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THE REGULATION OF REAL ESTATE SYNDICATE SECURITIES IN CALIFORNIA

The State of California has stringent regulations regarding real estate securities. This Comment examines these regulations, related administrative problems, and the resulting decline in the number of public syndications. A further study is made of the often elusive non-public exemption to the state regulations. This Comment concludes by suggesting that the Department of Corporations should consider less strict and less complex regulations in view of both the decline in public syndications and the Department of Corporations' legislative mandate to promulgate guidelines.

INTRODUCTION

Despite the inhibiting effect of the 1976 Tax Reform Act, the use of limited partnerships as a real estate investment tool continues to grow. This continued growth is a result of several characteristics that make the limited partnership attractive to both the syndicator and the investor. First, the limited partnership allows the investor to contribute capital to a business venture and to share in the profits without being subjected to unlimited liability. Syndicators are prohibited from transferring unlimited liability to the limited partners. 10 CAL. ADMIN. CODE § 260.140.111A (1978).

1. The Tax Reform Act of 1976 substantially restricts, and in some cases completely eliminates, tax benefits previously available to limited partnerships. For example, the old law allowed the partnership to allocate items of income and deductions to partners in a manner disproportionate to their capital investment except when the IRS could show that the major purpose of the allocation was the avoidance of taxes by the partners. Under the 1976 Act, no such allocation may be made, unless the taxpayer can establish that the allocation will have a "substantial economic effect." I.R.C. § 704(b). As a result, it will undoubtedly be more difficult for the partnership to justify a "special allocation." Matsen & Whitesides, The Basic Securities Law and Tax Aspects of Private Limited Partnership Offerings in California, 4 W. St. L. Rev. 199, 224 (1977).

2. Syndicators are prohibited from transferring unlimited liability to the limited partners. 10 CAL. ADMIN. CODE § 260.140.111A (1978).
of loss by purchasing interests in several syndications or by balancing his real estate investments with a traditional portfolio of stocks and bonds. Third, the limited partnership affords investors the opportunity for professional management. Many persons who might otherwise purchase real estate hesitate to do so because they do not have the time or inclination to become experts in property management and selection, or because they find it financially difficult to justify professional management in small projects.

Perhaps the major reason that investors prefer the limited partnership over other business forms for real estate investment is that the profits and losses are passed directly to the partners in proportion to their interests. This permits the individual partners to shelter income from the syndicate or from other sources.

The limited partnership also affords the general partner numerous benefits. For example, he can receive a wide range of fees from the partnership and the limited partners. These fees include commissions for selling the program interests, acquisition fees, compensation for managing the syndicate, additional interest in the potential profits, real estate commissions on the resale of the property, and special fees for managing or building the partnership's assets.

Abuse of this inviting investment device, by inadequate financing, poor management and deceptive advertisement practices, has led to a myriad of rules and regulations at both state and federal levels. Moreover, because the courts consider a limited partnership interest to be a security, it is subject to the stringent laws regarding securities. California’s regulation of syndicate securities is the strictest of all fifty states.

The comprehensiveness and complexity of the California law with respect to syndicate securities make it difficult for the syndicator to ascertain exactly what is necessary for compliance with it. Four problems currently facing syndicators compound the problem of understanding California law in this area. First, during the last ten years, jurisdiction over smaller syndicates has changed twice. Second, as a result of this change in jurisdiction,

5. 10 CAL. ADMIN. CODE §§ 260.140.113.1-.6 (1978).
there has been a corresponding change in the applicable presumptive standards of fairness. Third, the law governing syndicate securities at times has not been uniformly applied among different geographical sections of California. Finally, a practice exists of applying "desk-drawer" regulations, or those which are not found in any release or rule, but rather reflect informal policy guidelines.

This Comment will examine and attempt to clarify the current state of the California syndicate securities law. Some of the problems syndicators encounter in attempting to comply with the California law will also be explored.

BACKGROUND

Prior to December 31, 1977, jurisdiction over real estate limited partnerships was divided between the Department of Corporations and the Department of Real Estate. Partnerships with more than 100 partners were subject under certain circumstances to rules promulgated by the Commissioner of Corporations, while those with fewer than 100 partners could choose under certain circumstances to be governed by these rules or by rules formulated by the Commissioner of Real Estate under the Real Estate Syndicate Act.

Assembly Bill 983, effective December 31, 1977, repealed the Real Estate Syndicate Act and placed jurisdiction over small real estate syndicates under the exclusive jurisdiction of the Commissioner of Corporations. As a result, regulation of syndicate securities is now carried out under the Corporate Securities Law of 1968 and the Commissioner's rules.

The major requirement of these laws is that a security, unless exempt, must be registered or qualified before any interests can be sold. In addition, the Commissioner of Corporations may refuse to qualify any security if he finds that the issuer's present or

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proposed course of business is not "fair, just, and equitable." Pursuant to this authority, the Commissioner has established standards of presumptive fairness to serve as guidelines to syndicators. Although these standards create only a presumption of fairness on the part of the syndicate, the syndicate will usually be deemed fair, just, and equitable when the Commissioner's requirements are met. Although these rules are guidelines, not law, the courts accord great deference to administrative interpretations and decisions and will rarely overrule them.

It should be noted that if the syndicate offering is eligible for the non-public offering exemption, discussed later in the Comment, the rules regarding substantive fairness do not apply. Theoretically, the syndicator is not subject to any regulation by the Department of Corporations if he qualifies for this exemption. However, even an apparently exempt syndicator would be well-advised to follow the Department's general standards of presumptive fairness. This practice would assist the syndicator in attracting present and future investors and would also strengthen his case should the syndicate be found public.

**SUBSTANTIVE FAIRNESS STANDARDS**

The standards of substantive fairness promulgated by the Commissioner of Corporations are found in title 10 of the California Administrative Code. They are divided into the following six areas: (1) suitability of the investor, (2) requirements of the syndicator, (3) fees and compensation, (4) conflicts of interest and investment restriction, (5) rights and obligations of participants, and (6) disclosure and marketing requirements.

**Suitability of the Investor**

These rules are designed to ensure that the investor is able to bear the economic risk of the investment. The investor suitability standards impose both a net worth and a minimum investment requirement on the investor. An investor must have a minimum

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15. Id. § 25140. The Commissioner may refuse or revoke a qualification if he finds that it is in the public interest to do so and that the proposed plan of business is not fair, just, and equitable, or the securities or the method of issuance thereof will work a fraud upon the purchaser. Id.
17. Long, Beyond the Presumptive Standards of the Real Estate Syndicate Act's Private Offering Exemption, 5 CAL. SYNDICATOR 9, 10 (1975).
18. CAL. CORP. CODE § 25110 (West 1977). However, the syndicator is still subject to the common-law principles of contract and certain disclosure laws. Id.
20. Id.
annual gross income of $20,000 and a net worth of $20,000 (exclusive of home, furnishings, and automobile) or, in the alternative, a minimum net worth of $75,000 (exclusive of home, furnishings, and automobile) unless the Commissioner upon receipt of the application for registration approves a lower suitability standard. 21 In addition, the investor must make a minimum initial cash purchase of $2,000. 22

These rules apparently stem from two unique characteristics of limited partnerships. First, participants in a limited partnership do not have the same rights and protections afforded other investors. Corporate shareholders, for example, possess a vast inventory of rights, remedies, procedures, and guarantees designed to protect them and their investments. Second, a partnership investment generally lacks the liquidity afforded a corporate shareholder. Normally, a partnership interest cannot be readily converted into cash through the sale or transfer of the interest. 23

Requirements for the Syndicator

The syndicator must have at least two years of real estate experience or other experience which demonstrates that the syndicator has sufficient knowledge to acquire and manage investment property. 24 If the syndicator or any of his affiliates provide any services to the partnership, they must have at least four years of experience in the service being offered. 25 The syndicator is also required to have a net worth (exclusive of home, furnishings, and automobile) equal to the greater of $50,000 or five percent of the gross proceeds of the current offering and of all other offerings in which the syndicator has acted as general partner during the past twelve months to an aggregate maximum net

21. Id. § 260.140.112.5. Under the Real Estate Commissioner’s rules, the syndicator was required to have only an adjusted gross income of $15,000 and a net worth of $15,000 (exclusive of home, furnishings, and automobile) or, in the alternative, a net worth of $30,000 (exclusive of home, furnishings, and automobile). 1 H. Marsh & R. Volk, supra note 6, § 30.05[3]. For a discussion of investor suitability standards, see Comment, Investor Suitability Standards in Real Estate Syndication: California’s Procrustean Bed Approach, 63 Calif. L. Rev. 471 (1975).

22. 10 Cal. Admin. Code § 260.140.112.4 (1978). Under the Real Estate Commissioner’s rules, the investor was required only to make a minimum initial cash purchase of $1,000. Id. § 2995 (repealed 1977).


25. Id.
worth of the general partner of $1,000,000.26

Fees—Compensation

The Commissioner of Corporations requires the total amount of the syndicator's or his affiliates' compensation to be reasonable in light of the nature of the syndicate, the identity of the investors, and the experience and skills of the syndicator.27 The Commissioner's rules specifically permit the syndicator to receive the following types of compensation: organization and offering expenses, acquisition fees, program management fees, additional promotional interest, real estate commissions on the resale of the property, and a property management fee.28

Compensation for organizational and offering expenses, also referred to as selling expenses, is limited to fifteen percent of the initial invested capital.29 In addition, the Department of Corporations places on acquisition fees an overall limit of eighteen percent of the gross proceeds.30 Furthermore, the sum of the purchase price and the acquisition fee may not exceed the appraised value of the investment property.31 This sum must be computed on each individual property and cannot be aggregated.32

Arguably, this last requirement unreasonably limits the syndicator's choice of investment property. Undoubtedly, situations exist in which exceptional properties are passed over because the purchase price plus the acquisition fee is greater than the appraised value. A better approach may be to calculate the fee on the total proceeds of the syndicate's properties. The syndicator would then be able to balance properties with a high appraised value but a low sales price with properties with a high sales price but a lower appraised value.33

However, strong policy considerations mandate that acquisition

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26. Id. § 260.140.111.2. No specific net worth and experience requirements were imposed on the syndicator under the Real Estate Syndicate Act. See ch. 928, § 3, 1969 Cal. Stats. 1855 (repealed 1977).
27. 10 CAL. ADMIN. CODE § 260.140.113.2 (1978).
28. Id. §§ 260.140.113.1-.6.
29. Id. § 260.140.113.2. The Real Estate Commissioner's rules regarding selling expenses were essentially the same as the Corporations Commissioner's rules. Id. § 2994 (repealed 1977).
30. Id. § 260.140.113.3(a). The Real Estate Commissioner's rules contained no overall limit on acquisition fees. Id. §§ 2990-2999.6 (repealed 1977).
31. Id. § 260.140.113.3(d). The Real Estate Commissioner's rules only prohibited the purchase price of the investment property from exceeding the fair market value of the property. Id. § 2994.5 (repealed 1977).
32. Id. § 260.140.113.5(b).
fees be eliminated altogether and replaced by an increased interest in the profits. By eliminating the syndicator's acquisition fee, a front-end drain on the resources of the partnership could be prevented. Such a drain on partnership resources often results in a cash-flow difficulty. The elimination of the syndicator's real estate commission would reduce the purchase price of the investment property. Finally, because the syndicator would derive his compensation strictly from the profits of the program, he would be more likely to acquire properties that generate a good cash flow and have potential for appreciation.

The Commissioner of Corporations also limits the amount of program-management fees that the syndicator may receive. The syndicator may take such fees as a subordinated interest or as a direct fee. Direct fees are permitted only on unimproved land or on government-subsidized projects. The fees on unimproved land are limited to one-fourth of one percent of the cost of the land per year; those on government-subsidized projects are limited to one-half of one percent per year. All direct fees are limited to a cumulative total of two percent regardless of the number of years the land is held.

The Commissioner permits the syndicator to take a subordinated interest in the limited partnership as a program management fee provided that the fee is reasonable. Such fees are presumptively reasonable if the fee does not exceed twenty-five percent of the undistributed cash and is subordinated to the return of 100% of the investors' capital contributions. The fee is also presumed reasonable if it does not exceed ten percent of the cash available for distribution plus fifteen percent of the proceeds from the sale of the syndicate property, both subordinated to the

34. Id. at 461.
35. Id.
36. Id. However, on resale of the property, a third-party broker might still obtain a real estate commission. This commission would ultimately be reflected in the purchase price.
37. Id.
38. 10 CAL. ADMIN. CODE § 260.140.113.4 (1978). Under the Real Estate Commissioner's rules, professional management fees for income-producing residential property could not exceed six percent of the gross receipts. The professional management fee for non-income producing property could not exceed $100 per month.
40. Id.
41. Id.
repayment of the investors' capital contribution with a six percent cumulative annual return.\(^{42}\)

A full real estate commission on the resale of the property is permitted only if the syndicator did not receive a commission or a related fee on the acquisition of the property.\(^{43}\) If the syndicator did take a fee, his commission on the resale of the partnership's assets is restricted to fifty percent of the original acquisition fee permitted under the Commissioner's rules.\(^{44}\) These commissions must also be subordinated to the payment of the investors' contribution with a six percent cumulative annual return on the contribution.\(^{45}\) The Commissioner prohibits the syndicator's use of exclusive listings for the resale of the syndicate property.\(^{46}\)

**Conflicts of Interest and Investment Restrictions**

Under the Department of Corporations' rules, a limited partnership may not purchase or lease property in which the general partner has an interest unless the transaction occurs at the formation of the program and is fully disclosed in the prospectus, the property is sold on terms that are fair to the partnership, and the cost of the property is clearly established.\(^{47}\) If the partnership purchases property for a price greater than the cost to the syndicator, the Commissioner of Corporations considers the price unfair.\(^{48}\) Consequently, the syndicator is precluded from receiving a profit in a transaction in which he leases or sells land to the syndicate. However, this rule does not prevent the syndicator from holding title to the property in order to facilitate the acquisition of the land so long as no economic benefits accrue to the syndicator.\(^{49}\)

The Commissioner also prohibits the partnership from selling

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\(^{42}\) *Id.* § 260.140.113.5(a), (b).
\(^{43}\) *Id.* § 260.140.113.6.
\(^{44}\) *Id.*
\(^{45}\) *Id.* § 260.140.114.3. The Department of Real Estate permitted exclusive listings subject only to the examination of three factors: the length of the listing, its terms, and the appropriateness of such a listing to the type of syndicate being formed. *Id.* § 2994(b) (repealed 1977).
\(^{46}\) 10 *CAL. ADMIN. CODE* § 260.140.114.1(a).
\(^{47}\) *Id.* § 260.140.114.1(a) (3). Under the Real Estate Commissioner's rules, the sale to the partnership of property in which a syndicator had an interest was permitted if the price paid by the partnership could be "clearly substantiated" as the fair market price. *Id.* § 2994.5 (repealed 1977). This rule seems preferable to the Department of Corporations' rule because it should not matter from whom the syndicator receives a profit as long as he is acting openly and fairly. 1 *H. MARSH & R. VOLK, supra* note 6, § 30.05[11].
\(^{48}\) *Id.* § 260.140.114.1(a)(4) (1978).
property to the syndicator.\textsuperscript{50} Furthermore, the partnership may not make loans to the syndicator.\textsuperscript{51} Finally, the syndicator is prohibited from acquiring property in return for partnership interests unless the partnership agreement makes full disclosure of the transaction, the purchase price is supported by an independent appraisal, no more than one-fourth of the interests of the syndicate are exchanged, and no commissions are paid in connection with the exchange.\textsuperscript{52}

\textit{Rights and Obligations of the Participants}

The Department of Corporations' rules permit the limited partners holding ten percent or more of the outstanding interests in the syndicate to call meetings for any reason.\textsuperscript{53} The rules require that certain reports be made available to the limited partners and that limited partners be accorded the right of access to all partnership records.\textsuperscript{54} The Department further requires that the limited partnership agreement provide that the majority of limited partners in interest may vote to remove the general partner, to sell or exchange the partnership's assets, to amend the partnership agreement, or to terminate the partnership.\textsuperscript{55}

The Department of Corporations' insistence upon majority decisions by the limited partners rather than unanimous decisions has created a potential conflict between the requirements of the Department and the demands of the IRS. For a limited partnership to avoid taxation as a corporation, it must not meet more than two of four corporate characteristics examined by the IRS.\textsuperscript{56} One of these four characteristics, continuity of life,\textsuperscript{57} may be affected by the number of limited partners' votes necessary for consent to a continuation of the partnership after removal of the general partner.

\textsuperscript{50} \textit{Id.} \textsuperscript{\textsection} 260.140.114.1(b).

\textsuperscript{51} \textit{Id.} \textsuperscript{\textsection} 260.140.114.1(c).

\textsuperscript{52} \textit{Id.} \textsuperscript{\textsection} 260.140.114.2.

\textsuperscript{53} \textit{Id.} \textsuperscript{\textsection} 260.140.116.1.

\textsuperscript{54} \textit{Id.} \textsuperscript{\textsection} 260.140.116.4.

\textsuperscript{55} \textit{Id.} \textsuperscript{\textsection} 260.140.116.2.

\textsuperscript{56} \textit{Treas. Reg.} \textsuperscript{\textsection} 301.7701-2(a)(1) (1979).

\textsuperscript{57} \textit{Id.} \textsuperscript{\textsection} 301.7701-2(b)(1). The other three characteristics that the IRS examines in determining how a limited partnership is taxed are limited liability, centralization of management, and free transferability. \textit{Id.} \textsuperscript{\textsection} 301.7701-2(a)(1). For a discussion of these characteristics with respect to limited partnerships, see \textit{Stoecklein, 1978 Limited Partnerships . . . Taxable as Corporations, CREATIVE REAL EST. 19.}
In *Larson v. Commissioner*, the Tax Court found that two real estate syndicates lacked the corporate characteristic of continuity of life. As part of its holding, the Tax Court found that a requirement of 100% vote of limited partners to elect a new general partner made the possibility of continuity of life too contingent to qualify as a corporate characteristic. The majority in *Larson* does not address the continuity-of-life question when only a majority vote of the limited partners is necessary to continue the enterprise. However, Judge Simpson in dissent argued that there is no continuity of life even if only a majority vote is required. Nonetheless, under the majority view the syndicator may face a conflict between the demands of the IRS and those of the Commissioner's regulations.

The syndicator's tax difficulties are further complicated by the IRS's position regarding the transferability of interests. The IRS examines transferability for the purpose of determining whether a partnership should be taxed as a partnership or as an association subject to taxation as a corporation. The IRS's position is that a limited partnership has the corporate characteristic of free transferability if the partnership agreement provides that the general partner's consent for substitution of a partner may not be unreasonably withheld. Similarly, the IRS will find free transferability if the partnership agreement provides that the general partner must give his consent to substitution of persons meeting certain requirements.

Although the Commissioner of Corporations normally requires that such provisions be included in the partnership agreement, he currently allows deviations when absolutely necessary for tax purposes. Such deviations must, however, be supported by an opinion of counsel.

The Commissioner of Corporations' rules also require that under certain circumstances the partnership agreement contain

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59. 66 T.C. at 175.

60. Interestingly, this question was presented to the Tax Court because Somis, one of the limited partnerships involved in *Larson*, did not require a full 100% vote of limited partners to elect a new general partner. *Id.* at 168. However, the court resolved the continuity-of-life question with respect to Somis on another basis.

61. *Id.* at 201. The *Larson* decision is marked by two concurring and five dissenting opinions, leaving the question far from settled.

62. 1 H. MARSH & R. VOLK, *supra* note 6, § 31.05[5][b].

63. *Id.*
detailed provisions for any future assessments on the limited partners. For example, in the event of a default in the payment of assessments, the agreement may not provide for forfeiture of the defaulting partner's interest. However, a partner's interest can be proportionately reduced as a result of the default provided that such reduction is fair.

Disclosure and Marketing Requirements

The Commissioner of Corporations' advertising regulations are detailed and elaborate. Generally, "advertising used in the offer or sale of partnership interests shall conform in all applicable respects to requirements of filing, disclosure and adequacy currently imposed on . . . advertising used in the sale of corporate securities." Basically, securities advertising may not be false or misleading and may not omit any statements necessary to prevent the reader from being misled. The Commissioner also restricts the use of certain selling tactics, such as the offer of free merchandise or trips to visit the syndicate property, as an inducement to participate in the partnership. Finally, all advertisements must be filed with the Commissioner at least three days before publication.

The Commissioner's rules regarding disclosure are equally strict. The prospectus must disclose virtually all important aspects of the partnership, including: (1) the general nature of the securities being offered, (2) the risks to be considered before making an investment in the program, (3) the business expenses of, and all compensation to, the general partner, (4) the minimum aggregate amount necessary to initiate the program, (5) provisions for assessments, (6) a description of the investment property and of the proposed method of financing, (7) the track record of the general partner's experience in packaging syndicates, including the annual operating results of the syndicator's various investments, (8) the federal tax consequences of the investment, and (9) projections of future results, including graphs showing projected revenues in relation to occupancy levels and expendi-

64. 10 CAL. ADMIN. CODE § 260.140.116.8 (1978).
65. Id.
66. Id. § 260.140.117.1.
68. 1 H. MARSH & R. VOLK, supra note 6, § 31.10[1].
69. 10 CAL. ADMIN. CODE § 260.140.117.1(b) (1978).
The track-record requirement may be overly harsh when applied to the small syndicate. The protection afforded the investor by this comprehensive track-record requirement appears insufficient to warrant the expense to the small syndicate. A better approach might be to utilize a different track record for small syndicates. A small syndicate's basic record would focus on the general partner's experience and ability to manage and acquire profitable investment properties rather than on the annual operating results of diverse types of real estate investments. This modification would lessen the expense of providing a track record for small syndicates and simultaneously would provide investors with sufficient information on the background of the general partner to enable investors to make an intelligent investment decision.

The requirement of predicting future results in the real estate investment is also too harsh when applied to the small syndicate. The expense involved in the preparation of projections demands a less exhaustive rule for smaller syndicates. To reduce the cost of projections, the rules should be modified to require the utilization of pro forma financial statements rather than the charts and graphs now required under the Commissioner's rules.

Last, the Commissioner of Corporations imposes a legend condition on the syndicator. This condition requires the limited partnership interest to state that it may not be transferred without the Commissioner's consent. The purpose of the legend condition relates to the non-liquid nature of a limited partnership interest and to the possibility that a subsequent transfer may be unfair to the purchaser.

**The Paradox**

The strictness and complexity of the Department of Corporations' rules regarding substantive fairness have substantially contributed to the sharp drop in the number of public offerings of

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70. *Id.* §§ 260.140.117.1-.3.
71. This was a suggestion made at a meeting in December, 1977, between Willie Barnes, Commissioner of Corporations, Burton Smith, former Commissioner of Real Estate, and others representing the real estate industry. This meeting was part of a study initiated by the Commissioner of Corporations in late 1976. The study's purpose was to consider changes in the rules as they relate to small syndications. However, as yet no changes have been effectuated. Interview with Burton Smith, former Commissioner of Real Estate, in Irvine, California (Sept. 15, 1978).
72. *Id.*
73. 10 CAL. ADMIN. CODE § 260.140.118.7 (1978). For a discussion of the legend-condition requirement, see 1 H. MARSH & R. VOLK, supra note 6, § 31.12[7].
syndicate securities. In 1970, 165 permits were filed and ninety-six offerings qualified. In 1974, the number dropped to twenty-eight applications and twelve qualifications. The year 1977 ended with an even further drop to twenty-seven applications and seven qualifications.

The Department’s substantive fairness rules have created an interesting paradox. These rules were promulgated to protect the investor. However, they may be responsible for syndicators using the non-public offering exemption and thereby avoiding the requirement of strict compliance with the rules. This results in less overall protection for investors.

In light of this situation, the Department of Corporations should seriously consider revising the substantive fairness rules to make them less strict and less complex. Furthermore, the Department should consider applying these rules in a more flexible manner. In fact, the Department may be exceeding its administrative authority by applying them in such a strict manner. The legislature has authorized the Department to promulgate only guidelines with respect to syndicate securities. The current application of the substantive fairness rules seems inconsistent with this legislative mandate.

THE NON-PUBLIC OFFERING EXEMPTION

The Presumptive Standards

The Corporate Securities Law of 1968 provides that if a syndication does not involve a public offering, it is exempt from registration. The Commissioner of Corporations has promulgated

74. Robinson Interview, note 7 supra.
75. Interview with Willie Barnes, Commissioner of Corporations, in Los Angeles (Sept. 25, 1978) [hereinafter cited as Barnes Interview]. Although these statistics reflect the trend under the Department of Real Estate, the Department of Corporations has adopted substantially the same rules. Therefore the statistics are still persuasive in predicting the future trends of syndicate securities.
76. Id.
77. Id.
78. See text accompanying note 74 supra.
79. CAL. CORP. CODE §§ 25000-25804 (West 1977 & Supp. 1978). Section 25016 states that the Commissioner has authority to promulgate “rules” in respect to syndicate securities. However, this § defines the term “rule” as “any published regulation or standard of general application issued by the commissioner.”
80. Id. §§ 25000-25804.
81. Id. § 25102(a). For a discussion of non-public offerings, see Wertheimer &
rules interpreting the non-public offering. An offer of any limited partnership interest presumptively is not a public offering if offers are made to no more than twenty-five persons and if sales are consummated to no more than ten such persons. All the offerees either must have a pre-existing personal or business relationship with the offeror or, by reason of their business or financial experience, must merit the reasonable assumption that they are capable of protecting their own interests in the transaction.

For the purpose of the purchaser rule, a husband and wife acting for themselves or for their minor children are considered one person. Furthermore, a corporation, partnership, or other association is considered a single purchaser unless the entity is formed for the specific purpose of acquiring the syndicate securities. The purchasers need not be residents of California for the non-public offering exemption to apply. Although not mentioned in the rules as a prerequisite to qualification for the non-public offering, the method of offering the interests is also extremely important. The offering must be on a personal or private level. The use of any advertising in the sale of the syndicate's interests indicates that the offering is public even if it complies with the other requisites of the twenty-five and ten "rule." 

Finally, adequate disclosure, though not mentioned in the Commissioner's rules, is probably a prerequisite for a non-public offering. In the Commissioner's view, failure to make the disclosures necessary for investors to make informed investment decisions is sufficient to make an offering public.

It is important to note that the twenty-five and ten "rule" is only a yardstick used to determine the lack of a public offering; it cannot be used to determine that a public offering exists. An offering that does not conform to these standards is not presumed to

83. Id.
84. Id.
85. Although the Corporations Commissioner's rules do not address this issue, this is the rule under 17 C.F.R. § 230.146 (g)(2)(d)(ii) (1976). This portion of Rule 146 is both logical and reasonable, and the Commissioner and the California courts would almost certainly follow it.
87. Barnes Interview, note 75 supra.
88. Id.
89. Id.
90. Id.
91. 10 Cal. Admin. Code § 260.102.2 (1978). The 25 and 10 "rule" is also known as the "safe harbor" rule.
be a public offering.92

Beyond the Presumptive Standards

Whether an offering that fails to comply with the twenty-five and ten “rule” falls within the non-public offering exemption is a question of fact. Eight components, originating in the Corporations Commissioner's Release 5-C of 196993 and in a 1970 California judicial decision, People v. Humphreys,94 are considered in this determination. These components are: (1) the number of offerees, (2) the manner of the offering, (3) the size of the offering, (4) the relationship of the offerees to one another, (5) the relationship between the syndicator and the offerees, (6) the sophistication of the investors, (7) the character of the security offered and issued, and (8) the liquidity of the security.95

Number of Offerees

In Humphreys, the court of appeal stated that the greater the number of offerees, the more likely the offering is public and, conversely, the smaller the number of offerees, the more likely the offering is not public.96 The court further stated that the number of offerees, rather than the number of ultimate purchasers, is crucial in determining whether the offering is non-public.97 However, because the twenty-five and ten “rule” focuses in part on the number of ultimate purchasers, it seems that the number of purchasers is at least a factor in ascertaining whether the offering is non-public.

It is difficult, if not impossible, to determine a numerical boundary between public and non-public offerings. However, one need not stay within the presumptive numbers of the twenty-five and ten “rule.”98 In the Commissioner's opinion, the number of offerees is not the determining factor in the application of this test.99 Furthermore, one court has found a syndicate comprised of forty-

92. Id.
93. Dep't of Corporations Release 5-C, at 17 (1969) [hereinafter cited as Release 5-C].
94. 4 Cal. App. 3d 693, 84 Cal. Rptr. 496 (1970).
95. Id.
96. Id. at 698, 84 Cal. Rptr. at 498.
97. Id.
98. 10 CAL ADMIN. CODE § 260.102.2 (1978).
99. Barnes Interview, note 75 supra.
six investors to be non-public.100 Nevertheless, as the number of offerees increases, a greater likelihood exists that the offering will be found to be public. Moreover, at some point the offering will be considered public regardless of the fact that other factors tend to show that the offering is non-public.101

Manner of the Offering

Both Release 5-C and the court in Humphreys declare that the manner in which an offering is conducted is a particularly significant factor in determining whether the offering is public or non-public.102 The Department's position is clear: The use of seminars or public meetings constitutes strong evidence of a public offering.103 Interests should not be indiscriminately offered to a heterogeneous group; rather, interests should be offered to a group carefully screened to reflect the required suitability standards. If the syndicator lacks ready access to his friends and business associates, he may be tempted to resort to various devices to bring offerees together. However, the syndicator should avoid such action because the offering may ultimately be found to be public.

The Department of Corporations also scrutinizes the initiative for purchasing syndicate interests. If the initiative originates with the syndicator, it constitutes evidence of a public offering. An offer induced by the offeree, on the other hand, is evidence of a non-public offering.104

Of continuing concern to attorneys are the Commissioner's declarations that the use of a broker-dealer strongly supports the conclusion that the syndicate is public.105 Because many syndicators use broker-dealers, the Commissioner's enforcement of this opinion would have a drastic effect upon non-public offerings. Although important, the declarations of the Commissioner are only opinions and not the law. The use of broker-dealers may be a strong factor in a Department investigation, as long as the syndicator meets the other requirements of a non-public offering, but

100. Camerini v. Long, 184 Cal. App. 2d 292, 294, 8 Cal. Rptr. 174, 175 (1960). It should be noted that Camerini was decided before the enactment of the 25 and 10 "rule." Therefore, it is somewhat unclear whether it would be followed today.
103. Long, supra note 17, at 12.
105. See, e.g., Dep’t of Corporations, State of California, Commissioner's Opinion No. 74/86C (Sept. 3, 1974); id. 74/69C (June 19, 1974); id. 74/57C (May 23, 1974); id. 73/38C (Mar. 15, 1973).
the broker-dealer factor probably will not be determinative.\footnote{106} The syndicator's use of in-house broker-dealers rather than commercial brokerage firms would no doubt be to his advantage in a Department investigation.

Size of the Offering

The size of the offering is another factor the Commissioner and the courts consider in determining whether the offering is public or non-public.\footnote{107} Size refers to both the dollar amount of the offering and the number of syndicate interests. Release 5-C states that an offering consisting of only a limited number of syndicate interests is less likely to be considered a public offering than one consisting of a large number of interests.\footnote{108} The release further states that even if the number of interests is small, if they can be converted into a larger number of interests, the larger number will be determinative.\footnote{109}

Size is probably the least important component. The Commissioner has stated that the dollar amount of the offering alone will rarely cause the syndicate to lose its non-public exemption.\footnote{110} However, although the dollar amount by itself may not create a public offering, the Commissioner may combine the dollar amount with the other factors and thereby find a public offering. The syndicator probably will have difficulty with the size of the offering only when the Commissioner finds that the offering is part of an "integrated" series of offerings.\footnote{111}

\footnote{106} Robinson Interview, note 7 \textit{supra}.\footnote{107} People v. Humphreys, 4 Cal. App. 3d 693, 697, 84 Cal. Rptr. 496, 498 (1970); Release 5-C, \textit{supra} note 92, at 17, 20.\footnote{108} Release 5-C, \textit{supra} note 92, at 20.\footnote{109} Id. at 21.\footnote{110} Barnes Interview, note 75 \textit{supra}.\footnote{111} See Comment, \textit{SEC Regulation of California Real Estate Syndicates}, 61 CALIF. L. REV. 205, 221 (1973). An offering will be "integrated" when it is actually a part of a larger syndication or offering. Factors relevant to the determination of whether a purportedly private offering should be integrated are: (1) whether the different offerings are part of a single plan of financing, (2) whether the offerings involve the same class of security, (3) whether the offerings are made at or about the same time, (4) whether the offerings are made for the same type of consideration, and (5) whether the offerings are made for the same general purpose. 17 Rule 146 C.F.R. § 230.146 (preliminary note 3) (1978). For a discussion of the doctrine of integration, see Comment, \textit{Application of the Securities Doctrine of Integration to Real Estate Syndicates}, 46 S. CAL. L. REV. 428 (1973).
Relationship of the Offerees to Each Other

*Humphreys* and Release 5-C provide that a pre-existing relationship among members of the group to which the offering is made may be significant in determining whether the offering is non-public in nature. An offering to more than twenty-five persons may still be non-public so long as there is a close relationship of blood, friendship, or business association among the members of the group.

The relationship among the offerees, however, is only one factor in determining whether the offering is non-public. In *SEC v. Ralston Purina Co.*, the United States Supreme Court found that although all the offerees were employees of the same company, this relationship was not decisive when inadequate information was available to the offerees.

The Department of Corporations, with respect to non-public offerings, follows the same standards as the federal courts. At the same time, however, the state courts are not bound by the federal decisions and may reach different conclusions regarding the non-public offering exemption. Nevertheless, it is likely that the Commissioner and the California courts would follow the *Ralston Purina* decision.

Relationship Between the Offerees and the Syndicator

*Humphreys* and Release 5-C state that a close business or personal relationship between the syndicator and the investors is indicative of a non-public offering. The leading case on this point is *SEC v. Continental Tobacco Co. of South Carolina, Inc.* In *Continental Tobacco*, the Court of Appeals for the Fifth Circuit held that the violation of this component alone can cause a program to be public.

The Department of Real Estate also placed considerable emphasis on this component when it had jurisdiction over limited partnerships. The Department of Real Estate thought that if the

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112. People v. Humphreys, 4 Cal. App. 3d 693, 697, 84 Cal. Rptr. 496, 498 (1970); Release 5-C, supra note 92, at 17, 19.
115. Id.
116. Barnes Interview, note 75 supra.
118. 463 F.2d 137 (5th Cir. 1972). Although this landmark case was decided under federal securities law, the court's reasoning is still applicable to California securities law.
119. Id.
investors were not close to the syndicator, "[d]ue to natural human hesitancy on their part . . . [they would] not avail themselves of the kind of information necessary to critically evaluate the investment."120

Although the Commissioner of Corporations would most likely give substantial weight to this component, failure to satisfy this component apparently would not, in and of itself, cause the offering to be deemed public under the Commissioner's rule. As mentioned previously,121 the Commissioner requires as a condition precedent of a presumptive non-public offering either that the offerees have a pre-existing personal or business relationship with the syndicator or that the offerees can reasonably be assumed capable of protecting their own interests in the transaction by reason of their business or financial experience.

In many limited partnerships, the syndicator has a close relationship with a broker-dealer, and the broker-dealer has a close relationship with the offerees, but the offerees do not have a close relationship with the syndicator. This latter fact, in the eyes of the Department, may be evidence of a public offering.122

Sophistication of the Investors

The most important component in determining whether an offer is public or non-public is whether the offerees are, by reason of their business or financial experience, capable of defending their interests in the real estate transaction.123 In concluding that there was an offering to the public, the Humphreys court stated that "[i]t would appear that the offerees, as a class, were the type who needed the protection of the Corporate Securities Law."124

There is considerable disagreement regarding the kind of business experience required before a person no longer needs the protection of the state.125 The federal courts view "sophistication" as a general concept. The federal decisions focus on whether the offeree knew what to look for and how to interpret the available

120 Long, supra note 17, at 15.
121 See text accompanying note 83 supra.
122 Robinson Interview, note 7 supra.
124 Id. at 701, 84 Cal. Rptr. at 500.
information regarding the syndicator's business and his potential profits. The Department of Real Estate, on the other hand, felt that the best measure of sophistication was prior investment experience in the particular type of business being syndicated. The Commissioner of Corporations' treatment of sophistication will most likely parallel the approach of the Department of Real Estate.

The Department of Corporations and the federal courts also disagree on the effect that assistance of counsel should have on the determination of sophistication. One federal court held that the sophistication component is satisfied when the offerees have the assistance of counsel. Although it is a good practice for the syndicator to require the offerees to seek the advice of independent counsel, the Commissioner of Corporations has indicated that the use of counsel will not in itself satisfy the sophistication requirement. The offerees themselves must have the requisite knowledge and understanding with respect to the particular investment.

In attempting to satisfy the sophistication requirement, some syndicators have had investors execute letters stating that they are experienced and are in a high tax bracket. However, this ploy is inconclusive on the question of whether "the particular class of persons affected need [sic] the protection of the Act." Character of the Security Offered and Issued

The Commissioner of Corporations states in Release 5-C that "[s]ince some types of securities are more familiar or attractive to the investing public than others, the character of the security has a bearing on the question whether the offering is to the public." The use of a highly tax-structured limited partnership, rather than stocks or bonds that may be traded on a public market, will be evidence of a non-public offering. Moreover, the more the syndicator's offering resembles securities commonly in circula-

127. Long, supra note 17, at 15.
128. The Commissioner's treatment of a non-public offering is substantially the same as that of the Department of Real Estate. Barnes Interview, note 75 supra. Because sophistication is a factor in qualifying a non-public offering, it follows that the Commissioner of Corporations and the Department of Real Estate would take similar approaches to the sophistication issue.
130. Barnes Interview, note 75 supra.
132. Release 5-C, supra note 92, at 22.
133. Id.
tion, the more likely it will be considered a public offering.\textsuperscript{134}

Limited partnership agreements usually contain a provision giving partners the right to have their interests redeemed by the general partner or purchased by the other partners on a first-refusal basis.\textsuperscript{135} The underlying reason for this clause is to provide some liquidity for the limited partners. However, the syndicator should be careful in utilizing this right of first refusal because it will make the offering more similar to securities commonly in circulation and thus indicative of a public offering.\textsuperscript{136}

**Liquidity of the Security**

The *Humphreys* court added the liquidity of the security as the last of the eight components. It held that "[t]he more readily the transfer may be made, the more likely [it will] be deemed public."\textsuperscript{137} Furthermore, one federal court has held that the private offering exemption under the federal securities laws may be lost as a result of the facts surrounding the resale, especially if there is inadequate disclosure of the material facts.\textsuperscript{138}

A useful procedure is to have the investors provide letters of intent confirming that they have not purchased the securities for the purpose of reselling them. The syndicator may also include various transfer restrictions in the limited partnership agreement, such as high transfer fees as a condition of assignment, to minimize the liquidity of the syndicate security.\textsuperscript{139}

Although the Department may take this eighth component into account in determining the presence of a non-public offering, it is probably a relatively unimportant factor. The Commissioner has stated that he does not place a great deal of emphasis on this eighth component.\textsuperscript{140}

**Tomei v. Fairline Feeding Corp.**

In addition to the components noted above, the case of *Tomei v. Fairline Feeding Corp.*\textsuperscript{141} merits special mention. In *Tomei*, the

\begin{enumerate}
\item People v. Humphreys, 4 Cal. App. 3d 693, 701, 84 Cal. Rptr. 496, 500 (1970).
\item Long, *supra* note 17, at 18.
\item Id.
\item 4 Cal. App. 3d 693, 701, 84 Cal. Rptr. 496, 500 (1970).
\item SEC v. Guild Films Co., 279 F.2d 485, 490 (2d Cir. 1960).
\item Long, *supra* note 17, at 18.
\item Barnes Interview, note 75 *supra*.
\item 67 Cal. App. 3d 394, 137 Cal. Rptr. 656 (1977).
\end{enumerate}
court held that an issuer's previous packaging of public offerings is evidence that the present offering is public. Furthermore, the decision contains language that might be interpreted to mean that offers are non-public only if they are offered to no more than twenty-five offerees and sold to no more than ten investors. However, as previously discussed, the twenty-five and ten "rule" is not exclusive but provides only a yardstick for offerings conforming to the limits set forth within it. Furthermore, the question of whether the offering was public or non-public was not directly at issue in Tomei. Thus, the court's decision should not be determinative on the issue of the twenty-five and ten "rule."

**PRACTICAL CONSIDERATIONS**

Several practical problems regarding the administration of the syndicate securities rules should be highlighted. A major complaint of attorneys concerns the Department of Corporations' inflexibility in dealing with differences between syndicates. One attorney related an incident in which a limited partnership agreement called for a subordinated three-fourths of one percent of the sales price as compensation for the syndicator upon the resale of the property. The Department rejected this method of calculating compensation on the basis that the compensation had to be in the form permitted by the Commissioner's rules. A few computations reveal that the land would have had to appreciate 600% before the three-fourths percent would have been greater than the amount permitted under the Commissioner's rules. This type of inflexibility does not afford any more protection for the investor and imposes unnecessary restraints on the syndicator.

The Department of Corporations should apply its rules in a more flexible manner. The Department could substantially achieve this objective if its application of the rules were consistent with their intended nature as guidelines rather than as strict rules.

Another problem facing attorneys and syndicators is the lack of uniformity in the Department's decisions. Both "desk drawer" regulations and the geographically inconsistent application of the rules contribute to this situation. An example of the lack of uniformity was noted at a meeting between the Commissioner of

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142. *Id.* at 401, 137 Cal. Rptr. at 660.
143. *Id.*
144. See text accompanying notes 91-92 supra.
145. 10 CAL. ADMIN. CODE § 260.102.2 (1978).
146. Robinson Interview, note 7 supra.
147. See text accompanying note 8 supra.
Corporations and several representatives of the real estate industry. In the course of the discussion, it was discovered that a particular type of syndicate was systematically rejected in San Diego while an identical syndicate had been approved in Oakland. Fortunately for syndicators, the present Commissioner of Corporations has made the elimination of “desk-drawer” regulations one of his top priorities.

A closer working relationship between the Commissioner and his deputies could greatly alleviate the problem of uniformity. Better communication would ensure that the deputies’ performance of their duties is consistent with the Commissioner’s views.

A third problem complicating the syndicator’s efforts in complying with the Department’s rules is the natural hesitancy on the part of attorneys and syndicators alike to question the decisions of the local deputy. Many feel that a challenge to the deputy’s decisions might impair their relationship with him and make it more difficult to qualify their syndicates in the future. As a result, one finds “regulation by fiat,” that is, a deputy may do as he wishes without fear that his decisions will be challenged.

**Criminal and Civil Penalties**

It is extremely important that the syndicator understand the rules and regulations of the Department of Corporations with respect to both public and non-public offerings. Failure to comply with the rules discussed above can subject the syndicator to both criminal and civil penalties under California law.

The California legislature has imposed criminal penalties for the willful violation of any provision of the syndicate securities laws. Any person who willfully violates these laws is subject to a fine of not more than $10,000 and imprisonment for not more than one year.

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148. This meeting took place on December 30, 1977. Those present discussed possible changes in the Commissioner’s rules with respect to smaller syndicates. Interview with Burton Smith, former Commissioner of Real Estate, in Irvine, California (Sept. 15, 1978).
149. Robinson Interview, note 7 supra.
150. Id.
151. Id.
152. Id. Mr. Smith used the term “regulation by fiat” during the interview.
154. Id. § 25540 (West Supp. 1978).
The syndication is also subject to various civil penalties for failure to comply with the syndicate securities laws. If the syndicator violates any provision of the syndicate securities laws pertaining to the qualification and/or the registration of a syndicate security, the investor is entitled to rescind the transaction and to recover the consideration paid for the security plus interest thereon less any income received therefrom. Alternatively, the investor may sue the seller for the difference between the consideration received by the seller and the value of the security at the time the investor purchased the security.

CONCLUSION

This Comment illuminates the requirements for real estate syndicates under California rules and regulations and the difficulties encountered by attorneys and syndicators in attempting to comply with them.

The comprehensiveness and strictness of the Department of Corporations' rules regarding substantive fairness make compliance extremely difficult for the syndicator. In addition, the syndicator faces various administrative problems, such as the lack of uniformity and flexibility in the application of the Department's rules and "regulation by fiat," in attempting to comply with the substantive fairness rules.

Thus, one finds a paradox. The substantive fairness rules were formulated to protect the investor. However, because of their strictness and complexity, the rules have been at least partially responsible for syndicators going non-public and thereby avoiding strict compliance with the rules. As a result, investors receive less protection. In light of these circumstances, the Department of Corporations should consider revising the substantive fairness rules in order to make them less strict and less complex. Furthermore, it should apply these rules in a more flexible manner. Such a course of action would be consistent with the Department's administrative authority—the promulgation of guidelines regarding syndicate securities.

Bill Naumann

155. Id. § 25503 (West 1977).
156. Id.