

Real Estate Investments, Public Offerings, and the New York Real Estate Syndicate Act

Leslie J. Levinson

Follow this and additional works at: <https://scholarship.law.stjohns.edu/lawreview>

Recommended Citation

Levinson, Leslie J. (1983) "Real Estate Investments, Public Offerings, and the New York Real Estate Syndicate Act," *St. John's Law Review*: Vol. 57 : No. 3 , Article 13.

Available at: <https://scholarship.law.stjohns.edu/lawreview/vol57/iss3/13>

This Recent Development in New York Law is brought to you for free and open access by the Journals at St. John's Law Scholarship Repository. It has been accepted for inclusion in St. John's Law Review by an authorized editor of St. John's Law Scholarship Repository. For more information, please contact lasalar@stjohns.edu.

REAL ESTATE INVESTMENTS, PUBLIC OFFERINGS, AND THE NEW YORK REAL ESTATE SYNDICATE ACT

LESLIE J. LEVINSON*

Countless times each year, real estate transactions similar to the following hypothetical arrangement are presented to attorneys across the State of New York:

A and B, as an investment, desire to purchase a small apartment building or other income-producing property utilizing either a corporate or partnership form of ownership. The financial institution from which they planned to borrow substantially all of the purchase price, however, has advised them that it will loan them no more than 60 percent of the requisite sum, even though the loan will be secured by a first mortgage and security interest on the property to be acquired. A and B do not possess the collective financial ability to contribute all of the required equity portion of the purchase price. In discussing the prospective acquisition with their attorney, A and B inquire about alternative methods of obtaining the required equity capital including selling interests in the partnership or shares in the corporation to friends, relatives and business associates residing in New York.

Given such circumstances, it is essential to determine whether the New York Real Estate Syndicate Act¹ (the Act), which deals with "public offerings" of securities in real estate ventures, applies, for

* B.A., University of Wisconsin, 1977; J.D., Case Western Reserve University, 1980. The author is presently associated with the New York City law firm of Bloch, Graff, Danzig, Jelline & Mandel.

¹ N.Y. GEN. BUS. LAW § 352-e (McKinney 1968 & Supp. 1982-1983). Article 23-A of the General Business Law, commonly referred to as the Martin Act, provides the framework for the regulation of the offer and sale of securities in New York. *See id.* §§ 352 to 359-h. The Real Estate Syndicate Act was added to article 23-A in 1960, ch. 987, [1960] N.Y. Laws 2434, and "reaffirmed existing authority that . . . limited partnership interests, stocks, bonds and other securities of real estate companies are 'securities' within the purview of the Martin Act . . ." *Reiter v. Greenberg*, 21 N.Y.2d 388, 392, 235 N.E.2d 118, 121, 288 N.Y.S.2d 57, 61 (1968). The Act has encompassed, in addition, certain real estate offerings that traditionally had not been considered securities. *See Comment, Blue Sky Laws in the Empire State and the Uniform Securities Act*, 22 SYRACUSE L. REV. 925, 938 & n.73 (1971); *see also* 1 L. LOSS, SECURITIES REGULATION 491-93 (2d ed. 1961 & Supp. 1962).

if the Act applies, a number of requirements must be satisfied before potential offerees may be approached about the prospective investment.² The answer to this question, however, is not entirely clear. First, the term "public offering" is not defined in the Act, nor is it defined in any other section of the New York securities laws.³ Furthermore, there is a marked dearth of adequate guidelines concerning whether, in such a case, the "public" will be approached so as to invoke the provisions of the Act.⁴ Based upon a review of existing case law, this Article suggests parameters for the adoption of a statutory or administrative definition as to when a public offering is made with respect to the Act sufficient to require the application of the statute to a particular transaction.

The necessity for adequate guidelines in this area is manifest. Unless a legislative or administrative exemption is available,⁵ the hypothetical transaction above, if deemed to involve a public offering, would require a detailed disclosure document, previously filed with and approved by the New York State Department of Law, to

² See generally [1982] 13 N.Y.C.R.R. §§ 16.1-.10. Section 352-e requires that an "offering statement" or "prospectus" be filed with the New York State Department of Law before a public offering can be made. N.Y. GEN. BUS. LAW § 352-e(1)(a) (McKinney Supp. 1982-1983). Among other things, all information material to the offering must be included in the prospectus. See [1982] 13 N.Y.C.R.R. § 16.2(b)(3)(xxv). All firms required to file under section 352-e also must file annual reports with the Department of Law. *Id.* § 16.7. Filing fees are charged for all filings, amendments and exemptions. N.Y. GEN. BUS. LAW § 352-e(7)(a) (McKinney Supp. 1982-1983).

³ See *People v. Michael Glenn Realty Corp.*, 106 Misc. 2d 46, 47, 431 N.Y.S.2d 285, 286 (Sup. Ct. N.Y. County 1980); *Ledgebrook Corp. v. Lefkowitz*, 77 Misc. 2d 867, 871, 354 N.Y.S.2d 318, 322 (Sup. Ct. Westchester County 1974); see also *Montana, Limited Partnerships and the Martin Act*, 51 N.Y.S.B.J. 283, 284 (1979). According to *Montana*, the offer of even one limited partnership interest to a sophisticated investor may require compliance with New York's state securities laws. *Montana, supra*, at 285.

⁴ *E.g.*, *Montana, supra* note 3, at 284-85.

⁵ See N.Y. GEN. BUS. LAW § 352-g (McKinney 1968). Section 352-g permits the attorney general to exempt from registration requirements any offerings made to not more than 40 persons. *Id.* This section also allows the attorney general to exempt securities that have been fully registered with the Securities and Exchange Commission (SEC), and those that have received an exemption from registration from the SEC for any reason other than that the offering was an intrastate offering. *Id.* For a detailed explanation of the prerequisites for an exemption, see N.Y. Dep't Law, Instructions for § 352-g Exemptions 1-5 (1982) [hereinafter cited as Exemption Instructions]. See generally N.Y. Dep't Law, Policy Statement No. 100 (1982) [hereinafter cited as Policy Statement 100]; Note, *State Exemptions from Securities Regulation Coextensive with S.E.C. Rule 146*, 61 CORNELL L. REV. 157, 162 (1975). Section 352-e, by its terms, also provides an exemption for offerings not considered to be "real estate" as that term is defined in section 352-e. See N.Y. GEN. BUS. LAW § 352-e (McKinney 1968).

be delivered to prospective investors.⁶ Moreover, certain additional filings would have to be made with the department before the investors lawfully could be solicited.⁷ Needless to say, such requirements, including seeking an exemption therefrom, can often be costly and time consuming,⁸ and serious penalties may be imposed for violations of the Act.⁹ Thus, absent a clear definition of what constitutes a public offering, many prospective issuers and their principals may be advised by cautious counsel to comply with the statutory and administrative provisions in any offering that arguably might be considered public. As a condition of making its loan, moreover, the lender financing the acquisition may, depending upon the size of the loan, require the borrower to warrant that the sale of partnership interests or shares were made in compliance

⁶ See *supra* note 2.

⁷ In addition to delivering a detailed disclosure document to prospective investors, issuers of securities in a public offering must register as "dealers" with the Department of Law. See N.Y. GEN. BUS. LAW § 359-e (McKinney 1968 & Supp. 1982-1983). They may, however, seek an exemption from registration under section 359-f. *Id.* § 359-f. The attorney general may grant an exemption from registration as a dealer if, among other reasons, the offering is limited to not more than 40 persons. *Id.* § 359-f(2)(a). This exemption may be requested in the issuer's section 359-g exemption application or in a Policy Statement 100 application. The issuer must also file a "State Notice" and a "Further State Notice." *Id.* § 359-e(2), (8) (McKinney 1968).

⁸ In addition to detailed information about the issuer, its principals, and the proposed transaction which must be submitted in an affidavit form, the Exemption Instructions require that all offering literature or advertising material be submitted to and approved by the Department of Law prior to use. Exemption Instructions, *supra* note 5, at 1-3. It is also required that prospective purchasers be provided with a summary of the tax aspects of the proposed transaction. *Id.* at 4. The exemption available pursuant to section 352-g is granted upon the discretion of the attorney general. See N.Y. GEN. BUS. LAW § 352-g (McKinney 1968). Therefore, if the affidavit and supporting documents are unsatisfactory to the Department of Law and are not rectified accordingly, the exemption will not be granted.

Policy Statement 100, recently modified in part to reflect the adoption of regulation D by the SEC, likewise requires that information similar to that found in the Exemption Instructions be submitted in affidavit form to the Department of Law. Policy Statement 100, *supra* note 5, at 6. The applicant must wait until the exemption is granted before commencing a firm offering. *Id.* Policy Statement 100 also requires the issuer to undertake, within 10 days after the closing of the transaction, to furnish an opinion of its counsel that the offering is exempt from the registration requirements of the Securities Act of 1933, stating the basis upon which such opinion is rendered. *Id.* at 5. Pursuing either of these administrative exemptions therefore may require substantial participation by counsel in preparing the necessary affidavits and supporting documentation, in addition to the delays inherent in the review process.

⁹ Failure to register is deemed, in and of itself, a fraudulent practice. N.Y. GEN. BUS. LAW § 352-i (McKinney 1968 & Supp. 1982-1983). Pursuant to section 352-i, the New York State attorney general may obtain injunctive relief under section 353 for violations of section 352-e or any regulation of the attorney general promulgated thereunder. *Id.* The attorney general may also include an application for restitution in his complaint. *Id.* § 353(3).

with applicable securities laws.

Unfortunately, in contrast to the federal arena, in which the definition of public offering has received extensive treatment,¹⁰ the question of what constitutes a public offering for purposes of the Act, as well as for other sections of the General Business Law applicable to offers and sales of securities in or from New York or to New York residents, has generated no more than a handful of decisions.¹¹ In an early case, *People v. Ruthven*,¹² the president of a corporation sold additional shares of stock to five existing stockholders in order to finance ongoing litigation.¹³ Apparently, the sales were made without public advertising or general solicitation.¹⁴ The court applied a "plain meaning"¹⁵ analysis and held that the sales of stock were not made "to the 'public'" because the sales were to existing stockholders who had an "interest to support and conserve."¹⁶ The court also noted that the buyers had enjoyed a preexisting relationship with the president and all but one were apparently aware of the purposes for which the funds were being raised.¹⁷ The court left unanswered the question of whether these

¹⁰ See, e.g., *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125-27 (1953); *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 899-905 (5th Cir. 1977); *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 687-89 (5th Cir. 1971). In *Ralston Purina*, the United States Supreme Court held that an unsolicited offering of corporate shares to "key employees" of the corporation constituted a public offering not exempt from the registration requirements of section 5 of the Securities Act of 1933, 15 U.S.C. § 77e (1976). 346 U.S. at 126. The Court stated that the focus should be on the offerees' need for protection in determining whether the offering was public. *Id.* at 124-25. The Court reasoned therefore, that the primary inquiry should be whether the offerees have access to the information necessary to make an informed investment decision that would otherwise be provided in the registration statement. *Id.* at 127.

¹¹ See *Montana*, *supra* note 3, at 284.

¹² 160 Misc. 112, 288 N.Y.S. 631 (Rochester City Ct. 1936).

¹³ *Id.* at 113, 288 N.Y.S. at 633. *Ruthven*, the president of the corporation, was being prosecuted under the former section 359-e(2) of the New York General Business Law for failure to file a "dealer's statement." *Id.* at 112, 288 N.Y.S. at 632. The court indicated that fraud was not an element of the offense charged, *id.* at 114, 288 N.Y.S. at 634, and that the prosecution must prove that the offering was made to "the public," *id.*

¹⁴ 160 Misc. at 113-14, 288 N.Y.S. at 634.

¹⁵ See *Montana*, *supra* note 3, at 285 n.11.

¹⁶ *Ruthven*, 160 Misc. at 116, 288 N.Y.S. at 637. The court viewed the term "public" "as inclusive of all the people . . . not as exclusive, nor as a limited part or portion of the people." *Id.* at 115, 288 N.Y.S. at 636.

¹⁷ *Id.* at 113, 288 N.Y.S. at 633. The court viewed the primary purpose of the statute as the protection of the public from fraud. See *id.* at 116, 288 N.Y.S. at 636-37. Since the stockholders were furthering their own interests by financing this litigation, they stood in a position different from that of the public at large. *Id.* Therefore, the court concluded that the statute had not been violated. *Id.*

sales would have been deemed made to the "public" if the purchasers had not already been stockholders in the corporation.

In *Ledgebrook Corp. v. Lefkowitz*,¹⁸ a Connecticut corporation brought an action for a declaratory judgment to confirm that its advertisements in New York newspapers for condominiums located in Connecticut could be continued without filing an offering plan as provided for in the Act.¹⁹ In rejecting the plaintiff's assertions that such advertising did not constitute a public offering, the Supreme Court, Westchester County held that the ads were "a 'public offer' . . . within the scope of contemplation of § 352-e."²⁰ To hold otherwise, the court reasoned, would obviate the need for any out-of-state developer to file a prospectus, leaving "the citizens of New York [without] protection against an unscrupulous promotion by out-of-State developers."²¹

In a 1977 case, *Puro v. Zimmerman*,²² the plaintiff had agreed to contribute approximately \$200,000 to a limited partnership which was to be formed to acquire a hotel near LaGuardia Airport in New York City, and which was to lease the same back to a newly formed operating corporation in return for specified rental payments.²³ The plaintiff, an experienced real estate investor who had been represented by counsel in the transaction, commenced an action for fraud, asserting that his allocable share of the depreciation deductions arising from the property was less than projected.²⁴ The plaintiff also claimed that the offering was not conducted in accordance with the Act.²⁵ In rejecting the plaintiff's argument that the sale of the limited partnership interests constituted a pub-

¹⁸ 77 Misc. 2d 867, 354 N.Y.S.2d 318 (Sup. Ct. Westchester County 1974).

¹⁹ *Id.*, 354 N.Y.S.2d at 319. The advertisements included pictures and descriptions of the developments, route directions from New York, phone numbers, and the following blurbs, "[p]riced from the high thirties" and "[t]his does not constitute an offer where an offer may not legally be made." *Id.* at 868, 354 N.Y.S.2d at 320.

²⁰ *Id.* at 871-72, 354 N.Y.S.2d at 323.

²¹ *Id.* at 871, 354 N.Y.S.2d at 323.

²² N.Y.L.J., Apr. 18, 1977, at 14, col. 3 (Sup. Ct. N.Y. County.).

²³ *Id.* In return for his investments, the plaintiff was to receive a 10% interest in the operating corporation, an 11% return on his \$200,000 investment, and a depreciation allowance of \$66,000 per year. *Id.* He received the interest in the operating corporation and the expected return on his \$200,000 investment, but his depreciation allowance was considerably less than expected. *Id.*

²⁴ *Id.* The court reasoned that, as an experienced real estate operator advised by counsel, the plaintiff should have realized that estimates of the depreciation deductions were uncertain and promissory, rather than representations of fact. *Id.*

²⁵ *Id.* No prospectus or offering statement was ever filed with the attorney general. *See id.*

lic offering, the court stated that an "offering amongst a half dozen people, known to each other, not advertised to the general public in any way and made to a sophisticated investor does not meet any of the criteria required of a public offering."²⁶

More recently, the Supreme Court, New York County, provided a further pronouncement of how the concept of public offering for purposes of New York's state securities laws should be construed. In *People v. Michael Glenn Realty Corp.*,²⁷ the New York State Attorney General brought an action to enjoin the defendant from selling "cooperative interests" in an apartment building prior to filing a prospectus with the Department of Law.²⁸ The court cited four factors that were to be weighed to determine whether an offering is public or private:

- (1) number of offerees and their relationship to each other and to the issuer,
- (2) number of units offered,
- (3) size of the offering and
- (4) manner of offering (type and extent of advertising).²⁹

Considering these factors, the *Glenn* court determined that there were extensive relationships and past dealings between the prospective investors and the issuer and its representatives, that the total number of offerees involved was small, and that there had been no advertising.³⁰ Thus, the court held that the transaction involved did not constitute a public offering.³¹ Moreover, the court

²⁶ *Id.* at col. 4. Significantly, the court noted that the plaintiff never discussed the issue of registration with the defendants. *Id.* Additionally, it should be noted that a family relationship existed between the plaintiff and one of the defendant-offerors, Silver. *Id.* It was Silver, the plaintiff's nephew, who first approached the plaintiff with the offer. *Id.* at col. 3.

²⁷ 106 Misc. 2d 46, 431 N.Y.S.2d 285 (Sup. Ct. N.Y. County 1980).

²⁸ *Id.* at 46, 431 N.Y.S.2d at 286-87. Significantly, the court observed that the offerees had made no complaint about the offering. *Id.* at 48, 431 N.Y.S.2d at 287. It was one of the offerees, moreover, who approached the issuer about converting the building into a cooperative. *Id.* In addition, the offerees were represented by counsel in the transaction. *Id.*

²⁹ *Id.*; see *Ledgebrook Corp. v. Lefkowitz*, 77 Misc. 2d 867, 871, 354 N.Y.S.2d 318, 322 (Sup. Ct. Westchester County 1974); *Puro v. Zimmerman*, N.Y.L.J., Apr. 18, 1977, at 14, col. 3-4 (Sup. Ct. N.Y. County); accord *Edwards v. United States*, 374 F.2d 24, 28 & n.3 (10th Cir. 1966), cert. denied, 389 U.S. 850 (1967); *People v. Humphreys*, 4 Cal. App. 3d 693, 697-98, 84 Cal. Rptr. 496, 498 (1970). In *Edwards*, the court listed a fifth factor to be considered: whether the offerees need the protection afforded by registration. 374 F.2d at 28 & n.3. The importance of this consideration was acknowledged by the *Glenn* court. 106 Misc. 2d at 49-50, 431 N.Y.S.2d at 288.

³⁰ 106 Misc. 2d at 49, 431 N.Y.S.2d at 287. The court noted that the parties had been "neighbors and friends" for several years. *Id.*

³¹ *Id.*

noted that the attorney general had not demonstrated that "the offerees were in need of . . . protection, or that they did not have access to necessary information in the absence of a filed prospectus."³²

It is apparent, therefore, that when a limited number of persons with either pre-existing business or personal relationships with the issuer or its representatives, or who either appear to or in fact do possess adequate business and investment expertise, have been solicited without advertising for a real estate investment for which they actually or presumably have access to all relevant information about the investment by virtue of such status, no public offering has occurred, and as such the protections afforded by the Act are not required. In light of these decisional principles, it is suggested that much stability may be brought to this area of the law in New York by the adoption of a statutory or administrative definition clarifying the circumstances under which an offering would be deemed not to be made to the public for purposes of the Act.

The definition could achieve this salutary purpose consistently with the underlying case law by providing that to constitute a "private" as opposed to a "public" offering:

- (1) no advertising or general solicitation may be employed;³³
- (2) the number of offerees must be numerically limited; and,³⁴
- (3) each of the offerees must possess a preexisting business or personal relationship with the issuer or its officers, directors, or partners; or, by virtue of his or her business or financial experience or the business or financial experience of his or her advisers,

³² *Id.* at 48, 431 N.Y.S.2d at 287. The court went so far as to chastise the attorney general for bringing the action, stating that "the resources of [the attorney general's] office are not to be dissipated in a case such as this, where the handful of offerees were not in need, nor did they desire, the protection of the Martin Act." *Id.* at 49-50, 431 N.Y.S.2d at 288.

³³ *See* *People v. Humphreys*, 4 Cal. App. 3d 693, 699, 84 Cal. Rptr. 496, 499 (1970) ("[i]f the offerer makes use of public media, a public [offering] has almost conclusively been established").

³⁴ *See* *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 688 (5th Cir. 1971). While no absolute limit is suggested, it is apparent that "the more offerees, the more likelihood that the offering [may be] public." *Id.* Numerically limiting the number of offerees not only will help to ensure that the issuer and its representatives carefully police the type of investor approached but will also aid in making certain that those approached can be expected to meet the third element of the proposed definition. In addition, numerical limitations would assist in preserving the conceptual notion of private offerings which the New York courts have recognized underlies this area. *See Glenn*, 106 Misc. 2d at 49, 431 N.Y.S.2d at 287.

each offeree can reasonably be assumed to have the capacity to protect his or her own interests in the proposed investment without the delivery of a formal disclosure document.³⁵

The definition should, if its terms are satisfied, be self-executing. Indeed, since the statute requires action only in connection with public offerings or sales, once an issuer's representatives and counsel have determined that the definition's terms are satisfied, no further action of any kind would be required.³⁶ Further, if an action is commenced under section 352-e for failure to register, the burden of proving that the offer was made to the public, and that, therefore, the terms of the proposed definition were not satisfied, should be placed on the plaintiff or the attorney general, for the public nature of the offering is an essential element of the cause of action.³⁷

Codifying these or similar standards into a self-executing, definitional exemption from the requirements of the Act would, in addition to clarifying an important aspect of New York law, help effect a significant savings of both private and public resources in this area.³⁸

³⁵ California presently utilizes a standard similar to that proposed by this Article. See CAL. CORP. CODE § 25102(f) (West Supp. 1982). The California statute adds that each purchaser must represent that he is purchasing for his own account, "not with a view to or for sale in connection with any distribution of the security." *Id.* § 25102(f)(3).

³⁶ N.Y. GEN. BUS. LAW § 352-e (McKinney 1968 & Supp. 1982-1983).

³⁷ See *Glenn*, 106 Misc. 2d at 47, 431 N.Y.S.2d at 286. Placing the burden of proof on the plaintiff as to the public nature of the offering distinguishes New York law from federal securities law. To establish a prima facie violation of section 5 of the Securities Act of 1933, the plaintiff must prove the following three elements:

First, it must be shown that no registration statement was in effect as to the securities. Second, it must be established that the defendant sold or offered to sell these securities, and finally, the use of interstate transportation or communication or of the mails in connection with the sale or offer of sale must be proved.

Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 686 (5th Cir. 1971). No mention is made of the term "public" in section 5. See 15 U.S.C. § 77e (1976). Under federal law therefore, the public nature of the offering is not an element of the cause of action. See *id.* As a defense to an allegation of violating section 5, the issuer may assert that the offering encompassed a transaction "not involving any public offering" under section 4(2) of the Securities Act of 1933. *Id.* § 77d(2). The burden of establishing such defense, however, rests with the issuer. See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953); *Lively v. Hirschfeld*, 440 F.2d 631, 632 (10th Cir. 1971); *United States v. Custer Channel Wing Corp.*, 376 F.2d 675, 678 (4th Cir.), *cert. denied*, 389 U.S. 850 (1967).

³⁸ In those situations in which the issuer desires to make an offering to a larger group of prospective purchasers so as to place the offering beyond the scope of the proposed definition, the present administrative exemptions will continue to provide an intermediate level of regulation where full scale registration is not warranted. See N.Y. GEN. BUS. LAW §§ 352-g, 359-f (McKinney 1968 & Supp. 1982-1983); *supra* notes 5 & 8 and accompanying text.

