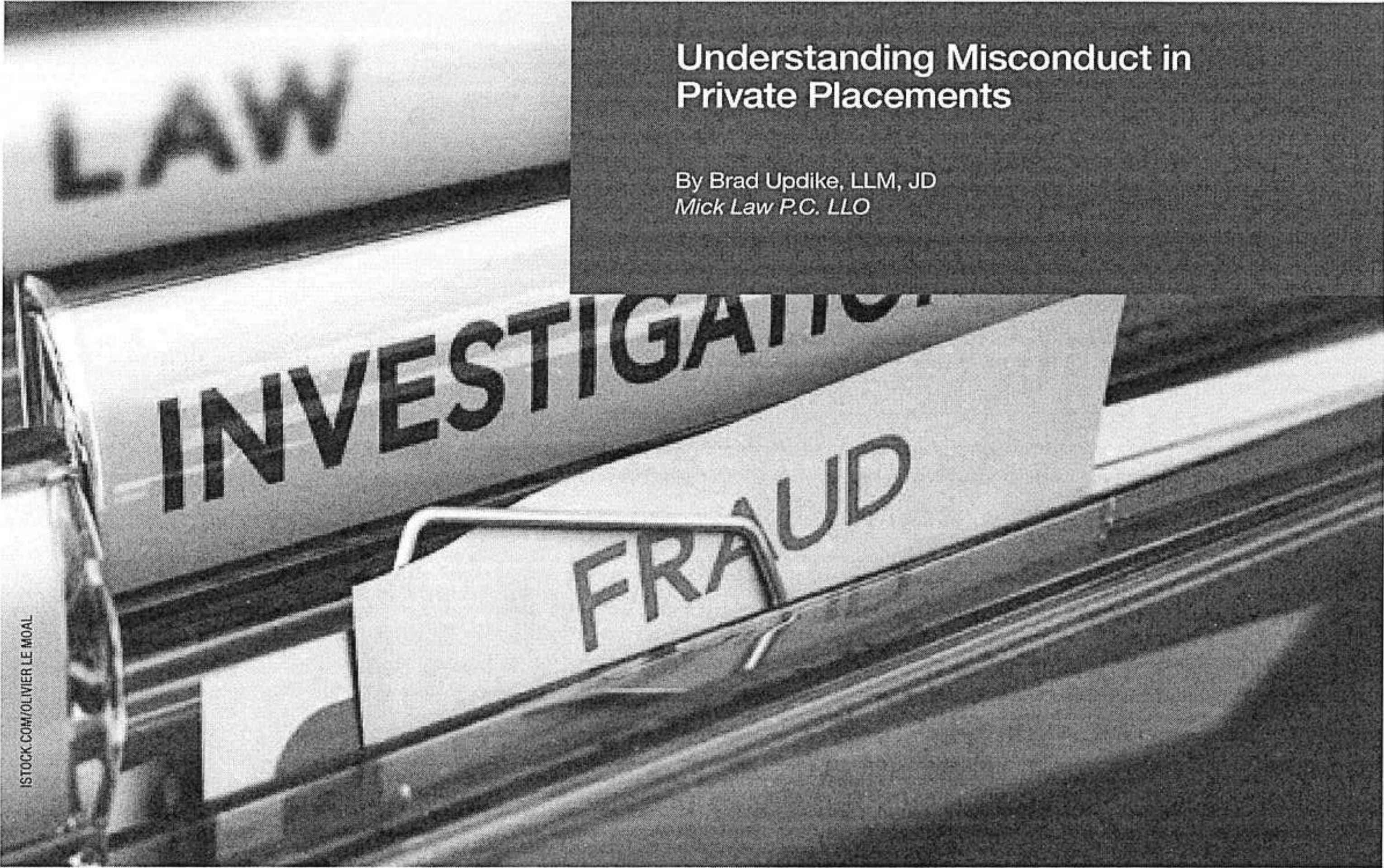

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Understanding Misconduct in Private Placements

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Private placements are non-public securities offerings marketed to a limited number of investors. These offerings are used by tens of thousands of companies on an annual basis to raise money for use within many sectors of the U.S. economy that include real estate, energy and private equity.

The capital raised by these offerings has been substantial, as evidenced by 20,000-30,000 Form D filings a year from sponsors seeking to raise trillions of dollars for their businesses.

Despite the widespread use of private placements, they became the subject of controversy during the Great Recession after law enforcement authorities uncovered multiple instances of misconduct perpetrated by sponsors such as Provident Royalties, LLC; Medical Capital Holdings, Inc.; Sunwest Management, Inc. and others. Excluding $65 billion of capital that was eviscerated by the misdeeds of Bernard Madoff, in 2008 authorities uncovered forty other Ponzi or Ponzi-like cases that affected about $23 billion of investor capital. The second year of the Great Recession was almost as bad, with Ponzi activities also being linked by authorities to $15 billion of capital in 2009.

In view of the *wave of frauds* revealed during the Great Recession, hundreds of broker-dealers and professional service providers were called forward to answer for the misdeeds of the wayward sponsors. The fallout of this was substantial. After the smoke cleared, many broker-dealers were forced to close their doors due to the lawsuits, arbitrations and enforcement cases. In the case of Provident Royalties, LLC alone, twenty of the sponsor's 53 selling group members were forced to close. For those that survived the fallout, the damages paid out to the investors were considerable.

While cases of misconduct have been generally down over the past decade, they continue to surface from time to time; these have included recent cases filed by the Securities and Exchange Commission (SEC) against EquiAlt, LLC (filed February 2020)

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and *GPB* Capital Holdings, LLC (filed February 2021). Acknowledging that these are open cases whose litigations are pending, the alleged wrongdoings unfortunately resemble those of the infamous cases that surfaced during the Great Recession.

On a positive note, our economy is positioned today for economic growth as the COVID-19 vaccine is administered on a broad scale and as various sectors of the U.S. and world economies reopen. *While we are encouraged by the prospects for economic growth, we believe it is important to reflect upon the challenges of the past to help empower our membership for responsible growth moving forward.* Accordingly, this article will provide a narrative of past misconduct cases to help facilitate improvements in the due diligence and risk management practices of ADISA's membership.

Misconduct Case Studies

We will discuss three cases involving private placement misconduct. These cases were selected based upon the finality of the underlying litigations. Despite the age of the cases, we believe they are worthy of reflection due to their common facts. These cases are similar in that each of the sponsors experienced success during the beginning of their business cycles, and in that the early promise of the sponsors led to successful fundraising results within the retail investment channel. Unfortunately, these cases are also similar in the sense that accountability and transparency were seriously lacking, which ultimately led to a pattern of misconduct in each sponsor's cash management practices within the programs.

1. Provident Royalties, LLC ("Provident")

Provident was an energy sponsor that acquired mineral interests and royalties. These acquisitions were accomplished through a series of preferred stock offerings whereby investors were to be paid dividends that ranged from 15% per year for shares with anticipated holding periods of two years and 18% per year for shares with anticipated holding periods of three years. Upon an investor's purchase of the shares, monthly dividends would commence at the beginning of the fourth month from the purchase date. At the end of the anticipated holding period, investors were to receive their invested principal and the monthly dividends that accrued during the initial three months of the investment.

Provident's preferred stock programs in 2007 raised approximately $100 million, and most of that capital was used to acquire mineral rights, royalties and working interests covering 90,000 acres within the Woodford Shale Play in central Oklahoma. This basin was deemed by the *Oil & Gas Investor* magazine in 2006 to be the next biggest E&P play in the U.S. due to the horizontal drilling results achieved by operating companies such as Newfield Exploration and others. Good fortune followed from Provident's ability to acquire its asset position, which included: (i) the procurement of a joint venture with SinClair Oil Corporation to develop the acreage position through additional asset purchases and through drilling; and (ii) the procurement of a $150 million credit line from Frost Bank (which was supposed to be used, in part, to manage Provident's dividend payments to investors and to fund drilling costs on new wells). This good fortune led to the funding of twenty programs that raised $465 million.

Despite Provident's promise, there were *serious* quirks within Provident's operations. First, Provident did not have a functional accounting system. While Provident hired a team of clerks and accountants to handle bookkeeping, at no time did it have a written set of practices and controls to follow when dealing with program capital and other sources of money. In accordance with the corporate charters of the program entities, Provident could pay investor dividends out of each program's capital surplus, i.e., determined by each program's net equity (as opposed to earnings). Also, Provident's offering materials allowed it to buy and sell

assets to and from its managed offerings, i.e., enabling an earlier program to sell its assets to a later entity to help fund dividend payments to early investors.

Interestingly, Provident could have perhaps avoided its fate by managing its investor payments through the credit line, as the credit line authorized Provident to use up to one-third of the principal to pay dividends. However, Provident allowed itself to get caught up in a *shale buying frenzy*, in which it imprudently took money from whatever sources were immediately available to buy assets, drill wells and pay dividends to investors. In addition to having an undisciplined accounting system, a second problem with Provident's strategy was that it did not have a backup plan in the event that a divestiture of the program's assets became unachievable. Thus, all fortunes rode high on Provident's ability to exit its Oklahoma asset position quickly.

With the Great Recession's onset in late 2008 came a massive drop in oil and gas prices. Due to Provident's improper cash management practices, the balance sheets of *each* of its programs were riddled with related party receivables and payables. While Provident's entities collectively acquired a promising base of assets located within a discernible path of future drilling (the valuation by Raymond James at the time approached $2 billion), many of these assets did not produce cash flow at the time they were held by the programs. At the end of the day, it was virtually impossible for anyone to confirm the exact source of the investor dividends, as Provident's sources of capital included $150 million of credit line proceeds and several millions of dollars of joint-venture reimbursements from SinClair, as well as the $465 million of investor capital.

With the recovery of oil and gas prices in late 2009, it was opined by a restructuring consultant during Provident's bankruptcy that its base of assets would have allowed it to restructure its finances and to recover from the carnage of the Great Recession. Provident was denied that opportunity, however, based upon the scope of the fraud and the magnitude of affiliated transactions conducted. In the end, assets were sold through the bankruptcy process, and losses were realized by investors and selling group firms.

2. Medical Capital Holdings, Inc. ("MCHI")

Formed in 1994, MCHI's business consisted of acquiring healthcare receivables owed to physicians or physicians' offices by medical patients or their insurance carriers. As of February 2001, and prior to the time in which it entered the retail broker dealer channel, MCHI had already purchased $500 million in healthcare receivables. MCHI was led by a number of individuals with respectable work backgrounds in insurance, finance, medical finance and accounting.

MCHI funded its healthcare financing activities by offering promissory notes ("notes") issued through a series of six special purpose corporations ("SPCs") formed at various times from 2003 through 2009. To raise capital, the SPCs sold notes through broker dealers. In these offerings, the notes had various maturities (one to seven years) and interest rates (8.5-10.5%). The notes with shorter maturities (i.e., one to three years) were automatically renewable for a one-year term unless the investor provided MCC with written notice that he or she did not want to renew the note.

The capital raised by the SPCs was anticipated to be used to acquire healthcare receivables purchased by MCHI. MCHI would use its financial resources to acquire receivables at a discount from various healthcare providers. The SPCs would then use the capital raised from investors to purchase the receivables from MCHI at cost plus a significant portion of the unrealized discount (i.e., at a price close to face value). Upon an SCP's procurement of the receivables, the receivables would be used as collateral for the investor notes. Based upon the marketing appeal of the notes as income products and the operational success of the initial program, MCHI raised $1.76 billion from 2003 through 2009.

Despite a promising beginning, there were many pitfalls with respect to the notes and their administration. Initially, the investment strategy of the SPCs, beginning with the initial 2003 program, consisted of purchasing receivables from physicians and physicians' groups, smaller hospitals and equipment distributors. The investment strategies of the SPCs, however, changed after the first

two programs. Beginning with the third offering launched in 2005, the scope of permitted investments was expanded to include non-receivable assets, including equity securities of all types of businesses and mortgage loans to receivable sellers or other parties in the healthcare industry. Unlike standard lending practices employed within the real estate lending community, which generally impose loan to value ratio (LTV) limits of 60%-75% upon loaned principal, MCHI's programs could make loans at LTVs of up to 100%.

MCHI's acquisition process was described within the offering materials of the SPCs. As stated within the materials, MCHI maintained a revolving credit line that enabled it to acquire receivables at discounted prices. Upon purchasing the receivables, MCHI would sell the receivables to the SPCs at a price equal to the sum of the money advanced to the seller of the receivables *plus* a significant portion of the unearned discount. The receivables purchased by MCHI and later sold to the SPCs were not subject to outside valuations.

According to the note agreements executed by the SPCs and the collateral agent banks, the definition of "Eligible Receivables" that could be purchased by the SPCs and ultimately used as collateral for the investor notes included receivables in which a claim for payment had been submitted to the approved payor within 180 days prior to the purchase of the receivable. As such, MCHI could sell "aged" receivables to the SPCs for which future collections were doubtful.

There were many other quirks of a problematic nature. The offering materials of the SPCs authorized MCHI to conduct related party asset sales among the SPCs for the stated purpose of diversification within each affiliate's portfolio. Despite the SPCs' collective issuance of approximately $1.7 billion in notes, neither MCHI nor any of the SPCs were required to procure audited nor reviewed financial statements, nor were they required to maintain accounting books and records that would otherwise enable them to provide GAAP-compliant financial statements to investors or stakeholders if requested. Unlike many note offerings, whereby a bank serves as a trustee on behalf of the noteholders and is empowered to monitor the debtor program's financial status and compliance with the borrower obligations, the borrowing agreements reduced the banks to the role of a collateral holding agent with limited monitoring powers.

MCHI's demise began with defaults of its payment obligations within its note programs in August 2008. As reported by Thomas A. Seaman, the court appointed Receiver for MCHI ("Receiver"), the climate of unaccountability within the various SPCs culminated in (i) massive collectability issues, (ii) a substantial number of related-party asset transfers among the SPCs, and (iii) ultimately, MCHI's misuse of investor funds. A summary of certain of the Receiver's findings is provided below:

- The purchases of receivables/loans of the programs were $2.288 billion (70% were receivables and 30% were loans);
- The collections of proceeds on the SPCs' purchased assets were $1.972 billion, thereby resulting in a collective loss of $316 million;
- Of the loss, almost all was attributable to the acquired loans (i.e., loan purchases exceeded loan collections by $352.556 million);
- Of the six SPCs, only the first was found to have realized profitable operations;
- Excluding the first program, the losses of the next five were $423 million; and
- Of the receivables/loan purchases by the SPCs, about $1 billion was derived from over 300 affiliate transactions among the SPCs.

On July 16, 2009, the SEC filed a Complaint against MCHI and its principals for various intentional violations of federal securities laws. Based upon the SEC's allegations against MCHI and its SPCs, many investors also filed a class action lawsuit against nine broker-dealers that were members of the selling group.

3. Sunwest Management, Inc. ("Sunwest")

Formed in 1992, Sunwest managed several senior living facilities throughout the U.S. Sunwest operated its business through certain affiliates, which included: (i) Canyon Creek Development, Inc., formed in 2001 to raise capital from investors through Tenancy in Common ("TIC") structured offerings; and (ii) Canyon Creek Financial, LLC, formed in 2005 to serve as a captive broker-dealer

for the TIC offerings. At the peak of its activities in 2007, Sunwest managed 300 retirement facilities in 34 states, with the assets collectively valued at approximately $2 billion.

From 2001 through 2008, Sunwest raised $430 million from investors. Sunwest raised most of these funds from 2006 through 2008 in 99 broker-dealer syndicated offerings that covered about a hundred retirement facilities. Most of Sunwest's programs were structured as TICs, whereby the investors acquired direct interests in the retirement facilities. The targeted properties were usually underperforming facilities with lower occupancy levels (e.g., 50-70%), which Sunwest's management believed could be improved.

Upon purchasing a facility, Sunwest's objective was to increase the facility's occupancy rate through prudent management, which would help to increase revenues and hopefully produce positive cash flows. Sunwest's return objective was intended to provide investors with annual returns of 10% during the facility's lease-up period. This was to be accomplished through a "Master Lease Agreement," whereby an entity affiliated with Sunwest would enter into a rental agreement in which the Sunwest Master Tenant would be required to pay ongoing rent to the TIC investors. The Sunwest Master Tenant would also designate Sunwest as each facility's operator and property manager.

Upon the achievement of a higher stabilized occupancy level, the platform's exit strategy was to refinance the loans of the facilities at an LTV that would enable Sunwest to repay the TIC investors their capital and an additional 2% return for each year invested. Each TIC was marketed as a stand-alone facility with separate operations, books and records, and financial resources. The offering materials characterized the future success of the programs as being dependent upon the cash flows and performance of the underlying facilities acquired by the TIC investors.

From 2001 through July 2008, TIC investors received rent payments that were consistent with Sunwest's objectives. Sunwest's practice of making timely rental payments to the investors was used to promote the offerings. While Sunwest established a history of timely payments to its investors, the source of the rental payments and the overall quality of Sunwest's accounting system was *not* well understood.

Sunwest's program accounting practice from the outset of its business in 1991 involved a "collective management approach," whereby the individual TIC properties were treated as a single consolidated entity. Similar to the facts of Provident, Sunwest managed the cash of its portfolio of facilities on an "as available" basis. As various costs at the facilities became due (e.g., vendor bills, payroll, debt service and payments to investors), Sunwest's finance team located and took cash from whatever facility happened to have it.

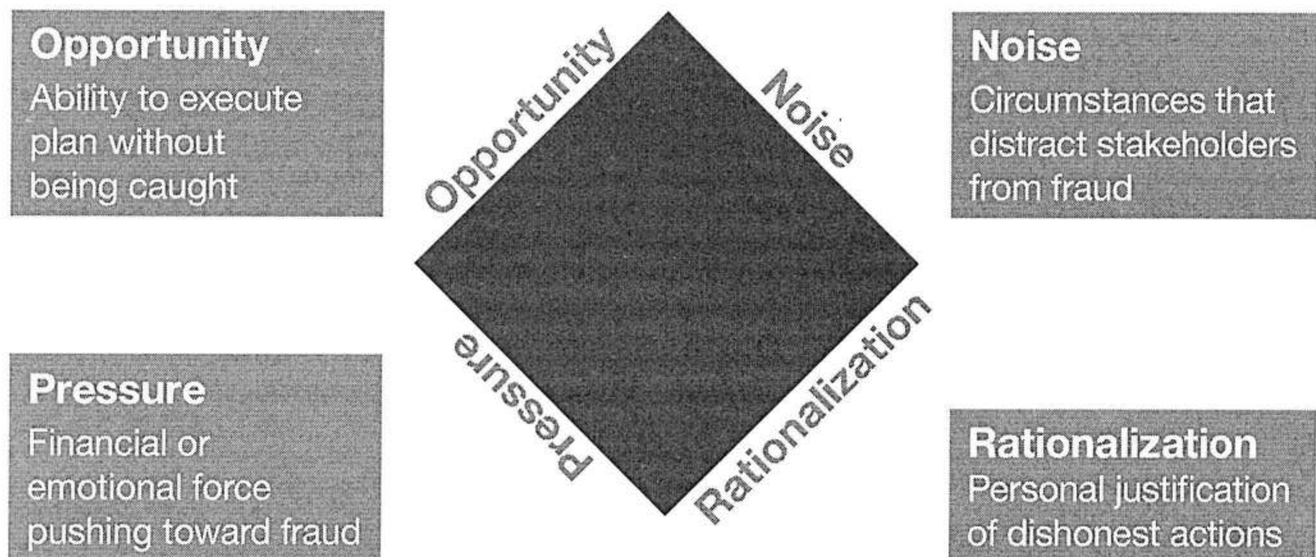
Unfortunately, as the credit markets tightened in 2007 and 2008, Sunwest's financial prospects for success were greatly frustrated. Despite Sunwest's practice of paying distributions to investors, almost one-third of the facilities it managed were cash flow negative for many years. Many facilities had never been cash flow positive. On a portfolio basis, and during 2007-2008, approximately 60% of Sunwest's managed facilities experienced negative cash flows.

By 2008, the U.S. credit crisis rendered Sunwest's business model unworkable. Sunwest's ability to refinance its facilities disappeared, and it faced problems funding operations at many facilities. By the onset of the Great Recession in January 2009, a majority of Sunwest's retirement facilities had been placed into foreclosure, receivership or bankruptcy, resulting in the effective elimination of the TIC investors' interests in the facilities. Similar to the fates of Provident and MCHI, the SEC pursued litigation against Sunwest and, ultimately, many investors sued the selling group members for their involvement in raising capital for Sunwest's business.

The Fraud Diamond

The Fraud Triangle, developed by criminologist Donald R. Cressey, is commonly used by fraud examiners to understand how and why fraud occurs in businesses. The three elements of the triangle are: (i) pressure (i.e., the motivation for the fraud); (ii) opportunity (i.e., operational weaknesses or weakness in the business's governance that allows the fraud to be undetected); and (iii) rationalization

(i.e., the justification for the fraud). Note that we added a fourth leg into our analysis that we shall refer to as "noise." The noise side of our "diamond" refers to the circumstances that distract stakeholders from discovering the misconduct.



A summary of the circumstances applicable to the three cases that fit into our Fraud Diamond are presented below, with each circumstance being applicable to two or all of the above cases.

Pressure/Motivation

- The market turns unfavorable, which affects cash flow of the programs
- Operations are unprofitable due to a failure by the sponsor to execute the core business strategy
- Operations are unprofitable because the sponsor moved away from its core business model
- The sponsor has a perceived need to pay investor distributions to preserve its reputation
- The sponsor has a perceived need to manufacture an exit within its first syndicated program to demonstrate a proof of concept to selling group members and investors
- The sponsor needs to continue to raise capital to accrue program management revenues and to stay in business

Opportunity

- The offering materials and organizational documents cultivate a "culture of unaccountability" stemming from a lack of oversight and transparency
  - (i) Lack of accounting practices/controls
  - (ii) Unconditional ability to change the program's investments
  - (iii) Ability to buy and sell assets among programs

(iv) Ability to loan funds among programs
(v) Unconditional ability to pay investors from capital
(vi) Lack of sponsor-level audits or reviewed financials
(vii) Lack of integrity as to the program-level accounting

- Failure of stakeholders during their due diligence to confirm/understand the:
  (i) Quality of the program's assets through independent underwriting
  (ii) Quality of the sponsor's accounting system
  (iii) Sources of investor distributions
  (iv) Accuracy of the sponsor's track record
- Failure of stakeholders to conduct ongoing due diligence after the first couple of offerings are funded

Noise—Why the Misconduct Went Unabated

- The sponsor's business started legitimately
- Investors received distributions on a timely basis
- Sponsor teamed up with well-respected industry partners
- There is a sentiment that the sponsor is on the verge of executing its strategy (i.e., cultivating a perceived need to be patient a little longer)
- The program offers a competitive yield that appeals to investors
- The sponsor has been in business for years, and the business just seems to work (i.e., assets are being acquired, money is being raised and investors are being paid)

Rationalizations

- *Administrative convenience*: the conduct is viewed as a temporary fix to a short-term liquidity problem
- *Ego*: the sponsor's accountability obligations are limited, and the sponsor therefore feels that its misconduct is allowed
- *Survival*: the sponsor believes it "has to" perpetrate misconduct to either save a troubled program and/or to stay in business

Conclusion

While the more recent cases may resonate negatively within the mainstream media, we should acknowledge that these unfortunate cases apply to a small segment of the sponsor/program universe. On this point, we acknowledge and commend the multitude of sponsors that have adopted sound operating practices and that are treating their investors as true partners.

As of the dates of this article, we believe our economy is positioned for growth as COVID-19 vaccines become available and as various sectors of our economy begin to reopen in earnest. With such growth will also come unprecedented opportunities for our membership to evaluate and perhaps approve of sponsors seeking to move their businesses forward through offerings of non-traded securities products. As such, we hope to empower our membership with a greater ability to evaluate and manage risks that have historically proved to be problematic.

Finally, I wish to acknowledge the contributions of the ADISA AI Betterment Task Force, whose feedback was instrumental in my ability to put this article together. ▲