A PRACTITIONER'S GUIDE TO WHEN REAL ESTATE BECOMES A SECURITY

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Commercial real estate attorneys are better equipped to guide clients through complex transactions if they develop baseline knowledge of federal and state securities laws. This article provides practitioners with tools to successfully navigate the complex statutory scheme and equally frustrating case law. This article (1) details the most important securities laws exemptions for real estate offerings; (2) identifies when a real estate interest becomes a "security" under the Howey test by developing several bright-line rules; (3) addresses the likelihood that particular partnership interests will become a security; (4) debunks the myth of a "safe harbor" for tenancy in common developments by providing a more plausible interpretation of Salameh v. Tarsadia Hotel; and (5) outlines the filing process for the private placement exemption and proposes a deal structure to avoid unnecessary securities litigation.

INTRODUCTION

Generally, real estate transactions involving just "bricks and mortar" do not implicate federal or state securities laws.[1] This is fortunate for both practical and economic reasons—compliance with the securities laws is burdensome and expensive.[2] However, commercial real estate developers and their counsel may run afoul of securities requirements during more complicated transactions.[3] According to a 1973 Securities and Exchange Commission (hereinafter SEC) release, "[t]he offer of real estate as such, without any collateral arrangements with the seller or others, does not involve the offer of a security.[4] When the real estate is offered in conjunction with certain services, a security, in the form of an investment contract, may be present."[5]

The SEC release settled some of the issues involved when tenancy in common (hereinafter TIC) real estate is combined with service contracts.[6] The SEC's guidance was undoubtedly helpful, but it was narrow in scope, considering its focus on condominiums and rental pool agreements.[7] As a result, there is a gap in the literature regarding today's more complicated transactions.[8] Thus, this article aims to fill that gap

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[1] *See* Guidelines as to the Applicability of the Fed. Sec. Laws to Offers & Sales of Condominiums or Units in a Real Estate Dev., Securities Act Release No. 5347, 33 Fed. Reg. 5347 (Jan. 4, 1973) [hereinafter "*Guidelines*"]; *see also* Doug Cornelius, *When is Real Estate a Security*, SEC. L. BLOG (Aug. 16, 2011, 8:55 AM), https://www.lexisnexis.com/legalnewsroom /securities (stating that "[f]ee simple ownership of the 'bricks and mortar' of real estate is not a securities transaction. 'The offer of real estate as such, without any collateral arrangements with the seller or others, does not involve the offer of a security.' As you move further away from that model, you move closer and closer to the ownership a security than the ownership of real estate. The line between the two is not a bright line.").

[2] *But see* Alvin Robert Thorup, *Tic or Treat: How Tenant-in-Common Real Estate Sales Can Avoid the Reach of the Securities Laws*, 34 REAL EST. L.J. 422, 423 n.4 (2006) (stating that "only in the highest debt leveraged transactions are the securities commissions comparable to real estate fees.").

[3] *See Guidelines*, *supra* note 1.

[4] *Id.*

[5] *Id.*

[6] *See id.* (referring primarily to condominiums when discussing tenancies in common combined with service contracts).

[7] *Id.*

[8] *See generally* Thorup, *supra* note 2 (discussing the existing literature about real estate transactions).

and provide guidance to transactional lawyers working with commercial real estate developers.

As an initial matter, this article introduces the reach of the 1933 Securities Act and the broad definition of "security." Section I not only addresses common errors in registering securities, but it also details the pitfalls associated with the most popular exemptions to registration.

In order to more thoroughly understand the intersection between real estate and securities, the real estate practitioner should understand the history of the relationship. Thus, Section II briefly reviews the history of tension between real estate interests and the securities laws. This will include early efforts at real estate syndication.

Section III introduces the investment contract as defined by the *Howey* test. It is critical for commercial real estate lawyers to understand at least the basics of the *Howey* test because it is the test most commonly applied by courts to contested real estate transactions.[9] The test can be separated into four elements, which is reflected in the structure and treatment of the topic in this section.[10] The sections below discuss three of these elements that are the primary considerations for the proposed model real estate transaction in Section V.

Section III also addresses one of the larger gaps in the 1973 SEC release. The release only addressed the sale of "condominiums and other types of similar units"[11]: thus, this section addresses case law surrounding other types of real estate interests, including joint ventures with various partnership structures.

Section IV discusses *Salameh v. Tarsadia Hotel*,[12] an important Ninth Circuit case that signals continued judicial confusion concerning real estate offerings and the securities laws.[13] Specifically, this section disagrees with the holding of the case in light of both Ninth Circuit

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[9] The author does not claim to know the ratio between cases citing to the *Howey* test as compared to the Risk Capital Test, which is discussed later in the article. However, in the author's judgment, the *Howey* test appears to be the overwhelmingly prominent analytical framework in securities litigation related to real estate interests.

[10] The discussion will exclude the first element, "an investment of money," as it is typically not a disputed element in a case.

[11] *See Guidelines*, *supra* note 1.

[12] 726 F.3d 1124 (9th Cir. 2013).

[13] *Id.* at 1129.

precedent and general developments of real estate and securities laws. Some real estate practitioners pointed to *Salameh* as a shift in real estate and securities laws.[14] However, this section claims that the Ninth Circuit did not apply the *Howey* test properly.[15] Instead, this article argues that the case provides useful guidance and does not represent a monumental shift as believed by some practitioners.[16]

Finally, using the *Salameh v. Tarsadia Hotel* transaction as a model, Section V provides guidance to real estate developers and counsel for executing a syndicated TIC real estate deal without inadvertently selling an unregistered security.[17] This model is intended to allow practitioners to avoid securities laws issues without sacrificing effective marketing strategies and crucial capital raising efforts.[18]

I. INTRODUCTION TO THE SECURITIES LAWS

A. The 1933 Securities Act and Investor Protection

The Securities Act of 1933[19] is a federal regulatory scheme that was developed primarily for investor protection.[20] If an investment falls under the broad definition of "security," it then becomes subject to the 1933 Act's disclosure requirements.[21] Once subject to the 1933 Act requirements, the seller is responsible for complying with antifraud provisions pertaining to the omission of material facts in connection with the offer or sale of a security.[22] Failure to comply with these requirements may give rise to several private remedies against the seller, regardless of whether the seller knew the investment qualified as a

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[14] Cornelius, *supra* note 1.

[15] *See generally Salameh*, 726 F.3d at 1129–33 (displaying the court's analysis of the *Howey* test).

[16] *See* Joshua G. Hamilton, *Future Of Hotel-Condo Developments Post-Salameh*, LAW360 (Mar. 5, 2014), https://www.law360.com/articles/515490/future-of-hotel-condo-developments-post-salameh (describing the shift in treatment of real estate development post-*Salameh*).

[17] *See infra* Part V.

[18] *See infra* Part V.

[19] 15 U.S.C. §§ 77a *et seq.* (2012) [hereinafter 1933 Act].

[20] 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1:17 (7th ed. 2016) [hereinfter HAZEN, TREATISE].

[21] *Id.*

[22] § 77q(a).

security.[23] The practical effect for attorneys involved in the relevant transaction is potential liability for legal malpractice as a result of failing to register the security.[24]

The first step in avoiding securities litigation is properly identifying whether the investment involved is a security.[25] Both the statutory and case law definitions should be considered. According to the 1933 Act, a security includes, but is *not limited to*:

> [A]ny note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.[26]

The statutory definition is helpful in identifying some types of securities, but it is not exclusive.[27] Securities share certain characteristics that have been developed through case law and make it more likely for a court to find that a security was sold.[28] For example, if an investor is led to enter into a business deal by a securities broker, a court would likely look beyond the form of the arrangement and favor finding a security for purposes of investor protection.[29] The investment vehicle may be anything from short-term notes to mortgage

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[23] *Id.*; *see, e.g.*, § 77k(a) (creating cause of action for purchasers against sellers of securities for material misstatements and omissions in registration statements); *see also* § 77l(a)(1) (creating liability for selling or delivery of an unregistered security, *inter alia*); § 77l(a)(2) (creating cause of action for sale of securities, whether exempted, registered, or unregistered, involving a material misstatement or omission).

[24] HAZEN, TREATISE, *supra* note 20, § 1.49.

[25] *Id.*

[26] § 77b(a)(1).

[27] *See* Pollack v. Laidlaw Holdings, Inc., 27 F.3d 808, 811 (2d Cir. 1994) (noting the statutory definition is not the exclusive definition).

[28] *Id.*

[29] HAZEN, TREATISE, *supra* note 20, § 1:49; *see, e.g.*, *Pollack*, 27 F.3d at 815 (holding that mortgage participations sold by securities broker were securities).

participations.[30] Of course, this may also include an interest in real estate, as detailed in the sections below.[31]

B. Filing a Registration Statement under Section 5

If a security is being offered for sale, it must then be registered under Section 5 of the 1933 Act, or else it must meet an applicable exemption.[32] Failing to register a non-exempt securities offering under the disclosure requirements of Section 5 is unlawful.[33] Fortunately, Section 5 was intended to cover large public offerings, and many securities are exempt from its coverage.[34] However, if the security is not exempt, it must comply with burdensome disclosure requirements.[35]

i. Disclosure requirements

Unless otherwise exempted, the issuer of a security is required to disclose all of the information listed in Schedule A of Section 77aa of the 1933 Act.[36] The required information includes a list of thirty-two discreet items, many of which may require lengthy research by the issuer, its accountants, and counsel.[37] Schedule A requires full biographical information about the issuer, including but not limited to: name; trade name; names and addresses of all large shareholders; and the capitalization of the issuer.[38] Some of the more onerous requirements include: full accounting information; pricing for the offering; profit and loss statements; projected proceeds from the sale; and copies of all pertinent contracts with third parties involved in the transaction.[39] In addition, Regulation C governs important mechanics of registration, including: the title of security; information required in prospectuses;

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[30] *See* Reves v. Ernst & Young, 494 U.S. 56, 73 (1990) (holding that short-term notes were securities); *see, e.g.*, *Pollack*, 27 F.3d at 815 (holding that mortgage participations sold by securities broker were securities).

[31] *See infra* Part III.

[32] HAZEN, TREATISE, *supra* note 20, § 2:13.

[33] 15 U.S.C. §§ 77e(a), (c) (2012).

[34] HAZEN, TREATISE, *supra* note 20, § 2:13.

[35] *Id.*

[36] § 77g.

[37] § 77aa.

[38] *Id.*

[39] *Id.*

advertising under section 10; the use of exhibits within the registration section; and the effective date as it relates to amendments.[40]

Before selling securities, a company is usually required to complete one of any number of SEC registration forms.[41] For example, registration for securities of "Certain Real Estate Companies"[42] must be completed on Form S-11.[43] According to the SEC, the estimated "average burden hours" required to complete the form is 779 hours.[44] Of course, this figure may assume that the issuer is starting from scratch with no pertinent information available.[45] Nonetheless, it reveals the general time commitment required to complete the registration process.[46]

ii. Timeline for filing registration statement and for the sale of a security

The post-filing timeline presents another complex set of requirements for the issuer of a security.[47] After a seller files a registration statement, the "waiting period" will begin, and the issuer is subject to several restrictions.[48] Typically, the seller receives an initial letter of comment from the SEC within forty days.[49] However, the registration becomes effective twenty days after filing, or after the most

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[40] 17 C.F.R. §§ 230.480–83 (2005).

[41] *See* U.S. Sec. & Exch. Comm'n, Form S-11, SEC Registration Form (2017), https://www.sec.gov/files/forms-11.pdf [hereinafter Form S-11].

[42] *See id.* (defining securities issued by a Real Estate Company as "(i) securities issued by real estate investment trust, as defined in Section 856 of the Internal Revenue Code, or (ii) securities issued by other issuers whose business is primarily that of acquiring and holding for investment real estate or interests in real estate or interests in other issuers whose business is primarily that of acquiring and holding real estate or interest in real estate for investment.").

[43] *See id.*

[44] *Id.*

[45] 17 C.F.R. § 239.18 (2007) (identifying that Form S-11 should be used for the registration of certain real estate companies under the Securities Exchange Act of 1933).

[46] Form S-11, *supra* note 41.

[47] *See generally* THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION § 2.4[1] (6th ed. 2009) [hereinafter HAZEN, THE LAW] (providing an overview of post-filing restrictions and requirements imposed on the security issuer).

[48] *See id.* § 2.2[1][A] ("After the registration statement has been filed with the SEC, there is a statutory twenty-day *waiting period* prior to the effective date of the registration statement . . . [but] the actual waiting period is rarely the twenty-day period specified by statute.").

[49] *See id.* § 3.7[1] ("[T]he [SEC] staff generally responds to the initial filing with a detailed 'letter of comment' or 'deficiency letter,' advising the issuer of changes that the Commission would like to see in the registration statement.").

recent amendment.[50] Therefore, the seller will likely be required to file a delaying amendment to avoid a stop order under Section 8.[51] The seller should expect at least two rounds of comment letters from the SEC.[52] Each letter requires a response from the seller, usually in the form of another amendment.[53] Once the SEC is satisfied with the seller's amendments, the seller may request acceleration of the effective date, or it may wait for the SEC to issue a final effective date.[54]

During the waiting period, the seller may begin oral sales efforts, but it should not complete any sales or accept any offers to buy the security.[55] The two primary vehicles for early sales efforts include the "red herring" prospectus and the road show.[56] The red herring prospectus and the "tombstone advertisement" are the only pieces of written sales literature that the seller can release.[57] During the road show, underwriters typically introduce management to prospective investors.[58] However, it is suggested that the road show does not begin until the seller has responded to the first two rounds of SEC comments.[59] Furthermore, the seller should not distribute any copies of written

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[50] 15 U.S.C. § 77h(a) (2012).

[51] The section 8 stop order is reserved for "woefully deficient filings," and it may result in additional disclosure requirements and lost eligibility for certain exemptions. HAZEN, *supra* note 20, § 2:15.

[52] *See id.* § 3:40 ("[T]he [SEC] staff generally responds to the initial filing with a detailed 'letter of comment' or 'deficiency letter,' advising the issuer of changes that the [SEC] would like to see in the registration statement. . . . As a practical matter, virtually all registration statements filed with the [SEC] require at least one amendment.").

[53] *See id.* ("Failure to respond to the letter of comment (or deficiency letter), in and of itself, has no legal consequences, [but] . . . the SEC will generally suggest that the issuer file a 'delaying amendment' in order to avoid the more drastic initiation of formal administrative proceedings.").

[54] Thomas L. Hazen, Professor, Univ. of N.C. Sch. of Law, Securities Regulation Lecture (Jan. 20, 2015).

[55] Carl W. Schneider et al., *Going Public: Practice, Procedure, and Consequences*, 27 VILL. L. REV. 1, 22 (1981).

[56] *See id.*

[57] *See* 17 C.F.R. § 230.430 (describing detailed requirements of what the red herring prospectus may contain); 17 C.F.R. § 230.134 (describing detailed requirements of a tombstone advertisement).

[58] Schneider et al., *supra* note 55, at 22.

[59] *See* HAZEN, TREATISE, *supra* note 20, § 3:40.

materials during the road show that may qualify as a prospectus, other than the red herring prospectus.[60]

Finally, the underwriters can begin selling the issue and delivering securities on the effective date.[61] The timing of the effective date will determine what type of financial statements the seller must file.[62] The seller may have to file audited statements covering anywhere from the previous quarter to the previous year, depending on the time between the last fiscal quarter and the effective date.[63]

C. Exemptions from Section 5 Registration Requirements

As detailed above, the registration process is complex and technical in nature.[64] To avoid the hazard of erroneous registration all together, a seller may want to take advantage of the multiple exemptions under the 1933 Act.[65] Of these exemptions, the most prevalent are the intrastate exemption under section 3(a)(11) and the private placement exemption under section 4(a)(2), as well as the related Regulation D requirements.[66] It is important to note that although a security may be exempt from the

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[60] *See* HAZEN, THE LAW, *supra* note 47, §§ 2.4[1], 2.4[2][A].

[61] 15 U.S.C. § 77e(a) (2012).

[62] *See* Schneider et al., *supra* note 55, at 28 (comparing required financial statement filings for a company that is going public for the first time by filing a Form S-1 compared to a company that filed a Form S-18).

[63] *See id*. (discussing various requirements for audited financial statement filings).

[64] *See infra* Section I.B.

[65] *See* HAZEN, TREATISE, *supra* note 20, § 4:2.

[66] *See id.* § 4:25 (citing 15 U.S.C. § 77c(a)(11)(12))("The intrastate exemption from 1933 Act registration is found in section 3(a)(11) which exempts '[a]ny security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory.'"); *id.* § 4:88 (citing 15 U.S.C. § 77d(a)(2)) ("Section 4(a)(2) of the 1933 Act exempts 'transactions by an issuer not involving any public offering' . . . is also commonly referred to as the private placement exemption, [and] has proven useful for both closely held and public issue corporations."); *id.* § 4:62 (citations omitted) ("In promulgating Regulation D, the SEC adopted a comprehensive scheme for exemptions relating to small issues and small issuers. Regulation D was 'designed to simplify and clarify existing exemptions, to expand their availability, and to achieve uniformity between federal and state exemptions.'").

statutory language, it may nonetheless be subject to the securities laws' antifraud protections.[67]

Under section 3(a)(11), a security is exempt from registration if it is a "part of an issue offered and sold only to persons resident within a single State or Territory" and if the seller "is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory."[68] Both courts and the SEC have interpreted this statutory exemption narrowly.[69] However, the JOBS Act added an exemption for crowdfunding that has resulted in a number of state crowdfunding exemptions.[70] One notable requirement for securities not subject to registration under the intrastate exemption is that the proceeds from the sale must be used entirely within the state itself.[71]

Rule 506 of Regulation D is another exemption that allows companies to raise an unlimited amount of money through the sale of a security if they meet certain requirements.[72] The rule is considered a "safe harbor" for private offerings falling under Section 4(a)(2) of the Securities Act.[73] There are two distinct ways to meet the requirements of the safe harbor standards.

First, a company may meet the requirements by avoiding widespread investor solicitation and marketing efforts. If this route is taken, the offering may then be sold to an unlimited number of "accredited investors" and up to thirty-five unaccredited investors.[74] An accredited investor must, among other requirements, "have sufficient

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[67] Even if the instrument being offered for sale does not meet the definition of "security," it may still fall under the 1934 Exchange Act's Rule 10b-5 antifraud requirements. *See* 17 C.F.R. § 240.10b–5 (2016) (prohibiting fraud, untrue statements, and deceptive practices in relation to the sale of certain investment vehicles).

[68] 15 U.S.C. § 77c(a)(11) (2012).

[69] HAZEN, TREATISE, *supra* note 20, § 4:25.

[70] *Id.*; *see also* 15 U.S.C. § 77d(a)(6) (2012) (describing what is known as the "crowdfunding exemption").

[71] *See* Sec. & Exch. Comm'n v. McDonald Inv. Co., 343 F. Supp. 343, 445–47 (D. Minn. 1972) (holding that funds raised exclusively in Minnesota, provided exclusively by Minnesota residents, and used exclusively by a Minnesota corporation were nonetheless ineligible for the 3(a)(11) exemption because the funds were used on an out-of-state project).

[72] *Id.*

[73] *Rule 506 of Regulation D*, U.S. SECURITIES & EXCH. COMMISSION (Oct. 6, 2014), https://www.sec.gov/answers/rule506.htm.

[74] *Id.*

knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment."[75] Although the seller need not provide extensive disclosures to accredited investors, the seller must still provide registration-like disclosures to any unaccredited investor in the offering.[76] Further, the company must provide the same information required by Rule 505[77] while remaining responsive to all investor inquiries.[78]

Second, under Rule 506(c), broad solicitation and advertisement related to the sale of a security are allowed. However, all investors must be accredited—this means the company should verify that investors meet the accreditation standards. According to the SEC, the company should do its due diligence by "reviewing [the investors'] documentation, such as W-2s, tax returns, bank and brokerage statements, credit reports and the like."[79]

Regardless of whether the offering qualifies for an exemption, the seller may still need to register the security under the applicable state securities laws.[80] Generally, states have been preempted from applying what are known as "blue sky" registration requirements to many securities transactions, including securities that meet the requirements for a 3(a)(2) exemption.[81] However, if a seller fails to meet all of the requirements of an exemption, the sale will once again be subject to the various state registration requirements.[82]

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[75] *Id.*

[76] *Id.*

[77] 17 C.F.R. § 230.505 (2015). *See Rule 506 of Regulation D*, *supra* note 73 (explaining Rule 506 requirements in an investor-friendly manner).

[78] *Id.*

[79] U.S. SEC. & EXCH. COMM'N, NO. 157, ADVERTISING FOR UNREGISTERED SECURITIES, SEC INVESTOR ALERT (2013), https://www.sec.gov/files/ia_solicitation.pdf.

[80] *Id.*

[81] 15 U.S.C. § 77r(b)(4)(C) (2012).

[82] *See* HAZEN, TREATISE, *supra* note 20, § 4:8 (discussing this general rule, with limited exceptions).

II. REAL ESTATE SYNDICATION

A. Early History

In 1960, Edward N. Gadsby, then Chairman of the SEC, addressed a group of New York City real estate developers and attorneys on the topic of securities and real estate syndication.[83] At the time, syndication was making a comeback from the speculative mortgage bond market that failed during the Great Depression.[84] Limited partnership interests emerged as the preferred vehicle for syndication, whereby investors divided up the equity in a property into limited partnership interests in order to avoid the double taxation of corporate ownership.[85]

According the Gadsby, a real estate syndicate "is nothing more or less than a group of investors who join together and pool their funds to purchase a specific piece of real property."[86] Generally, real estate syndicators "have three objectives: cash return on investment, profits from appreciation, and security."[87] In addition, and similarly to the early promoters of syndication, modern real estate developers choose syndication for tax benefits, although these benefits have eroded since the 1986 tax reforms.[88]

At the time of Gadsby's speech, syndicators were relying primarily on the private placement exemption under Section 4(1) and the intrastate exemption under Section 3(a)(11) of the 1933 Securities Act to avoid registration under the securities laws.[89] The Chairman was under the

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[83] Edward N. Gadsby, Chairman, Sec. & Exchange Commission, Securities Aspects of Real Estate Syndicates, Address Before the Securities and Exchange Commission (Nov. 18, 1960) (on file with author).

[84] ALVIN ARNOLD, REAL ESTATE INVESTOR'S DESKBOOK § 6:22 (3d ed. 2016).

[85] *Id.*

[86] Gadsby, *supra* note 83, at 1.

[87] PAUL WENDELL, MODERN ACCOUNTING AND AUDITING CHECKLISTS § 6.416 (Warren, Gorham, & Lamont, eds., 1997).

[88] *See* Gadsby, *supra* note 83, at 1 ("The choice of form for the syndicate involves consideration of a number of factors, such as continuity of organization, transferability of the property, limitation of liability and, most important, the application of the income tax laws."). *But see* PAUL WENDELL, MODERN ACCOUNTING AND AUDITING CHECKLISTS § 6.416 (Warren, Gorham, & Lamont, eds., 1997) ("Although the Tax Reform Act of 1986 severely reduced the tax benefits associated with owning real estate, federal income taxes continue to be a significant consideration in structuring real estate investments.").

[89] *See* Gadsby, *supra* note 83, at 5–6.

impression that most investors in syndicates were "tax conscious" and fairly sophisticated, although not necessarily in the formal sense of the word.[90]

B. Modern Syndication Issues

Today, real estate syndication is still basically "nothing more or less than a group of investors who join together and pool their funds."[91] However, this poses a challenge in identifying when a real estate investment is actually the purchase of a security.[92] The level of managerial effort required by the real estate investor is often the determinative factor in securities litigation.[93] Of course, investors have varying degrees of tolerance for both risk and involvement in an investment, which necessitates a variety of partnership interests with various levels of managerial involvement.[94] The resultant advantages of an investment are thus dependent upon an investor's particular circumstances.[95] The advantages of syndication, such as enhanced capital raising, typically weigh in favor of syndication.[96] However, some of the risks of modern real estate syndication and the securities laws should be considered before structuring a deal.[97]

Only certain risks of real estate syndication arise under the securities laws. For example, a syndicator may need to employ third parties to select and value properties.[98] If these third parties are not carefully vetted, new "bad actor" provisions under Rule 506 as mandated by the Dodd-Frank Act may result in a lost exemption and subsequent exposure to SEC or state security agency action.[99] In addition, the sale of syndication or joint venture interests may become subject to the disclosure and anti-fraud requirements of Section 5 of the 1933 Act and

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[90] *Id.* at 7.

[91] *Id.* at 1.

[92] *Id.* at 7.

[93] *See* Williamson v. Tucker, 645 F.2d 404, 425 (5th Cir. 1981) (stating partnership interests that grant meaningful power will not be held to be securities).

[94] *Id.* at 423.

[95] *See id.* at 427.

[96] Gadsby, *supra* note 83, at 1.

[97] *Id.* at 2.

[98] *See id.*

[99] Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 33–9414, 106 SEC Docket 3289 (July 10, 2013).

Section 10b-5 of the 1934 Exchange Act.[100] Some common joint venture structures and associated risks are discussed below as they relate to securities litigation.[101] A developer and its counsel will be better equipped for handling these risks if it first can identify when a real estate interest becomes a security governed by the securities laws.

III. DEFINING A "SECURITY" – THE *HOWEY* TEST AND ITS PROGENY

A. The Howey Test

Unfortunately for the real estate practitioner, defining "security" is not necessarily intuitive. The statutory definition under the 1933 Act is purposefully broad to allow for flexible interpretation and expansive investor protection.[102] Accordingly, the 1933 Act provides an expansive definition of "security" that includes a laundry list of investment vehicles intended to be covered:[103] "[t]he term "security" means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, *investment contract* . . . ."[104] Of these numerous vehicles, courts typically analyze a real estate offering under the "investment contract" category.[105]

The Supreme Court clarified the definition of an investment contract in *Howey.*[106] The rule, now known as the *Howey* test, states that an investment contract exists where the scheme involves: 1) an

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[100] *See* discussion *supra* Section I.C.

[101] *See* discussion *infra* Section III.C.

[102] Sec. & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293, 301 (1946) ("The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae").

[103] The 1934 Act contains a very similar provision that is considered identical to the 1933 Act for practical purposes, and therefore this article will not discuss the 1934 Act definition. *See* Tcherepnin v. Knight, 389 U.S. 332, 335 (1967) (explaining that the 1933 Act definition is "virtually identical" to the 1934 Act definition).

[104] 15 U.S.C. § 77b(a)(1) (2012) (emphasis added).

[105] *See, e.g.*, Revak v. SEC Realty Corp., 18 F.3d 81, 91 (2d Cir. 1994) (holding that a condominium offering was not a security because it was not an investment contract).

[106] *Howey*, 328 U.S. at 298–99.

investment of money in; 2) a common enterprise with; 3) an expectation of profits to come; 4) solely from efforts of others.[107]

In *Howey*, the defendant W.J. Howey Company offered a land sale contract to investors in combination with a service contract.[108] The investors purchased "units" of a citrus grove and also entered into a contract for "cultivating, marketing and remitting the net proceeds to the investor."[109] Each unit was an acre, and each acre was planted with forty-eight trees.[110] However, the management company told investors that it was "not feasible" to invest without the services contract.[111] Thus, the company had "full discretion and authority" over every commercial aspect of the grove, from cultivation to sale, and the investors participated in pooling and sharing of profits.[112] Profits were distributed on a pro rata basis, regardless of the production of the investors' respective units.[113]

The Supreme Court held that the transactions were investment contracts and emphasized the fact that the citrus company performed all of the work required to make a profit.[114] Furthermore, the Court noted that the investors had no other use for the land besides generating a profit.[115] In other words, the "transfer of rights in land [was] purely incidental."[116] In finding an investment contract, it was immaterial as to whether profits were speculative, and the language of the contracts was not dispositive. [117]

Howey also emphasized the "economic reality" of the transaction, a blue-sky doctrine that emphasizes the substance over the form.[118] The Court noted that the plots of citrus grove were useless without the service

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[107] *Id.* at 301.
[108] *Id.* at 295.
[109] *Id.* at 294.
[110] *Id.* at 295.
[111] *Id.*
[112] *Id.* at 296.
[113] *Id.*
[114] *Id.* at 299–300.
[115] *Id.* at 300.
[116] *Id.*
[117] *Id.*
[118] *Id.* at 298.

contract.[119] For one, there was no right to access the land.[120] Additionally, the plots were marketed as an investment, and were only useable as an investment.[121] Moreover, the targeted investors were typically not from Florida and did not have the requisite skillset to contribute to the success of the investment itself.[122]

In general, the *Howey* test "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[123] Thus, courts typically assess three aspects of a transaction under the *Howey* test framework to determine whether a security exists: 1) the terms of the offer; 2) the plan of distribution; and 3) the economic inducements that were held out to the prospective purchaser.[124] Within this analytical framework, what is being offered is less important than how it is being offered and what is being promised.[125]

B. Applying the Howey Test to Real Estate

The analysis of whether a real estate offering is a security can be distilled to a simple question: does the offering have the characteristics of other securities?[126] For example, a real estate cooperative whereby tenants own "stock" in a cooperative association may appear to be a security on its face, but it may not rise to the level of a security if the stockholders receive only nominal profits.[127] This illustrates the importance of substance over form, *i.e.* the "economic reality." The *Howey* test provides the basic analysis, but an underlying policy of investor protection pervades decisions at the district level.[128]

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[119] *Id.* at 295.

[120] *Id.* at 296.

[121] *Id.* at 299.

[122] *Id.* at 296, 299–300.

[123] *Id.* at 299.

[124] HAZEN, THE LAW, *supra* note 47, § 1.6[2].

[125] *Id.*

[126] *Id.* § 1.6[9].

[127] *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851 (1975) (holding that residents of a subsidized apartment complex that owned stock in the apartments did not hold securities because they did not expect, and in fact did not receive, profits beyond nominal rent reduction).

[128] HAZEN, THE LAW, *supra* note 47, § 1.6[2].

Nonetheless, there are several bright lines that a real estate promoter and their counsel can heed to avoid securities litigation and SEC enforcement action.[129] The next section focuses on the three most contentious elements of the *Howey* test: i) a common enterprise; ii) expectation of profit; and iii) solely from the efforts of other.[130] Each element is analyzed within various real estate transactions and business arrangements in an effort to discover the bright-line rules for avoiding the sale of a security.[131] Ultimately, this analysis forms the framework for avoiding securities litigation.

i. Common Enterprise

Generally, an investment vehicle satisfies the "common enterprise" factor of the *Howey* test when there is sufficient correlation between a particular investor's interest and the interest of others involved in the transaction.[132] Courts have used two tests to determine the correlation: 1) horizontal commonality; and 2) vertical commonality.[133]

Horizontal commonality is sufficient to constitute a common enterprise.[134] Such commonality consists of "the tying of each individual investor's fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits."[135]

On the other hand, courts are split as to whether vertical commonality constitutes a common enterprise.[136] Furthermore, courts use both a narrow (strict) or broad interpretation of the vertical commonality test.[137] Vertical commonality "focuses on the relationship

[129] *Id.* §§ 1.6[1], 1.6[9].

[130] The author has excluded the element "investment of money" because it is a prerequisite for conducting a *Howey* test analysis. *See* Sec. & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

[131] *See supra* notes 132–198 and accompanying text.

[132] HAZEN, *supra* note 47, § 1.6[2][B].

[133] *See, e.g.*, Revak v. SEC Realty Corp., 18 F.3d 81, 87–88 (2d Cir. 1994).

[134] Sec. & Exch. Comm'n v. Infinity Grp. Co., 212 F.3d 180, 187–88 (3d Cir. 2000), *aff'g* 993 F.Supp. 321 (E.D. Pa. 1998).

[135] *Revak*, 18 F.3d at 87; *see Infinity Grp. Co.*, 212 F.3d at 187–88 (finding an investment contract based on pooling of investments and promise of fixed returns, and noting that "horizontal commonality is characterized by 'a pooling of investors' contributions and distribution of profits and losses on a pro-rata basis among investors.").

[136] HAZEN, THE LAW, *supra* note 47, § 1.6[2][B].

[137] *Id.*

between the promoter and the body of investors."[138] Broad vertical commonality only requires that the success of the investment be linked to the efforts of the promoter.[139] On the other hand, strict vertical commonality requires that the fortunes of the investors be tied to the fortunes of the promoter.[140] Although all circuit courts recognize the concept of vertical commonality, only the Fifth and Eleventh Circuits have adopted the broad vertical commonality approach.[141] The Ninth Circuit has adopted a version of the strict vertical commonality approach.[142]

Despite the split in authority, a common enterprise will be found where there is a pooling of investor interests.[143] The "pooling of interests" is best understood in the context of the interaction between a promoter and purchaser of a real estate interest.[144] In fact, a common enterprise has been found in the relationship between only one promoter and one investor.[145] With this in mind, the following deal structures present different scenarios where pooling may occur.

a. Rental Pools

The 1976 SEC Release left many questions unanswered, but it provided substantial guidance to developers of condominiums.[146] Specifically, the Release addressed public offerings of condominiums with optional rental pool arrangements.[147] In its guidance, the SEC

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[138] *Revak*, 18 F.3d at 87.

[139] HAZEN, THE LAW, *supra* note 47, § 1.6[2][B].

[140] *Revak*, 18 F.3d at 87–88.

[141] HAZEN, THE LAW, *supra* note 47, § 1.6[2][B].

[142] *See, e.g.*, Long v. Shultz Cattle Co., 896 F.2d 85, 86–88 (5th Cir. 1989) (focusing on economic reality of transaction and emphasizing the large number of investors who shared risk of cattle-feeding business).

[143] *See, e.g.*, Sec. & Exch. Comm'n v. Montana, 464 F. Supp. 2d 772 (S.D. Ind. 2006) (discussing a high yield "trading program" involving pooling of interests)

[144] *Id.* at 782.

[145] *See* Vale Nat. Gas Am. Corp. v. Carrollton Res. 1990, Ltd., 795 F. Supp. 795 (E.D. La. 1992) (finding a common enterprise under the vertical commonality test where an oil and gas production payment was an investment contract under the securities law, and noting that under the vertical commonality test, a security could be found even if only one promoter and one investor were involved in the deal).

[146] *See* Guidelines, *supra* note 1.

[147] *Id.*

stated that the offering of a condominium unit would be construed as a security if it was offered in conjunction with any of the following:

> 1. The condominiums, with any rental arrangement or other similar service, are offered and sold with emphasis on the *economic benefits* to the purchaser to be derived from the *managerial efforts* of the promoter, or a third party designated or arranged for by the promoter, from rental of the units.
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> 2. The offering of participation in a *rental pool arrangement*; and
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> 3. The offering of a rental or similar arrangement whereby the purchaser *must hold his unit available* for rental for any part of the year, must use an *exclusive* rental agent or is *otherwise materially restricted in* his occupancy or rental of his unit.[148]

A "rental pool arrangement" is a contract whereby the promoter or third party rents the unit on behalf of the actual owner during a period of time when the owner does not occupy the unit.[149] These arrangements effectively operate like a timeshare because of the division of property expenses and limited occupancy by the owner.[150] Normally, a "promoter" is involved in raising capital for condominium projects by identifying investors and promoting the real estate.[151] Promoters may also directly manage the deal.[152] In a typical pool, "the rents received and the expenses attributable to rental of all the units in the project are combined and the individual owner receives a ratable share of the rental proceeds regardless of whether his individual unit was actually rented."[153] The offer of the unit for sale together with the offer of an opportunity to participate in such a rental pool creates an offer of an investment contract (*i.e.* a security interest) that must be registered unless an exemption is available.[154]

For example, the Ninth Circuit held in *Hocking v. Dubois*[155] that the sale of a condominium in combination with a rental pool arrangement implicated the securities laws because the transaction satisfied the *Howey*

[148] *Id.* (emphasis added).

[149] *Id.*

[150] *Id.*

[151] Sec. & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293, 298 (1946).

[152] *See, e.g.*, *id.* at 300 (describing the promoter in this particular case as someone who "manage[s], control[s] and operate[s] the enterprise").

[153] *See* Guidelines, *supra* note 1.

[154] *Id.*

[155] 885 F.2d 1449 (9th Cir. 1989).

test.[156] Before the purchase, the realtor told the plaintiff that a "rental pool arrangement (RPA) would be available to [him] if he were to purchase the condominium."[157] Furthermore, the realtor emphasized the profit potential of the condominium, stating that they "were renting for an average of $100 a day, from which [Hocking] calculated the monthly income would be $2,000 to $3,000 per month."[158] According to Hocking, he expected rental income to cover the expenses of the condominium and result in a net profit.[159] Most importantly, Hocking would not have purchased the condominium "but for" the Rental Management Agreement (RMA) that was marketed along with the condominium.[160]

b. Limited partnership interests

The sale of limited partnership interests may also meet the requirements of a common enterprise if the limited partners have no control over the business.[161] For example, in a Pennsylvania District Court case, a group of general partners purchased six ethanol plants, but subsequently leased-back the plant to the company that originally owned and operated the business.[162] The court emphasized that the limited partners would "reap the profit" from the enterprise without managerial control.[163] The court distinguished the original sale of the plants—where the investments were not pooled—with the leaseback agreement, whereby the limited partners would receive the benefits of the agreement without any managerial effort.[164] Ultimately, this case is illustrative of common deals that will implicate the securities laws when a partner in a business venture fails to retain any control, either explicitly or constructively.

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[156] *Id.* at 1462.
[157] *Id.* at 1452.
[158] *Id.*
[159] *Id.* at 1452–53.
[160] *Id.* at 1453.
[161] *See* Williamson v. Tucker, 645 F.2d 404, 425 (5th Cir. 1981) (describing that partnership interests that grant meaningful power will not be held to be securities).
[162] Ethanol Partners Accredited v. Wiener, 635 F. Supp. 18, 20 (E.D. Pa. 1985).
[163] *Id.* at 20.
[164] *Id.* at 21.

c. The absence of pooling or pro-rata payment system

A real estate offering may be a securities offering, even if the offering does not include a traditional rental pool.[165] Instead, the pertinent factors become common control and managerial efforts by the promoter or third party.[166] For example, in *Cameron v. Outdoor*,[167] a sale of campsite blocks was found to be part of a common enterprise when the purchasers were under the common control of a rental management company.[168] The Court did not find it persuasive that the owners could use a different company or rent the property out.[169] Instead, the "crucial factor" was that the "fortunes of all investors [were] inextricably tied to the efficacy" of the rental company's promotional and managerial activities.[170] The Court looked past the fact that the RMA was optional, and instead noted that no single investor could succeed without the success of the campsites as a whole.[171] And despite the lack of a rental pool and pro rata distribution of profits, the Court found that a common enterprise existed.[172]

ii. Expectation of Profit

This factor seems to get at the heart of a security as defined by the *Howey* test. Courts typically will not find a security "when a purchaser is motivated by a desire to use or consume the item purchased."[173] "Profits" generally include capital appreciation from the development of an initial investment or a participation in earnings resulting from the use of investors' funds.[174] Like rental pool arrangements, the "expectation of

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[165] Cameron v. Outdoor Resorts of Am., Inc., 608 F.2d 187, 192 (5th Cir. 1979); *see* Guidelines, *supra* note 1.

[166] *Cameron*, 608 F.2d at 192.

[167] *Id.* at 193.

[168] *Id.*

[169] *Id.*

[170] *Id.*

[171] *Id.*

[172] *Id.*

[173] United Hous. Found., Inc., v. Forman, 421 U.S. 837, 853 (1974).

[174] *See* Tcherepnin v. Knight, 389 U.S. 332, 344 (1967) (holding dividends on the investment based on savings and loan association's profits to fulfill the "expectation of profits" element under the *Howey* test); *see also* Sec. & Exch. Comm'n v. C. M. Joiner Leasing Corp., 320 U.S. 344, 351–52 (1943) (holding the sale of fractional undivided oil interest to be securities when the sale included oil leases conditioned on promoters' agreement to drill exploratory well).

profit" manifests differently depending on the investment structure.[175] The following deal structures represent only a portion of the potential arrangements that may satisfy the "expectation of profit" element.[176]

a. Co-tenancy participations

In *Cook v. Farrell*, the plaintiff purchased a 32% interest in an office building that, according to the purchase agreement, was "an investment in a commercial property that will return a maximum capital gain utilizing the philosophy of group purchase."[177] The court held that this "group purchase" philosophy was a clear example of a common enterprise.[178] In fact, the court stated "one could hardly better describe an investment in a common enterprise for profit."[179] The agreement referred to "maximum capital gain," and the defendants anticipated "a return of $642.00 each year, mostly tax free, per position, plus the appreciation of the building."[180] Combined, these facts made it "clear" that the co-tenancy agreement was a security offering.[181] Notably, the court focused on the economic reality of the transaction and eschewed the boilerplate language in the agreement that stated that the interest was "not a security."[182]

b. Guaranteed Returns

A court may find an expectation of profit where a promoter guarantees a minimum monthly rental income on the purchase of a Condominium unit.[183] The court in *Hodges* held that a "condominium unit and collateral agreements guaranteeing *minimum rental receipts*,

[175] *See* Cook v. Farrell, No. 75–247 A, 1975 WL 427, at *1 (N.D. Ga. Aug. 26, 1975) (demonstrating an investment structure of co-tenancy participation); *see also* Hodges v. H & R Invs., Ltd., 668 F. Supp. 545 (N.D. Miss. 1987) (demonstrating an investment structure of guaranteed returns).

[176] *See Cook*, 1975 WL 427, at *1 (explaining how co-tenancy participation can satisfy the expectation of profit element); *see also Hodges*, 668 F. Supp. at 550 (explaining how an investment structure can satisfy the expectation of profit element).

[177] *Cook*, 1975 WL 427, at *3.

[178] *Id.* at *4.

[179] *Id.*

[180] *Id.* at *3, *5.

[181] *Id.* at *5.

[182] *Id.* at *3.

[183] Hodges v. H & R Inv., Ltd, 668 F. Supp. 545, 548 (N.D. Miss. 1987).

providing for a *reduction in price for future sales* from a list which the purchaser provides the seller, and providing for a *'take-back'* of the property in the event the purchaser is *dissatisfied* constitute a security."[184] The promoters in *Hodges* promised the purchasers a minimum monthly income and financed the down payment for the condominium.[185] The purchaser prevailed in an action for securities fraud because the promoters falsely represented the nature of the deal and the subject property foreclosed.[186] In finding a security, the Court relied on the 1973 SEC release and emphasized that the purchaser was motivated entirely by financial considerations.[187] *Hodges* presents a clear case of a court looking past the representations of promoters in favor of the economic reality of the transaction.[188]

iii. Solely from the Efforts of Others

Cook presents a case where a promoter provided the 'sole efforts' to fulfill the investor's expectation of profit.[189] The investor in *Cook* purchased a 32% interest in an office building and also signed an irrevocable power of attorney that gave the "property manager" the ability to act in the shoes of the investor.[190] This type of agreement combined with the fact that the investor would have no control of the investment fulfills the "effort of others" requirement.[191] Notwithstanding the more explicit agreement in *Cook* (*i.e.* the power of attorney), other cases present more subtle tactics that promoters have used to retain control.[192]

Even if the promoter or rental pool manager does not retain complete control, courts have flexibility in finding that there was an

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[184] *Id.* at 549.

[185] *Id.* at 548.

[186] *Id.* at 549.

[187] *Id.* at 550.

[188] *See id.* (stating that ["t]he value of the units themselves, irrespective of any rental prospects, was 'inextricably tied' to the efficacy of Howard's and Rhett's future sales efforts.").

[189] Cook v. Farrell, No. 75-247 A, 1975 WL 427, at *3 (N.D. Ga. Aug. 26, 1975).

[190] *Id.*

[191] *Id.* at *4.

[192] *See* Hocking v. Dubois, 885 F.2d 1449, 1460–62 (9th Cir. 1989) (explaining the difference between legal control and physical control); see *also Hodges*, 668 F. Supp. at 550 (explaining efforts of others can be met by the promoter providing crucial lending services).

expectation of profit "solely from the efforts of others."[193] For example, the Ninth Circuit has adopted a flexible test for this element.[194] In *Hocking*, the Court noted that the efforts made by others need not be the 'sole' efforts; they may be "the efforts made by those other than the investor [that] are the undeniably *significant ones*, those *essential managerial efforts* which affect the failure or success of the enterprise."[195] Other cases have held that there may be substantial "efforts of others" if a promoter provides crucial lending services to the investor.[196] Overall, courts may look beyond the terms of the transaction and to the reality of managerial control by the promoter.[197]

C. Joint Ventures and the Williamson Factors

A joint venture[198] is generally not a security. This is because most participants likely are in control of some combination of investment and managerial decisions.[199] However, courts will look past a joint venture (hereinafter JV) agreement in determining whether a security exists.[200] Courts have used what are now called the *Williamson* factors to determine whether a JV is actually a security.[201]

Williamson v. Tucker developed a three-factor test for when a general partnership can be a security, with a focus on the 'efforts of others':

> A general partnership or joint venture interest can be designated a security if the investor can establish, *for example*, that:

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[193] *Hocking*, 885 F.2d at 1455.

[194] *See id.*

[195] *Id.* (emphasis added) (citing Sec. & Exch. Comm'n v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir. 1973)).

[196] *Hodges*, 668 F. Supp. at 548.

[197] *See Hocking*, 885 F.2d at 1455 (noting that the Supreme Court found an investment contract where "the purchaser relinquished all control . . . .").

[198] For purposes of this section, a "joint venture" refers to a limited liability company (LLC), a partnership, general partnership (GP), or limited partnership (LP).

[199] *See* Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir. 1981).

[200] *Id.* at 424–25.

[201] *Id.* at 425 ("We have determined that absent one of the limited circumstances discussed above, meaningful powers possessed by joint venturers under a joint venture agreement do indeed preclude a finding that joint venture interests are securities.").

> (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or
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> (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or
>
> (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.[202]

By the use of "for example," the Court in *Williamson* notes that these factors are not exclusive.[203] Thus, the holding seems to maintain the flexibility of the *Howey* test in finding an investment contract.[204] Regardless, if a JV meets any one of these factors, an investor and JV participant may have a plausible claim that the JV interest was a security.[205]

D. Applying the Risk Capital Test: An Alternative to the Howey Test

Although courts most often apply the *Howey* test, some state and federal courts have adopted an alternative test, named the "risk capital" test, to determine when a security is being sold.[206] The test requires a four-factor analysis to determine whether the investment vehicle is an investment contract under the securities laws:

> The risk capital test will result in the finding of an investment contract when (1) the offeree provides initial value to the enterprise; (2) the initial value is subject to the risks of the enterprise; (3) the initial value is induced by representations leading to a reasonable understanding that the offeree will realize a valuable benefit beyond the initial value; and (4) the offeree does not exercise practical and managerial control over the enterprise.[207]

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[202] *Id.* at 424 (emphasis added).

[203] *Id.*

[204] *See* HAZEN, TREATISE, *supra* note 20, § 1:54 (indicating the flexibility of the Howey test due its expansion under case law).

[205] *See generally* Yearsich, Pierce, & Budreika, *Securities Law Aspects of Partnerships, LLCs, and LLPs*, SR056 ALI-ABA 879, 881 (2010) (detailing the consequences of a JV meeting the *Williamson* factors).

[206] For cases applying the risk capital test, *see, e.g.*, Crocker Nat'l Bank v. Rockwell Int'l Corp., 555 F. Supp. 47, (N.D. Cal. 1982); *see also* State by Comm'r of Sec. v. Haw. Mkt. Ctr., Inc., 485 P.2d 105, 109 (1971) (applying the risk capital test); Simon Oil Co. v. Norman, 789 F.2d 780, 781–82 (9th Cir. 1986) (applying the risk capital test).

[207] HAZEN, TREATISE, *supra* note 20, § 1:55.

Importantly, the risk capital test does not require a finding of vertical or horizontal commonality in order to find an investment contract.[208] Instead, it applies a flexible standard and only requires a finding of "substantial benefit" as opposed to an "expectation of profit."[209] For example, a security has been found where a sale-leaseback arrangement lacked the "common enterprise" element.[210] It is important to consider the risk capital analysis in determining whether a security exists, but it is also important to recognize that it is focused on the same primary issue as the *Howey* test: the investment of money or property.[211]

E. Additional factors: Public Policy

An important policy piece to the *Howey* puzzle involves quasi-pyramid schemes and high-pressure sales tactics.[212] Although not dispositive, sales of condominiums that use a pyramid scheme-like sales strategy have been held to be a security.[213] For example, a federal court in Mississippi held that "[a] condominium unit and collateral agreements guaranteeing minimum rental receipts, providing for a reduction in price for future sales from a list which the purchaser provides the seller, and providing for a 'take-back' of the property in the event the purchaser is dissatisfied *constitute a security*."[214] Although the court analyzed the condominium sale and collateral agreements under the *Howey* test, the court also emphasized additional abuses that warranted consumer protection under a public policy analysis.[215] Thus, even if the court cannot find evidence to meet all four *Howey* factors, it may apply a broader public policy approach to adequately protect an investor.[216]

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[208] *Id.*

[209] *Id.*

[210] King v. Pope, 91 S.W.3d 314 (Tenn. 2002).

[211] HAZEN, TREATISE, *supra* note 20, § 1:55.

[212] *See generally id.* § 1:54 (noting that some investor efforts are necessary for the success of the operation, such as pyramid sales arrangements).

[213] *See* Hodges v. H & R Inv., Ltd., 668 F. Supp. 545, 548 (N.D. Miss. 1987) (detailing a promotional scheme whereby promoters promised to cover the down payment for the purchase of a condo, as well as reduce the purchase price for every condo unit sold by referral).

[214] *Id.* at 549 (emphasis added).

[215] *See id.* at 549–50.

[216] *See id.*

IV. *SALAMEH V. TARSADIA HOTEL*

A. Introduction

The *Salameh v. Tarsadia Hotel* case was an opportunity to put a significant practice issue to rest. Namely, the Ninth Circuit Court of Appeals could have extinguished the controversy of when the sale of a condominium or a condo hotel, coupled with a rental agreement, becomes a security.[217] In fact, most commentators after *Salameh* believed that the case signaled a victory for condominium developers.[218] Some even touted the decision as potentially creating a safe harbor to "protect condominium hotels from being characterized as securities under federal and state securities laws."[219] Nonetheless, the idea of a "safe harbor" is overly optimistic and obscures the major error in the Court's reasoning.[220]

Instead, much like in *Hocking*, the Court should have found an issue of material fact as to whether the arrangement in *Salameh* constituted the offering of a security.[221] The Court ignored the flexibility of the *Howey* test—as well as Ninth Circuit precedent—and failed to issue a ruling that would have more adequately protected investors.[222] Thus, even if the arrangement did not meet the 1976 SEC Release

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[217] *See* Salameh v. Tarsadia Hotel, 726 F.3d 1124, at 1124–33 (2013); *see also* Timi A. Hallem & Jason T. Taketa, *Treatment of Condominium Hotels as Securities after* Salameh, 36 L.A. LAW. 11 (2014) (discussing the impact of *Salameh*).

[218] *See* Joshua G. Hamilton, Michael B. Bradford & Jenifer Q. Doan, *Future of Hotel-Condo Developments Post-*Salameh, LAW360 (Mar. 5, 2014), https://www.law360.com/articles/515490/future-of-hotel-condo-developments-post-salameh (calling the holding of *Salameh* a "significant win for hotel-condominium developers"); *see also* Hallem & Taketa, *supra* note 217, at 11 (claiming that the *Salameh* decision creates a safe harbor for developers that separate the condominium offering from the rental management agreement); *see also* James Butler, Jr., *The Hard Rock Hotel San Diego—A Condo Hotel—Did NOT Offer "Securities" According To New Appellate Court Decision In* Salameh v. Tarsadia Hotel. *Lower District Court Dismissal Upheld*, MONDAQ (Aug. 19, 2013), http://www.mondaq.com/unitedstates/x/258640/Hotels+Hospitality/The+Hard+Rock+Hotel+San+Diego+A+Condo+Hotel+Did+NOT+Offer+Securities+According+To+New+Appellate+Court+Decision+In+Salameh+v+Tarsadia+Hotel+Lower+District+Court+Dismissal+Upheld (claiming that *Salameh* provides "an important set of guidelines for marketing condo hotel properties").

[219] Hallem & Taketa, *supra* note 217, at 12.

[220] *Id.*

[221] *See* discussion *supra* Section III.B.i.a.

[222] *See* discussion *supra* Section III.A.

Guidelines related to rental pool arrangements, the court should have given proper weight to the control exerted by the hotel operator.[223] Considering all of the material facts of the transaction, the economic realities of the condo hotel deal appear to meet the definition of an investment contract under the *Howey* test.

B. The Court's Reasoning

In *Salameh*, the Ninth Circuit held that the sale of a hotel condominium, in combination with a later rental management agreement, was not the sale of a security.[224] The plaintiffs based the securities laws claims on the alleged existence of an investment contract.[225] Each plaintiff purchased condominiums in the Hard Rock Hotel in San Diego, a mixed-use commercial development with 420 condominium units.[226] The sales occurred while the hotel was under construction, and then a separate rental management agreement was executed between eight and fifteen months later.[227] The plaintiffs claimed that the combination of the sale and later management agreement amounted to an investment contract.[228]

The Court, relying on its previous holding in *Hocking*, emphasized the fact that the sale and later rental management agreement[229] were not offered as a package.[230] The Court distinguished this case from *Hocking* because here, unlike the sale and rental pool agreement in *Hocking*, there was a time gap between the sale and execution of the Agreement.[231] Furthermore, the plaintiffs in *Salameh* did not allege that the Agreement was promoted at the time of the sale.[232] Lastly, the Court found that the plaintiffs were not "induced to buy the condominiums by the rental-management agreement."[233] In other words, there was no "but for"

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[223] *See* discussion *supra* Section III.B.i.a.
[224] Salameh v. Tarsadia Hotel, 726 F.3d 1124, at 1129 (2013).
[225] *Id.* at 1128.
[226] *Id.*
[227] *Id.*
[228] *Id.*
[229] Hereinafter referred to as the "Agreement."
[230] *Salameh*, 726 F.3d at 1131.
[231] *Id.* at 1131–32.
[232] *Id.*
[233] *Id.* at 1128.

causation as in *Hocking*.[234] Nonetheless, the Court's analysis of causation and motivation led it to misapply both the *Howey* test and its own reasoning in *Hocking*.[235]

C. *The Court Failed to Properly Apply the* Howey *Test*

To reiterate, the *Howey* test is intended to "embod[y] a flexible rather than a static principle" that allows courts to see through transactions that, in reality, are premised on the "promise of profits."[236] When analyzing the deal, courts assess the terms of the offer, the plan of distribution, and the economic inducements that were held out to the prospective purchaser.[237] In *Salameh,* the Court held that there was no issue of material fact as to the "expectation of profit that comes solely from the efforts of others."[238] The Court emphasized that the real estate and rental-management contracts were not offered as a package.[239] By focusing on the timing of the rental-management agreement, the Court failed to give proper weight to the economic inducements under the terms of the deal.[240] As a result, the Court did not properly apply the *Howey* test and should have found an issue of material fact as to whether the purchasers of the condo had an "expectation of profits [to come solely from] the efforts of others."[241]

i. There was a 'common enterprise' between the condo owners and Hotel operators.

Under the proper application of the *Howey* test, the material restrictions on the owner's occupancy, including the zoning ordinance to that effect, and the economic reality that the Hotel operator was the exclusive rental agent represent a "common enterprise."[242] When no rental pool or pro rata distribution is present, a common enterprise can be found if there are "material restrictions on the owner's occupancy or

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[234] *Id.* at 1130 (citing Hocking v. Dubois, 885 F.2d 1449, 1457 (9th Cir. 1989)).
[235] *Id.* at 1124–33.
[236] Sec. & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293, 299 (1946).
[237] HAZEN, TREATISE, *supra* note 20, § 1.50
[238] *Salameh*, 726 F.3d at 1131 n.4.
[239] *Id.* at 1131.
[240] *See id.* at 1131–32.
[241] *See id.* at 1131 n.4.
[242] *Id.* at 1128, 1130–31.

rental of his unit, such as a requirement for making the unit available for rental for part of the year or a requirement for using an exclusive rental agent."[243] Thus, the Court failed to properly address the economic realities of the transaction and errantly dismissed the weight of the local zoning ordinance in favor of focusing on the timing of the rental management agreement.[244] If the Court had given the ordinance proper weight, the Hotel transaction would have met the third factor of the *Howey* test because it was a material restriction on occupancy.[245] Admittedly, the plaintiffs in the case purchased condominium hotel rooms without the offer of a rental agreement.[246] However, the plaintiffs purchased the units and were not issued keys, were required to request permission for their keys from the hotel operator, and depended on the hotel for the "daily management, operation, and marketing of the units."[247] And because the owners were not allowed to occupy the rooms for more than twenty-eight days per year under a local zoning ordinance, the only practical option was to rent the condo.[248]

The terms of the transaction present a picture of an owner without control.[249] In fact, the owners appear to own more of a timeshare interest than the actual "bricks and mortar" of the condo hotel room.[250] Without the efforts of the Hotel operator, the owner would be left with very little opportunity to rent the room for profit, and owners could not use the room at their leisure.[251] Moreover, the Court agreed that the economic realities argument based on these facts was the Plaintiff's "strongest argument."[252] However, the Court made a logical leap in dismissing the argument.[253] The leap seems best explained by its failure to apply the

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[243] Cameron v. Outdoor Resorts of Am., Inc., 608 F.2d 187, 192 (5th Cir. 1979); *accord* Guidelines, *supra* note 1.

[244] *See Salameh*, 726 F.3d at 1131–32.

[245] *Compare Salameh*, 726 F.3d at 1131–32, *with Cameron*, 608 F.2d at 192 (holding that a common enterprise can be found if there are "material restrictions on the owner's occupancy or rental of his unit.").

[246] *Salameh*, 726 F.3d at 1131.

[247] *Id.* at 1128.

[248] *See id.*

[249] *See id.*

[250] *See id.* at 1132 ("[T]here is no plausible reason why there cannot be a viable market for owner-occupied hotel-condominiums for use as short term vacation homes.").

[251] *Id.* at 1128.

[252] *Id.* at 1132.

[253] *Id.*

Howey test. Instead, the Court fallaciously relied on its own reasoning in *Hocking* and ignored the unique facts of this case.[254]

ii. The owners had an expectation of profit to come solely from the managerial efforts of the Hotel operator.

If the Court had applied the *Howey* test, it would have asked whether the twenty-eight-day restriction, key restriction, and overall management of the hotel combined to show that the owners' had an expectation of profit to come solely from the managerial efforts of the Hotel operator. In reality, these were the terms that were presented to owners.[255] The terms, which took nearly all of the control of the property out of the owners' hands, induced the owners to make the purchases.[256] Despite the defendants' claims, it appears that owners were enticed to buy the condos because they presumably could make a profit by renting them.[257] Notwithstanding, the Court stated that the plaintiffs were not "induced to buy the condominiums by the rental-management agreement,"[258] and by extension, they did not purchase a security.[259] This reasoning ignores the presence of the other factors that were present *prior* to the purchase.

As the court noted, the investors were induced by factors other than the rental management agreement.[260] Nonetheless, the Court errantly interpreted the issue in the case as "whether a condominium sold in combination with a rent-pooling arrangement constituted a security."[261] Instead, much like in *Howey*, it should have asked "whether the economic realities of the transaction were such that the owners expected to profit solely from the efforts of others."[262] This more appropriate issue statement would undoubtedly raise an issue of material fact.

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[254] *Id.* at 1130–32.
[255] *Id.* at 1128.
[256] *See* discussion *supra* Section IV.C.i.
[257] *See Salameh*, 726 F.3d at 1128.
[258] *See id.* at 1131–32.
[259] *Id.*
[260] *Id.* at 1128, 1132.
[261] *See id.* at 1130 (citing the fact in *Hocking* that "but for the availability of the rental pool arrangement [Hocking] would not have purchased the condominium").
[262] Sec. & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

The facts in *Salameh* are strikingly similar to those in the *Howey* case, making the sale of condo hotel units in *Salameh* more likely to be the sale of a security.[263] Much like the investors in the *Howey* case, the owners in *Salameh* had no connection to the operation of the hotel and likely were not in the business of operating hotels.[264] In *Howey*, the Court noted that the 'snowbird' investors would have no investment in the success of the orange grove; they were not farmers, and had no experience in raising orange trees.[265] Only the efforts of the grove operators could produce profit, and as a result, the profitability of each and every orange grove unit depended on grove management.[266]

Under the assumption that the owners in *Salameh* were motivated by profit[267], using anyone other than the hotel management to rent condominiums would frustrate the purpose of the investment. A hotel operates as a single business entity, and for all intents and purposes, the profitability of each condo hotel unit would depend heavily—if not exclusively—on successful hotel management. It is undisputed that the Hotel operator was responsible for the "daily management, operation, and marketing of the units." [268] Furthermore, guests looking to rent a hotel room will likely turn to the hotel rental office or hotel website for reservation, and the hotel's success would depend on the operator's success or failure. For this reason, it would be impractical for an owner to entrust the rental process to an outside company. Consequently, there appears to be at least an issue of material fact as to the third and fourth *Howey* elements.

D. Conclusion

In conclusion, the Ninth Circuit missed an opportunity to apply the *Howey* test properly and to provide further guidance to real estate practitioners. Instead, its analysis ignored the "economic realities" of the

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[263] *Compare Salameh*, 726 F.3d at 1128, *with Howey*, 328 U.S. at 294–97 (discussing the terms of the contract and the extent of the hotel's control).

[264] *Compare Salameh*, 726 F.3d at 1128, *with Howey*, 328 U.S. at 294–97(discussing hotel operations and the extent of the hotel's control).

[265] *See* discussion *infra* Section III.A.

[266] *See* discussion *infra* Section III.A.

[267] This assumption is supported by the existence of material restrictions on occupancy, all of which were known by purchasers prior to entering into the condo hotel deal. *See* discussion *infra* Section IV.C.i.

[268] *Salameh*, 726 F.3d at 1128.

transaction in favor of relying on a fallacious comparison to precedent in *Hocking*.[269] Because of this analytical failure, it would be folly to rely on this case as a "safe harbor" for avoiding the reach of the securities laws. Nonetheless, the case provides valuable lessons for structuring a deal to avoid litigation.

V. Structuring a Deal

To reemphasize, TIC deals (*e.g.* condominium developments) do not inherently involve the sale of securities.[270] However, the case law provides clear warnings for developers of condominiums—it is easy to cross the line and unknowingly sell a security instead of a simple real estate interest. This is especially true when the sale comes with collateral agreements such as service contracts.[271] And if the real estate interest becomes an unregistered security, there are far-reaching consequences for the seller, real estate brokers, and others involved in the transaction.[272] Thus, this section provides guidance to real estate developers and counsel when executing a syndicated TIC real estate deal. This model is intended to allow practitioners to avoid securities laws liability without sacrificing effective marketing strategies and capital raising efforts.

A. Meeting the Private Placement Exemption

The private placement exemption is critical if the investment vehicle would create an issue of material fact as to whether a security is being sold.[273] This is likely to occur if a real estate deal involves the sale of passive partnership interests to individuals, as opposed to institutional investors.[274] Ideally, the seller should be sure that all individuals are "accredited" under Regulation D to avoid having to make burdensome

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[269] *Id.* at 1131.

[270] *See supra* text accompanying notes 1–18.

[271] *See* Hodges v. H & R Invs., 668 F. Supp. 545, 549 (N.D. Miss. 1987).

[272] For example, a real estate broker involved in the sale of a security may face liability for not registering as a broker. However, this is not an insurmountable or novel issue. *See* Thorup, *supra* note 2, at 424 ("Some later entrants into the TIC marketplace closely examined whether TICs inherently are 'securities,' and they discovered that TIC real estate could be designed to avoid securities regulation and thus to allow participation by and compensation to real estate agents.").

[273] *See* discussion *supra* Section I.C.

[274] *See* discussion *supra* Section III.C.

securities disclosures.[275] To be an accredited investor, the individual must fall within one following categories:

> [(1)] any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer[;] [(2)] [a]ny natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000[;] [or (3)] [a]ny natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.[276]

For option (2), the net worth calculation does not include a primary residence or debt related to the primary residence if the debt does not exceed the fair market value of the home.[277]

B. Common Enterprise

RPAs combined with RMAs create a strong presumption of a common enterprise in securities litigation.[278] However, the SEC and case law have provided considerable guidance on the topic of offering RPAs in combination with the sale of a condominium.[279] Outside of the Ninth Circuit, the sale of a condominium in conjunction with a later RPA or RMA may still be viewed as the sale of a security, even if the initial sale is several months before first offering the collateral agreements.[280] If a condominium developer is going to offer an RPA or RMA, he or she should be cognizant of what inducements are presented to the purchaser.

If the project is a condo hotel, the purchaser should ideally be able to rent the unit without the efforts of hotel management. If the owner cannot feasibly rent his or her unit, *i.e.* the owner relies on the marketing efforts of hotel management, then an RPA may be necessary. If this is the case, the RPA should leave substantial control in the hands of the

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[275] *See* discussion *supra* Section I.C.

[276] 17 C.F.R. § 230.501 (2013).

[277] *Id.*

[278] *See* Hocking v. Dubois, 885 F.2d 1449, 1455 (9th Cir. 1989) ("We must therefore determine whether Hocking's purchase of a condominium and rental pool was (1) an investment of money, (2) in a common enterprise, (3) with an expectation of profits produced by the efforts of others.").

[279] *See* discussion *supra* Section III.B.i.a.

[280] *See* discussion *supra* Section III.B.i.a.

owner. For example, the keys should remain in the possession of the owner and should not be left with hotel management. If keys are left with management, then management should give the owner some control over rental decisions. This may include a right to refuse rentals, or the option to customize the number of rental days per year. Most importantly, no RPA should apply a pro-rata system of rental and profit distribution.[281]

Additionally, unlike hotel management in *Salameh*, condominium management should refrain from providing all cleaning and maintenance services to the units aside from common area maintenance. It is advisable to require owners to contract a third party for cleaning, repairs, etc. A condo hotel presents a dilemma because the entire enterprise is inherently tied to the success of hotel management. If hotel management must be in charge of cleaning and maintenance for practical reasons, other efforts will have to be made to avoid meeting all factors of the *Howey* test such as leaving control over rental decisions in the hands of purchasers.

Finally, material restrictions on occupancy should be avoided.[282] The Court in *Salameh* was inexplicably dismissive of the local ordinance limiting occupancy to around one month per year.[283] In fact, it would be advisable for condominium or condo hotel management to restrict *rental* of units to a certain number of days per year. Presumptively, a restriction on rentals would weigh in favor of the condominium being a true real estate interest and not a security because the owner would be "consuming" the potential investment, as opposed to leveraging it for profit.[284] This would be particularly useful in the case of a condo hotel where a rental pool or rental management agreement may be unavoidable.

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[281] *See* Guidelines, *supra* note 1.

[282] *See id.* (explaining that a security will be found for "[t]he offering of a rental or similar arrangement whereby the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in his occupancy or rental of his unit").

[283] Salameh v. Tarsadia Hotel, 726 F.3d 1124, 1128 (9th Cir. 2013).

[284] *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852–53 (1975) (explaining that the courts will likely not find a security "when a purchaser is motivated by a desire to use or consume the item purchased").

C. Expectation of Profit Coming Solely from the Efforts of Others

A condominium promoter could avoid the reach of both the *Howey* test and risk capital test by avoiding the sale of a passive investment while incorporating certain disclaimers and disclosures. Generally, both the *Howey* test and risk capital test will be met where buyers are induced by the prospect of making a profit without managerial effort.[285] Thus, a condominium developer could both disclaim responsibility for returning a profit and disclose all material risks associated with condominium ownership. If buyers are not induced by a prospect of profit, the *Howey* test will not be satisfied.[286] Of course, the risk capital test may still be met, even without the expectation of profit.[287] This can be avoided by proper disclosures related to the risk of loss, even if there is no intention of returning a profit to the owner.[288]

If the condominium promoter offers a management contract on the front end, this should be done in combination with a restriction on *rental*. This restriction, as discussed above, will likely rebut a presumption that the purchaser intended to profit from the condominium. Instead, even if a third party will manage the property, hotel management will primarily benefit the owner because they are "consuming" the item purchased. This combination of an RMA and restriction on rental would likely avoid crossing the line even under the more liberal risk capital test.

D. Additional Marketing Issues

Much of securities litigation related to real estate centers on the prospect of profits used to induce investors.[289] If litigation does arise, there are some practical methods to defeat claims of an inducement based on profit via managerial efforts of condominium management. For example, real estate brokers involved in the sales should use a standard sales pitch that includes disclaimers of guaranteed profit and the risk of loss if the project fails (especially in condominium hotels). If used consistently, these disclaimers both discourage litigation and dissuade courts from presuming that the condo purchase was an investment. If

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[285] *Id.* at 2061.

[286] *See* discussion *supra* Section III.B.iii.

[287] *See* discussion *supra* Section III.D.

[288] *See* discussion *supra* Section III.D.

[289] Sec. & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

practical, it would be wise to record all material interactions with potential purchasers, particularly if salespeople are using a standard, well-vetted sales pitch.

CONCLUSION

In conclusion, working with commercial real estate requires a baseline knowledge of the definition of an investment contract under the *Howey* test. With such baseline knowledge, a commercial real estate lawyer is better equipped to guide clients through most complex transactions, without unknowingly selling an unregistered security. Again, more complex JVs require special attention. It is crucial for a lawyer to assess the managerial involvement of all partners, and to determine the likelihood that the sale of a partnership interest will become a security. Once this initial assessment is made, the real estate developer's attorney can prepare to file for an exemption or take proper steps to avoid unnecessary securities litigation.