ANNE M. EBERHARDT

The excitement of Thoroughbred ownership can be shared through racing partnerships

MANAGING RACING PARTNERSHIPS

BY LAURA A. D'ANGELO

This is the first of a two-part series on partnerships. Part 2, which will examine what prospective partners should look for, will run in the Nov. 19 issue.

RECENT NEWS COVERAGE INVOLVING THE arrest of a pharmaceutical executive who brazenly declared his intent to raise the price of a life-saving drug by 55 times had nothing at all to do with his price-gouging or apparent lack of a moral compass. The 32-year-old was arrested for repeatedly losing investor money, moving money between companies that did not share common ownership, and lying to his investors about these activities and the financial performance of the companies.

What does this have to do with Thoroughbred racing partnerships? More than you might think. The Securities and Exchange Commission and state securities regulators are very active in such high-profile investigations, but also in day-to-day compliance and investor fraud. This isn't surprising in light of the volume of investor activity in the stock market, the volatility of the market since 2008, and the proliferation and often sudden demise of start-up companies.

What Promoters Need to Know

Securities laws are designed to protect investors and to ensure the stability and integrity of the market. Media stories focus on scams, corporate failings, unsavory promoters, penny stocks, and insider trading. But the regulations extend beyond big business and publicly-traded companies to impact investors in, and promoters of, completely legitimate private business enterprises. Closely held businesses formed to raise capital and further a business purpose, such as racing partnerships, are subject to regulatory scrutiny.

Racing partnerships, wherein a "promoter" or "issuer" offers and sells interests in a racehorse or group of racehorses, may fall within the scope of the SEC's regulatory mission. Generally, the racing manager is the promoter or issuer. The SEC has issued numerous private letter rulings over the years, clearly stating that if centrally managed and sold to investors with the expectation of a profit, such partnerships will be considered securities.

Racing partnerships are of great value to the horse industry. Partnerships increase participation and bring new fans to the sport while lowering both costs and risk exposure. Partnerships take many forms and may be formal or informal.

Formal entities most often include limited partnerships, general partnerships, and limited liability companies. Partnerships may be comprised of a group of friends or a widely diverse group of individuals who don't know each other and may have had no prior dealings with the racing manager or promoter. There may be two investors (owners) or 100.

Prospective purchasers are able to utilize the advice and knowledge of a manager who is experienced in horse selection, racing management, and interfacing with trainers. Likewise, potential owners may use a partnership to buy a piece of a more expensive horse and participate at a higher level than they would otherwise be capable of doing individually. The value of partnerships to the Thoroughbred industry in terms of generating capital, interest, and participation is evident by the proliferation of new entities promoting such opportunities. This was a particularly active sector during the recent economic downturn.

The larger the number of investors and the more attenuated their relationship with the racing manager, the higher the degree of risk to the racing manager. Beyond possible civil and criminal liability, an investor's remedy when an investment is found to be a security and is either unregistered or not subject to an exemption from registration, is complete rescission of the deal. In other words, the investor is entitled to the return of all money invested without regard to the current value (or lack thereof) of the horse(s) or the entity.

What is a security? A security is defined as "any investment in a common enterprise with an expectation of profits derived solely from the efforts of a promoter or third party."

Racing partnerships can fall into the definition by virtue of their centralized management, the investment for profit, and the pooling of income (common enterprise). Out of necessity, racing managers are typically delegated broad decision-making authority in order to manage the horse(s) day-to-day. The investors are generally passive or have no involvement at all in the decision-making process, relying instead on the expertise of the racing manager.

Every security is required to be registered with the SEC and in each state in which a potential investor (to whom an offer is made) resides unless that security qualifies for an exemption from registration. Registration can be a cumbersome and expensive process.

Consequently, in 1980, the Small Business Incentive Act was created to purportedly provide a less-expensive route for small businesses. Many, however, say that it failed in its goal as the requirements continue to be burdensome. Regulation D is probably the most utilized exemption and provides issuers with important and useful exemptions to the full registration process.

Regulation D provides for exemptions of private placements or limited offerings if the offering meets certain dollar restrictions and investor qualifications. If an offering qualifies for a Regulation D exemption, a limited filing is required at the federal level.

The most commonly utilized exemptions fall under Rule 504, 505, or 506 of Regulation D of the Securities Act of 1933. Which exemption applies depends on the size of the offering and the character of the investors. The size of the deal is measured by the size of the initial offering. Offerings cannot be divided in an effort to qualify for an exemption unless a separate business purpose exists. Otherwise, all similar purpose offerings made by an issuer within a 12-month period will be combined.

The issuer must inquire into the financial status and sophistication of each potential investor. An individual "accredited investor" is an investor with a net worth of at least $1 million (excluding the person's principal residence) or who earned more than $200,000 in each of the past two years (or $300,000 combined income if married). If the interest is bought through an entity such as a limited liability corporation, all members of the LLC must be accredited if the LLC is to be considered an accredited investor. A "sophisticated investor" is one with experience investing in the markets and in the particular industry. Each Regulation D exemption has a cap on the number of non-accredited investors that may take part. This is not to say a non-accredited investor may not invest in a racing partnership, but that the number of non-accredited investors should be limited.

Disclosure of all material facts regarding the investment and how the partnership will be operated is required. A material fact is one that a prudent investor would consider important in making an investment decision. For example, if the manager desires to have the authority to drop a partnership horse into a claiming race, this should be expressly noted in the agreement.

In *Pugliese v. Mondello*, a 2008 New York case, the manager did just that and was sued with the investor arguing that the claim price was not the true value of the horse. The manager prevailed with the court holding that the decision was made for a legitimate business interest and "absent evidence of bad faith, fraud, self-dealing, or other misconduct." The decision of the manager would not be overturned by the court. But the time and expense of litigation could have been avoided if the agreement had included language expressly granting or denying such decision-making authority.

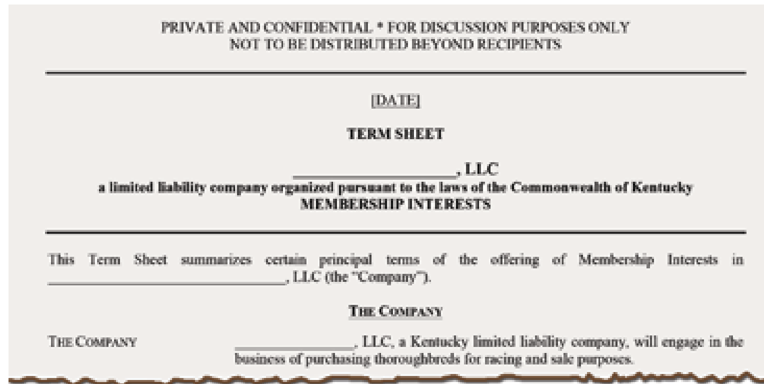
If financials are provided in the form of pro-formas, they should represent a range of possible and conservative outcomes. One often-used practice is to show at least three versions: one losing money; one breaking even; and one mak-

COMMONLY UTILIZED EXEMPTIONS

Rule	Dollar Limit	Number of Non-Accredited Investors Permitted
504	$1,000,000	No limit
505	$5,000,000	Up to 35 non-accredited permitted
506(b)	Any Size	Up to 35 non-accredited but sophisticated permitted
506(c)	Any Size	Zero non-accredited investors permitted
Crowd	$1,000,000	No limit

ing a modest profit based on reasonable assumptions.

Overstating potential financial outcomes is a recipe for trouble. In *Roman's v. Shearson Lehman Hutton* (a 1991 case brought in the 1st Circuit), investors in a horse-breeding limited partnership sued alleging "fraudulently induced investments through misrepresentations and omissions in the offering materials that falsely inflated the partnership's financial potential." The court dismissed the claims because one was barred by the statute of limitations and the other was not plead with sufficient particularity. Misleading or overly enthusiastic financial predictions are often the source of litigation.



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[DATE]

TERM SHEET

_______________, LLC
a limited liability company organized pursuant to the laws of the Commonwealth of Kentucky
MEMBERSHIP INTERESTS

This Term Sheet summarizes certain principal terms of the offering of Membership Interests in _______________, LLC (the "Company").

THE COMPANY

THE COMPANY _______________, LLC, a Kentucky limited liability company, will engage in the business of purchasing thoroughbreds for racing and sale purposes.

Partnerships should be carefully structured to protect both the issuer and investors

Similarly, in *Bruce v. Martin*, a 1989 New York case, a group of investors invested in 25 horse-related limited partnerships and sued the general partners alleging a pyramid scheme claiming fraud (misleading financials and other fraudulent behavior was alleged). The case was settled after the court acknowledged that the acts by the general partners resulted in plaintiff's losses and the defendants agreed to pay the plaintiffs a total of $275,000. Defendants later defaulted on the settlement payment, and the plaintiffs later brought the case again.

Regulation D also includes a complete ban on general solicitation and advertising (including websites) and commissions (other than to licensed broker-dealers). Public relations-type websites or ads are generally acceptable such as promoting a racing stable generally and past successes. However, current offerings with details on horses and prices should never be advertised or posted on websites.

In 1982 the SEC issued a "no action" letter indicating that the mailing of a racing partnership brochure to members of the Thoroughbred Owners and Breeders Association, the placing of the brochure on car windshields at the fall sales, and the placement of an ad in a prominent Thoroughbred magazine violated the prohibition on general solicitation.

The crowdfunding exemption prohibits any advertising beyond a simple "tombstone ad" that merely describes the basics of the offering. The crowdfunding rule also contains other requirements (including methods to confirm the accredited status of investors and use of an intermediary) that decrease the likely use in racing partnerships due to complexity and costs. The most applicable crowdfunding exemption permits individuals, accredited or not, to invest $2,000 or more (depending on their income level) in a business in exchange for an equity interest in the business. However, there are some limits, including: (1) the business can raise no more than $1 million in a 12-month period through this exemption, (2) the money must be contributed through an SEC-registered intermediary, and (3) there are specific disclosure requirements.

State compliance is required in every state where an offer to an investor is made (so-called "Blue Sky Laws"). Most states put their own unique spin on the federal statutes and regulations and therefore are non-uniform. As a result, if an issuer offers to investors in 20 states, the issuer's attorney should review the securities laws in each of those states for compliance. If an offering is made on the internet (which it shouldn't be), the offer is considered to have been made in all 50 states and possibly internationally.

Kentucky has several "self-executing exemptions" from registration that simply require the filing of the Service of Process Consent form, for which there is no filing fee. The two more common self-executing exemptions are: (1) no more than 15 non-accredited investors in Kentucky that have received full disclosure, or (2) no more than 35 non-accredited investors in Kentucky and elsewhere that have received full disclosure and the total investment is less than $1 million.

Kentucky also passed an "intrastate crowdfunding exemption" for those companies that are a resident in Kentucky, operate in Kentucky, and only have investors that are residents of Kentucky. Those qualifying Kentucky businesses can raise no more than $10,000 per non-accredited person up to $1 million. Disclosures to investors and filing at the state level are required.

Racing partnerships are useful tools to create interest, revenue, and new fans for the industry while decreasing exposure and risk at the individual level. Partnerships provide both entertainment and sometimes profit to the investors. However, they should be carefully structured with professional guidance in order to protect both the issuer and the investors and to comply with state and federal law. BH

This article is not intended to provide legal advice and should not be relied upon as such. Please consult with your own attorney and other professional advisers as necessary.

Laura A. D'Angelo is an attorney with Dinsmore & Shohl LLP in Lexington.

PART II OF THIS ARTICLE WILL APPEAR IN THE NOV. 19 EDITION
A SPECIAL ADVERTISING SECTION FOLLOWS THIS FEATURE