



RE VS. SECURITIES

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TICs as Real Estate or Securities: Insignificant Sponsors?

This article weighs in on the question that has been debated in this publication by Mr. Richard Lipton and Mr. Darryl Steinhauser: Under what circumstances will a tenant-in-common (“TIC”) offering not involve the offer and sale of a security under the securities laws? It is generally agreed that the analysis of this question must involve application of the Howey test, which provides that an arrangement constitutes an investment contract, and thus a security, if “...a person invests his money in a common enterprise and is led to expect profits solely from the efforts of [others]....”¹ To this point, the debate has focused on the final prong of this test, that is, whether the anticipated profit from the transaction will be generated from the significant² efforts of others. Mr. Lipton has argued that a TIC transaction can be sold as real estate if the sponsor of the TIC transaction is not active in the management of the TIC property (the “active investor argument”). The active investor argument is based on the idea that if investors, after a property is sold to them by a TIC sponsor, exercise control over TIC property and hire a property manager that is not affiliated with the sponsor (the “non-affiliate TIC transaction”), then investor profit is not based on the significant efforts of others. If investor profit is not based on the significant efforts of others, the investment is not an investment contract under Howey. To reach the conclusion that profit is not based on the significant effort of others, the active investor argument presumes that pre-closing activities of sponsors of non-affiliate TIC transactions are insignificant to overall investment profit when compared to the impact on profit of post-closing managerial activities undertaken by investors.

Mr. Steinhauser challenged the active investor argument on a factual basis by arguing, among other things, that pre-closing activities undertaken by TIC sponsors are key to investment profit and that investor control after

closing is illusory. This article will further examine the active investor argument by analyzing (i) the legal precedent for analysis of pre-closing activities under the Howey test and (ii) whether typical sponsor activities in the non-affiliate TIC transaction sufficiently affect profit on TIC investment to be considered an investment contract under Howey.

Legal Background

As a starting point, one must recognize that “Congress’ purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.”³ Ignoring that purpose, the active investor argument embraces a highly-criticized case that distinguishes between a sponsor’s activities before and after receiving investor funds. In *SEC v. Life Partners Inc.*, the D.C. Circuit held that viatical settlements were not investment contracts under federal securities laws because “profits from their purchase do not derive predominately from the efforts of a party or parties other than investors.”⁴ This decision was based on facts similar to those that Mr. Lipton has relied upon for the active investor argument. Before *Life Partners, Inc.* (“LPI”) sold viatical settlements, it evaluated insureds’ medical condition, reviewed insurance policies, negotiated policy purchase prices, and prepared necessary legal documents. LPI did not perform any post-purchase services for investors; however, LPI indicated to investors that it could perform on-going administrative services upon an election by the investor. Interestingly, after a number of orders by the district court (and in an attempt to address issues raised by the SEC), “...LPI declared it would no longer provide any post-purchase services to purchasers either directly or indirectly and all such services would become the sole responsibility of the investor....”⁵ The court found that because LPI had no power to affect investors’ returns after the sale of the investment, that profit on the investment was not based predominately on the efforts of LPI, and

¹ *SEC v. Howey*, 328 U.S. 293, 299 (1946).

² N.B. Although the Howey Court used the word “solely” (328 U.S. at 299), this term has not been strictly interpreted by the courts, but rather the courts have applied “a more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones.” *SEC v. Glenn W. Turner Enterprises*, 474 F.2d 476, 482 (9th Cir. 1973). This idea was examined in Mr. Steinhauser’s previous article; the analysis will not be repeated here.

³ *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990) (quoting H.R. Rep. No. 85, 73rd Cong., 1st Sess. 11 (1933)).

⁴ 87 F.3d 536, 537 (D.C. Cir. 1996).

⁵ *Id.* at 540.

therefore the investment was not a security.

The pre-/post-investment activity distinction that was discussed in *Life Partners* has been widely criticized by federal and state courts, scholars, and state regulators. For example, the 11th Circuit, in *SEC v. Mutual Benefits Corp.*, “decline[d] to adopt the test established by the *Life Partners* court.”⁶ In rejecting *Life Partners*, both courts cited⁷ the Supreme Court’s reaffirmation of the flexible *Howey* test in *SEC v. Edwards*.⁸ According to one article, “...the bright-line rule espoused in *Life Partners* is not supported by any Supreme Court precedent, statutory text, or legislative history.”⁹ The position of the North American Securities Administrators Association, Inc., as detailed in its brief in support of the SEC in the *Mutual Benefits* case (representing states and other governmental authorities) is that “...the *Life Partners* decision conflicts with the policy of full disclosure underlying the federal securities laws and with the Supreme Court’s admonition that the securities laws must be interpreted flexibly to serve that policy.”¹⁰ Undeniably, the profit potential of many of the specifically listed investments in the definition of a security stems from pre-investment activities.¹¹ There have been many cases where federal courts have found a security, such as with respect to investments in rare coins, cattle embryos or whiskey, despite little or no post-investment efforts of the issuer.¹² These cases make it clear the Federal courts have rejected the idea that sponsors’ efforts prior to investment are not relevant to the *Howey* analysis. Narrowly construing the definition of investment contract in contravention of the principle that it should be applied flexibly allows clever sponsors to thwart the intent of securities laws and regulations through careful transaction structure. Indeed, the Supreme Court, in *SEC v. Edwards* stated that, “we will not read into the securities laws a limitation not compelled by the language that would so undermine the securities laws’ purposes.”¹³ Thus, the important question is not “when” the efforts of “others” take place, but whether those efforts are the significant ones that the investor relies upon for the success of the venture.

Significance of Real Estate TIC Sponsor Efforts to the Profitability of the TIC Investment

Sponsors of real estate TIC programs typically undertake various activities prior to investment that affect profitability of the transaction. According to the active investor argument, the efforts of TIC sponsors prior to the sale of TIC properties are “insignificant in comparison to those post-purchase managerial activities in terms of affecting the profitability of the TIC.”¹⁴ This conclusion is factually tenuous. As Mr. Steinhouse has argued, sponsors undertake significant efforts during the property acquisition process, such as (i) choosing the Property, (ii) performing due diligence, (iii) sourcing and negotiating the loan, (iv) obtaining property insurance, (v) “proposing” the initial property manager, (vi) providing offering documents or similar summary materials, and (vii) providing financial projections. A review of a website by a well-known sponsor of TIC programs offered as real estate listed certain pre-purchase “efforts” undertaken by that sponsor including, in addition to most of those listed above, (i) securing properties with cash advances, (ii) contributing equity, (iii) supervision and coordination of closing, and (iv) obtaining tax opinions. At a minimum, in order to sponsor a TIC investment, the non-affiliate TIC transaction sponsor must (i) locate and negotiate the purchase of a piece of real estate, (ii) structure the transaction and draft the transactional documents appropriately in order to take advantage of Internal Revenue Code §1031, (iii) locate and organize investors, and (iv) facilitate the closing on the property. It is hard to imagine how these activities could be characterized as insignificant to success of the investment.

To pass the *Howey* test, the pre-closing efforts by TIC sponsors must significantly impact profits of the investment. All of the tasks undertaken by TIC sponsors prior to the sale of a TIC Property have a significant impact on profits. First, negotiation of property purchase price plays a vital role in property profitability – overpaying for a property will make even the best piece of real estate unprofitable. The selection of the property and the due diligence process also have a major impact

⁶ 408 F.3d 737, 743 (11th Cir. 2005).

⁷ 408 F.3d at 742; 310 F.Supp.2d at 902.

⁸ 540 U.S. 389 (2004).

⁹ Brian Coner Levin, Note, *Killing Life Partners: Why Viatical Settlements are “Securities” in Light of SEC v. Mutual Benefits Corporation and Other Recent Cases that Explicitly Reject SEC v. Life Partners*, 6 J. Bus. & Sec. L. 71 (2006).

¹⁰ Brief of the North American Securities Administrators Association, Inc., as Amicus Curiae in Support of Appellee Securities and Exchange Commission and in Support of Affirmance, 2004 WL 3481941 at 15.

¹¹ See 15 U.S.C. §77b.

¹² See, e.g., *SEC v. Brigadoon Stock Distributors, Ltd.*, 388 F. Supp. 1288 (S.D.N.Y. 1975) (rare coins).

¹³ 540 U.S. at 390.

¹⁴ Richard Lipton, *TICs Without Securities: A Response to Darryl*, TIC talk 3rd Quarter 2007.

on property performance – poor markets and dilapidated properties are usually not very profitable. Next, particularly in today's credit-strained economy where sourcing and negotiating loans with attractive interest rates is becoming increasingly difficult, the terms of any debt placed on a property have a direct impact on profit realized by a TIC investor. Further, if the lender requires the sponsor maintain ownership of a portion of the property as a condition to funding the loan, the argument that the investment is a security is even stronger. Indeed, the author of a recent article posited that, "the mere fact that the lender has tied the TIC sponsor to the property during the term of the loan could erode the claim that the TICs are not securities under the Howey test."¹⁵ The supervision and pooling of a nation-wide group of unrelated investors prior to and through the closing process provides TIC investors with the opportunity to profit from investment in a property the size and quality of which would not likely be available to those investors on their own. Even a service that appears as seemingly innocuous as sourcing property insurance goes to generation of profits if the sponsor maintains the policy or pools policies among its TIC properties to receive better rates.

A court examining TIC investments would likely also be interested in the expectations created by TIC sponsors during the sales process. Although Mr. Lipton has focused on the non-affiliate TIC transaction in which the TIC sponsor has no role in property management after sale, it is unclear whether this arrangement exists to a significant extent in practice. At least one prominent real estate TIC sponsor's website touts its investments as "...an opportunity for individuals to own quality real estate while stepping away from day-to-day property management and deferring capital gains tax".

Further, generally, as properties become less management intensive (e.g. a property with mostly long-term triple net leases in place) the pre-purchase efforts of the sponsor become relatively more important to property profits. For example, the real estate TIC sponsor selling an office property that is fully leased (triple net) over the anticipated holding period of TIC investment would have a more difficult time proving that its pre-closing activities did not affect the profitability of the investment compared to the sponsor selling a multifamily development with regular lease turnover. While significant pre-investment efforts are likely to exist in most TIC offerings regardless of property type, properties that require little post-investment management seem to strengthen the argument that TICs are securities even further.

The discussion to this point has focused on which activities of sponsor have a significant impact on the profitability of the real estate, however, another persuasive reason why TIC investors purchase real estate from

TIC sponsors, and why the active investor argument likely fails, is that the TIC investor's purchase is inherently motivated by the benefit of the like-kind exchange that is packaged in every TIC offering. The TIC investor seeks a real estate investment that is structured to take advantage of §1031 – this is clear from the meteoric rise in equity placed in TIC investments after Rev. Proc. 2002-22. When the TIC investment is viewed from this perspective, it becomes clear that the pre-closing efforts of TIC sponsors are not merely significant, but vital to the success of the TIC product. Moreover, this is the only explanation as to why the supposedly-real-estate-savvy active investor would be willing to pay the load on TIC real estate rather than sourcing real estate in the market. Thus, every TIC sponsor undertakes efforts that provide significant benefits to investors, including drafting the legal documents, obtaining tax opinions, and generally structuring the transaction in order to take advantage of §1031. Although the result of a §1031 exchange, the deferral of taxes, is not "profit" in the classic sense, tax deferral does allow investors to reinvest a larger portion of their gain on previously owned properties, which directly impacts the size of their income stream. Investor reliance on the "efforts of others" to provide this profitable tax-deferral service is what has driven the rapid growth of the TIC industry, and what makes every TIC product a security.

Finally, one must consider this question: If pre-investment activities truly are inconsequential and investors are responsible for post-investment activities, what justifies the substantial sponsor fees charged to investors?

Public Policy

While the Life Partners case has not been widely accepted, it does create a split in authority at the federal circuit court level. If addressed by the U.S. Supreme Court, there are significant public policy reasons that would weigh heavily on a finding that the significant pre-investment activities discussed above are sufficient for TICs to be treated as securities under federal securities laws. Most important are application of the regulatory and remedial protections provided under the federal securities laws. If TIC interests are not securities, the SEC will be unable to employ its power of injunctive and ancillary relief to protect investors in the event of fraud. Further, SEC jurisdiction over TICs reduces the burdens on state regulators to police the TIC industry. Additionally, characterization of TICs as securities provides significant remedies to defrauded investors under several federal securities laws.

In addition to making additional remedies available in the case of fraud, characterization of TICs as securities should help to prevent fraud in the

¹⁵ Elizabeth Ayres Whitman, A "TIC"ing Time Bomb: Rule 506 Meets Section 1031, 12 Fordham J. Corp. & Fin. L. 121, 161 (2007).

first instance, through the in terrorem function of the federal securities laws. The purpose of the civil liabilities provisions of the federal securities laws "...are not so much to compensate the defrauded purchaser as to promote enforcement of the [Securities] Act [of 1933] and to deter negligence by providing a penalty for those who fail in their duties."¹⁶

For example, an owner, officer or director of a TIC sponsor issuing securities likely would consider his or her personal potential liability under securities laws when making a decision as to potential offering disclosure. Additionally, characterization as a security allows the Financial Industry Regulatory Association (FINRA) to oversee and regulate the actions of involved broker-dealers under a system much more rigorous than the system applicable to real estate sales professionals.

For these reasons, courts presented with the issue of whether TICs are securities are likely to lean heavily to holding that TICs are securities – to protect investors, not sponsors.

The Rulemaking Problem

In the practice of law, there is a constant struggle between the need for predictability provided by bright-line rules and the need for more flexible tests to adapt to new situations. Under the flexible, fact-driven Howey test, it is difficult to accurately predict how courts will view the range of

structures and services provided by the various TIC sponsors. However, because the intent of Congress was to create a broad definition of securities, the conservative approach is to sell TICs as securities until clear guidance is otherwise obtained from the SEC, Congress, the court system, or other appropriate authority. In this regard, if a real estate TIC sponsor is confident in its position, that sponsor should avail itself of the SEC's "no-action" letter process as a means to obtain such guidance. Wouldn't it be prudent for real estate TIC sponsors to seek and obtain a no-action letter before structuring a business model around an application of the securities laws that is widely questioned in the industry? ◀

P.S. As this article went to press, Spectrus Real Estate Group (FOR 1031) announced that it was halting sales of TIC offerings through real estate channels, "[f]ollowing discussions with the staff of the SEC specific to Spectrus, and in light of potential industry changes[.]" Perhaps this portends the end of this debate.

¹⁶ *Globus v. Law Research Service*, 418 F.2d 1276, 1288 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970).

