Private Investments by Estate Planning Entities:

Qualification as Accredited Investors and Qualified Purchasers

By Jessica Mering Hardin

High net worth families increasingly look to hedge funds and other private securities offerings for investment opportunities, many of which are available only to "accredited investors" and "qualified purchasers." A person who qualifies as an accredited investor and qualified purchaser in her individual capacity is often surprised to learn that her qualification does not necessarily extend to her estate planning and charitable giving vehicles. Since it is generally the investor's responsibility to determine and represent whether a planning vehicle meets the necessary qualifications, estate planning advisors must understand whether their clients' trusts and other entities are eligible for these investment opportunities.

General

Federal securities law requires a company offering its securities to register them with the Securities and Exchange Commission ("SEC") unless the offering qualifies for an exemption from registration. Companies making private offerings seek to qualify for those exemptions in order to avoid substantial disclosure obligations and other requirements that accompany registration. In order to meet certain exemption criteria, issuing companies often limit offerings to those who are accredited investors and qualified purchasers.

Regulation D of the Securities Act of 1933 sets out the requirements for an accredited investor and the Investment Company Act of 1940 defines a qualified purchaser.

An individual qualifies as an accredited investor or a qualified purchaser because of his or her income or net worth, while a business entity, a charity or a trust qualifies either because of the value of certain assets or because of the identity of one or more key persons.

Individuals

Accredited Investor. An individual qualifies as an accredited investor (or "AI") if (i) he or she earned income in excess of $200,000 in each of the prior two years ($300,000 if combined with a spouse) and reasonably expects the same for the current year or (ii) he or she has a net worth in excess of $1 million (alone or with a spouse but excluding the value of the primary residence).

Qualified Purchaser. An individual who owns at least $5 million in "investments" is a qualified purchaser (or "QP"). "Investments" include real estate, commodities, and financial contracts that are held for investment purposes and securities, cash and cash equivalents, but such an asset's value is reduced by outstanding acquisition indebtedness, if any.

Business Entities

Accredited Investor. A non-charitable corporation, partnership or LLC is an AI if its assets at the time of investment exceed $5 million and it was not formed for the specific purpose of acquiring the securities offered. Assets of any type apply toward the $5 million threshold and the calculation does not consider the entity's debt. For purposes of qualifying such an entity as an accredited investor, a loan or even a line of credit that pushes the gross asset value over $5 million may suffice.

A number of facts and circumstances determine whether, for accredited investor qualification, an entity is formed for the specific purpose of acquiring the securities offered and no one factor is determinative. The SEC considers the entity's prior activities, whether it has centralized management, its proposed activities, the value of the entity's proposed investment as compared to the value of its total assets and the participation of all of the entity's equity owners in the investment.

A business entity that does not hold more than $5 million in assets still qualifies as an AI if all of its equity owners (that is, shareholders, partners or members) are AIs.

Qualified Purchaser. A business entity is a QP if (i) the value of its investments is at least $5 million or $25 million and it meets certain other conditions or (ii) all of its owners independently qualify as QPs.

A business entity with at least $5 million of investments is a QP if it has two or more owners, all of whom are related as siblings or by direct lineal descent (each a "family member"), the spouse or former spouse of a family member, the estate of a family member or a foundation, charitable organization or trust established by or for the benefit of one or more family members.

An entity with unrelated owners, like a family-controlled business with non-relative minority interest holders, may still qualify as a QP if it has no less than $25 million in investments.

Even with sufficient investments, however, an entity will not qualify under the $5 million or $25 million value tests if it was formed for the specific purpose of acquiring the securities offered. Again, a facts and circumstances test determines, for QP qualification, whether an entity was formed for the specific purpose of making an investment. SEC guidance suggests that an entity that invests 40% or more of its assets in a single investment will be deemed to have been formed for the specific purpose of making that investment, even if the entity has been in existence for a long time and was clearly formed for other purposes.

Finally, a business entity is a QP if all of its beneficial owners independently qualify as QPs, regardless of the value of the entity's assets, the relationships of its owners or whether the entity was created for the specific purpose of purchasing the offered securities.

Charitable Organizations

Accredited Investor. An Internal Revenue Code Section 501(c)(3) organization that is not formed as a trust is an AI if its assets exceed $5 million and it was not formed for the specific purpose of acquiring the securities offered. Unlike business organizations (discussed above) or charitable trusts (discussed below), a charitable

corporation with assets under the $5 million threshold cannot qualify as an AI because of the identify of a contributor or decision maker.

Qualified Purchaser. The same rules that apply to business entities apply to charities. For purposes of qualifying for the $5 million investment value threshold, all contributors to the charity must be related as described above. If one or more contributors are not related, the charity must have at least $25 million in investments. In order to meet either test, the charity may not have been formed for the specific purpose of acquiring the securities.

A charity with insufficient investments is a QP if each person who has contributed to the charity and each person authorized to make investment decisions for the charity is a QP. In addition, the charitable organization may not have been created for the specific purpose of acquiring the offered securities.

Charitable and Non-charitable Trusts

Accredited Investor. A charitable or non-charitable trust is an AI if it meets a minimum asset value, if its grantor is an AI and also considered an "equity owner" of the trust, or if it has a corporate trustee.

Like a business entity or charitable organization, a charitable or non-charitable trust is an AI if its assets exceed $5 million and it was not formed for the specific purpose of acquiring the securities offered. In addition, in order for a trust to qualify under this asset test, a "sophisticated person" must direct the purchase of the offered securities.

A party is a sophisticated person if he has (or the issuer reasonably believes him to have) sufficient knowledge and experience to evaluate the benefits and risks of the investment. A trust with a corporate trustee or an individual trustee who independently qualifies as an AI should meet the sophisticated person test. In certain situations, however, even a trust with an individual trustee who is not a sophisticated person may meet this requirement. For example, the terms of a trust may confer the power to make investment decisions on a party other than the trustee, particularly in situations where the grantor's spouse or child serves as trustee but does not have sufficient expertise to manage the trust's investments. If the investment advisor's decisions are binding on the trustee (as they are on a directed trustee under N.C.G.S. Section 36C-8A-804) and the investment advisor is a professional or otherwise has sufficient expertise, the trust likely meets the sophisticated person test. It is less clear whether trusts with an individual trustee who does not qualify as a sophisticated person, but who delegates investment decisions to a sophisticated person pursuant to a power to delegate granted by the terms of the trust or N.C.G.S. Section 36C-8-807, will meet the sophisticated person test.

Also like a business entity, a trust that does not hold at least $5 million qualifies as an AI if all of its "equity owners" are accredited investors. Since the concept of equity owners is generally inapplicable to trusts, few trusts will qualify under this test. However, in very narrow circumstances, the SEC has found that a grantor's relationship to a trust may be so analogous to that of an equity owner of a business entity that the trust is an AI. For example, a revocable trust is an AI if the grantor is an AI since the grantor is treated as the "equity owner" of the trust. The SEC has held that a grantor retained annuity trust and a rabbi trust (created by an employer as part of an employee's compensation) were AIs where the trust's grantor and trustee was an AI, the trust was a grantor trust for federal income tax purposes, and the trust assets were subject to the claims of the grantor's creditors. Outside of those narrow situations, however, a trust will not be considered to have an equity owner and the grantor's AI status will be immaterial to the trust's qualification.

Finally, a trust, regardless of the value of its assets, is an AI if it has a corporate trustee. A national bank, or any banking institution organized under the laws of a state or Washington, D.C. whose business is "substantially confined to banking" and that is governed by the state banking commission, is an AI. That accredited investor status is imputed to a charitable or non-charitable trust of which such a bank serves as trustee as long as the bank has the power to – and, in fact, does – direct the trust with respect to its investment in the securities. A trust may have one or more trustees in addition to the bank and qualify under the corporate trustee test as long as the trust follows the bank's instructions with regard to investment in the securities.

The SEC has not published clear guidance on whether a non-depository trust company qualifies as a bank for purposes of determining AI status. Commentators generally believe that trust companies fall within the "bank trustee" category. In at least one instance, the SEC did not challenge a trust company's assumption that it qualified as a "banking institution" since a "substantial portion of its business consists of exercising fiduciary powers" and it was supervised by a state banking commission.

Qualified Purchaser. Like a business entity or a charitable organization, a trust is a QP if the net value of its investments exceeds $5 million (and all of its two or more beneficiaries are related) or $25 million (if it has fewer than two beneficiaries or not all of its beneficiaries are related) and it was not formed for the specific purpose of acquiring the securities offered.

A trust of any value is a QP if both the grantor and the person(s) with investment authority over trust assets (generally, the trustee) are qualified purchasers and if the trust was not formed for the specific purpose of acquiring the securities offered. It is immaterial whether any beneficiary is a qualified purchaser.

While family partnerships, foundations and trusts may benefit from holding private investments, determining their eligibility as accredited investors and qualified purchasers requires careful analysis.

For additional consideration of these complex issues, see 15 U.S.C. §§ 77b(a)(15), 80b-2(a); 17 C.F.R. §§ 230.501(a), 270.2a51-1 to -3; Goldman Sachs Asset Management, L.P., SEC No-Action Letter, 2007 WL 1027885 (March 13, 2007); American Bar Association Section of Business Law, SEC No-Action Letter, 1999 WL 235450 (April 22, 1999); Meadowbrook Real Estate Fund, SEC No-Action Letter, 1998 WL 541510 (Aug. 26, 1998); Trans-Resources, Inc., SEC No-Action Letter, 1997 WL 280674 (May 27, 1997); Wolf, Block, Schorr and Solis-Cohen, SEC No-Action Letter, 1996 WL 714670 (Dec. 11, 1996); Nemo Capital Partners L.P., SEC No-Action Letter, Fed. Sec. L. Rep. 78,506 (March 11, 1987); Herbert S. Wander, SEC No-Action Letter, 1983 WL 28826 (Oct. 6, 1983); Hall Moneytree Associates Limited Partnership I, SEC No-Action Letter, 1983 WL 29899 (Oct. 3, 1983); Lawrence B. Rabkin, SEC No-Action Letter, Fed. Sec. L. Rep. 77,341 (July 16, 1982); Securities Act Rules Compliance and Disclosure Interpretations (available at sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm).

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