were in violation of Section 5(a) and 5(c) of the Securities Act.

Exchange Act Violations

The SEC further accused Capsource, Byrne and Herlean of acting as unregistered broker-dealers in violation of Section 15(a) of the Exchange Act. Section 15(a) of the Exchange Act states that "[i]t shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person. . . to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security. . . unless such broker or dealer is registered in accordance with subsection (b) of this section."

A broker is a person engaged in the business of effecting transactions in securities for the account of others. A dealer is a person engaged in the business of buying and selling securities for such person's own account. Capsource, Byrne and Herlean were effecting transactions for third party real estate developers and investors, and therefore were acting as brokers for purposes of the Exchange Act. Capsource was not registered as a broker with the SEC and neither Byrne nor Herlean were associated with a registered broker. Accordingly, if the interests that were being sold to investors constituted "securities" under the Exchange Act, Capsource, Byrne and Herlean were in violation of Section 15(a) of the Exchange Act.

Passive Interests in Real Estate Investments are Securities under both the Securities Act and the Exchange Act

Both the Securities Act and the Exchange Act define "security" to include, among other things, an "investment contract". The Supreme Court in the seminal case of SEC v. Howey Co., 328 U.S. 93, 298-99 (1946) defined an "investment contract" as a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interest in the physical assets employed in the enterprise."

In evaluating whether a real estate investment constitutes a security, the operative question is whether the interest constitutes a passive investment in which the investor expects to realize profits solely from the efforts of a third party, or an investment in which the investor expects to realize profits from his own efforts.

Investors who passively invest in a real estate investment, whether in the form of equity or debt, in the expectation that a third-party owner or developer will develop and operate the real estate and generate profit that will be shared with the investor, whether such return is characterized as profit, interest, dividend, or something else, are investing in an investment contract and therefore a "security" as defined under both the Exchange Act and Securities Act.

As discussed above, the investors in the loans sold by Capsource were passive investors who were relying solely on the third-party developers to realize profits from their investments. The loans thus constituted investment contracts and were thus "securities" under both the Exchange Act and Securities Act. Because the securities were sold using the means or instruments of interstate commerce without an effective registration statement or a valid exemption therefrom, they were being sold in violation of Section 5(a) and 5(c) of the Securities Act. Because Capsource, Byrne and Herlean were using the mails or any means or instrumentality of interstate commerce to effect the sale of securities, Capsource was required to be registered as a broker with the SEC and Byrne and Herlean were required to be associated with a registered broker. Because Capsource was not so registered and Byrne and Herlean were not so associated with a registered broker, their actions were in violation of Section 15(a) of the Exchange Act.

Conclusion

Persons engaged in the selling of passive interests in real estate investments must be aware that such investments constitute securities under the Exchange Act and Securities Act and must ensure that such transactions are compliant with the Exchange Act and the Securities Act. If acting as brokers and using the mails or any means or instrumentality of interstate commerce, such persons must register as brokers or associate themselves with a registered broker. Further, sales of such securities must be made only in reliance on an effective registration statement or in transactions exempt from such registration requirement.

This article does not constitute legal advice and is provided for general information purposes only. If you require specific legal advice, you should contact an attorney. Fragner Seifert Pace & Mintz, LLP can only offer legal advice to its clients who have engaged the firm for that purpose.

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About Eric Rubenfeld

Eric Rubenfeld is a partner with Fragner, Seifert Pace & Mintz, LLP (f/k/a Fragner Seifert Pace & Winograd, LLP), a boutique law firm serving the legal needs of emerging and institutional business clients. Eric specializes in advising alternative investment advisers on all aspects of their business, including operational and transactional matters (including joint-ventures, financings, asset acquisitions and dispositions, fund formation and fund raising), dispute resolution, and regulatory compliance. Eric draws on his experience as a former principal, general counsel and CCO at multiple alternative investment firms and at top international law firms to deliver business savvy and cost-effective legal service to his clients.

Before returning to private law practice with FSPM in 2017, Eric spent over a decade as the general counsel and chief compliance officer of multiple multibillion-dollar institutional investment advisers specializing in private and public equity investments in real estate and corporate debt and equity. In addition to handling legal and compliance matters, Eric also managed HR and risk management and served on the management, investment, valuation, and risk and conflict committees.

Eric began his legal career practicing corporate law and litigation in New York City and Washington, D.C., including stints at Fried, Frank, Harris, Shriver & Jacobson and Arnold & Porter. Eric advised leading financial institutions, including Goldman Sachs, Morgan Stanley, Merrill Lynch and J.P. Morgan, in connection with their securities and structured product offerings, and represented private and public companies in litigation in both federal and state courts.

Eric earned his J.D., cum laude, from the Harvard Law School in 1995 and his B.A., magna cum laude and with college and departmental honors, from UCLA in 1991.

Eric recently:

- Represented a co-general partner in the formation of a new real estate private equity fund adviser and the formation of its first co-mingled fund
- Represented a private equity fund in assembling, financing, and selling a $300+ million data center portfolio in the United States and Canada
- Represented a private equity fund in $200 million of secured, property financings
- Represented a private equity fund in a $75 million shopping center construction loan
- Represented a private equity fund in $50 million subscription credit facility
- Advised a founding partner of a private equity firm in a business control dispute

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About Fragner Seifert Pace & Mintz, LLP

Fragner Seifert Pace & Mintz, LLP was founded nearly 20 years ago with one simple mission: to provide the highest quality legal services to real estate and business clients to help them achieve their business objectives with maximum efficiency. To accomplish this goal, we staff matters leanly with highly experienced attorneys who use time-tested strategies grounded in decades of experience to achieve efficient execution. Our quality over quantity approach results in lower cost and superior execution that yields benefits to our clients on an immediate, short-term and long-term basis.

Our core practice is representing sophisticated owners, operators, investors, lenders, and advisers in real estate and business matters, including entity formation and structuring, joint ventures, capital raising and financing, asset and stock acquisitions and dispositions, mergers and acquisitions, and leasing and operations, across the United States.

Our attorneys are licensed to practice law in California, Illinois, New Jersey, New York, Pennsylvania, and Texas.