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Selling Securities? Owners and Managers can be Personally Liable. PPM Reduces Risk

Article By:

Michael Van Someren

Joseph E. Tierney IV

Under state and federal securities laws, owners and managers of companies raising capital through sale securities (e.g., stock or membership interests in companies) can be personally liable for material misrepresentations and omissions in any description of the business or investment. To reduce the likelihood of any personal liability, companies selling securities should utilize a private placement memorandum (a “**PPM**”). A PPM provides companies (and their ownership and management) with proof that no material misrepresentations or omissions were made in connection with the sale of the securities, allowing such companies to counter any fraud claim brought by an unhappy investor.

An investment in a new company, whether it is an operating company that provides goods and services or a real estate holding company, is usually evidenced by an ownership interest in the entity in the form of stock certificates for corporations, membership interests for limited liability companies (“**LLC’s**”), or limited partnership interests for limited partnerships. Regardless of the type of entity or the business that the entity will undertake, all of the ownership forms discussed above likely constitute a security under federal and Wisconsin law, and therefore, the investment is governed by the federal and state securities laws.

What is a Security?

A “security” is a term that includes a wide variety of investments but can essentially be defined 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.” Thus, when an investor gives his or her money to a developer or owner in connection with the acquisition or development of a real estate project or an investment in a new business, that investor is likely purchasing a security. Determining whether an investment is a security will depend, for the most part, on the amount of involvement of the investor in the success or failure of the real estate project or new business. The more active the involvement in the real estate project or business (e.g., having a substantial degree of control over the entity, or sourcing sales, tenants, contracts, managers, etc.), the less likely the investor’s investment will be considered a security.

Whether an investment is a security is important because every sale of a security must either be (1) registered with the Securities and Exchange Commission (the “SEC”); or (2) subject to an exemption to registration under the Securities Act of 1933 (the “’33 Act”).

In addition to operating companies providing goods and services, investments in real estate are often subject to the securities laws. Most investments in real estate are made through an exemption to securities registration known as a private placement. Generally, private placements are only available to “accredited investors.” Accredited investors are a class of entity or individuals (generally wealthy individuals) believed to not need much legal protection. Other than a prohibition on making misleading statements or omissions, there are no statutory provisions governing the disclosure of information to accredited investors. Only when securities are being sold to non-accredited investors do the securities laws require certain disclosures be made about the investment and its potential risks and rewards.

The potential liability for making a materially misleading statement or omission can be steep. Under Rule 10b-5, if it is determined that an issuer made a materially misleading statement or omission to investors, the investors may be able to sue for the difference between the price paid for the securities and the actual value when purchased. Further, under Section 20(a) of the Securities Exchange Act of 1934, “controlling persons” may be jointly and severally liable for any materially misleading statements or omissions in a securities offering. This means an issuer’s managers and the individual owners who indirectly or directly control the issuer may be personally liable for damages incurred by investors caused by materially misleading statements or omissions. For example, an investor may invest $100,000 for a 10% interest in a real estate venture that includes the acquisition and construction of a new project. The project is never completed and the investor sues on the basis that a materially misleading statement was made by the issuer. If the courts determine that a materially misleading statement was in fact made, or included a statement that would have made a factually accurate statement not misleading, the court may determine that the value of the 10% interest at the time of investment was$0.00 because the issuer did not own the real estate. In such a scenario, the investor could potentially collect a total of $100,000 in damages from the company as well as the controlling members of the company at the time the investment was made.

Private Placement Memorandum, When to Utilize and Benefits.

Despite the lack of a legal requirement to make disclosures about an investment, many companies prepare and distribute a PPM relating to each investment. Such PPMs are then distributed to potential investors regardless of whether such investor is accredited or not. In fact, even in offerings limited to accredited investors only, issuers often still prepare and distribute PPMs. So when and why are PPMs necessary? When is it worth the time and money to have a PPM prepared? What level and detail should be included in the PPM?

It is a best practice, and some argue a legal requirement, to prepare a PPM for every investment, regardless of the number of investors. A well-prepared PPM works as both a marketing tool and an insurance policy. The PPM should set forth a detailed description of the investment, the intended sources and uses of all funds necessary for the project (including all debt and issuer and investor equity contributions), a history of the issuer and any sort of market studies that support the proposed investment. Also, it should include a detailed analysis of potential risks related to the investment, including the prospect that it could fail completely and the investor could lose his or her money. The PPM should also avoid any sort of puffery or exaggerations that could be deemed to be misleading. The foregoing is not a comprehensive list of items to be addressed, and a lawyer should be consulted on a formal basis in PPM preparation to ensure disclosure is appropriate.

The primary benefit of the PPM is from a risk mitigation standpoint. It is a written record of the issuer’s adequate explanation of the risks related to the investment. If a PPM is provided in connection with an investment and the investment does not pan out, it will be much harder for investors to claim they were misled.

While it is best from a legal perspective to use a PPM for every investment, a full PPM may not always be practical. If an issuer intends to raise a small dollar amount and/or intends to raise the investment dollars from a small group of sophisticated investors, the parties may forego a full PPM for a smaller and condensed version. In these instances, the potential investors should be able to negotiate the exact terms of the investment directly with the issuer and work those terms into the operating agreement or limited partnership agreement. Those investors should also possess the requisite business experience to meaningfully negotiate such document. While the investment is more tailored and incorporated in the issuer’s operating agreement or limited partnership, a subscription agreement should be utilized for the investment. The subscription agreement should include a number of disclaimers and notices (similar to those in a PPM) which ensure that each investor acknowledges the risks associated with his or her investment. This includes the risk that the investor could lose his or her entire investment. Again, this may not be legally optimal, but rather a practical decision of the parties.

Conclusion ?

In light of the flexibility of the securities laws and the potential liability for violating the securities laws, it is important to have counsel review the proposed offering and determine whether, and to what extent, a PPM is appropriate. Generally, if there is a larger pool of investors, a substantial amount of funds to be raised, or any lack of relative sophistication among the investors, the more a thorough PPM is going to be appropriate. It is important to note that this article does not address any filing requirements associated with an investment in a company. It is limited to only the disclosure obligations related to a private placement of securities.

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